REALTY INCOME CORP
Form 10-Q
July 31, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

x Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2008, or

o Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File Number 1-13374

REALTY INCOME CORPORATION
(Exact name of registrant as specified in its charter)

Maryland (State or Other Jurisdiction of Incorporation or Organization)	33-0580106 (IRS Employer Identification Number)

600 La Terraza Boulevard, Escondido, California 92025
(Address of Principal Executive Offices)

Registrant's telephone number, including area code: (760) 741-2111

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 o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer x Accelerated filer o Non-accelerated filer o 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 o No x

There were 101,340,803 shares of common stock outstanding as of July 21, 2008.

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REALTY INCOME CORPORATION

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

REALTY INCOME CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

June 30, 2008 and December 31, 2007
(dollars in thousands, except per share data)

ASSETS	2008 (unaudited)	2007
Real estate, at cost:		
Land	$ 1,161,705	$ 1,110,897
Buildings and improvements	2,250,919	2,127,897
	3,412,624	3,238,794
Less accumulated depreciation and amortization	(512,082)	(470,695)
Net real estate held for investment	2,900,542	2,768,099
Real estate held for sale, net	13,892	56,156
Net real estate	2,914,434	2,824,255
Cash and cash equivalents	39,373	193,101
Accounts receivable	9,130	7,142
Goodwill	17,206	17,206
Other assets, net	62,794	35,648
Total assets	$ 3,042,937	$ 3,077,352
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Distributions payable	$ 16,006	$ 15,844
Accounts payable and accrued expenses	37,377	38,112
Other liabilities	11,233	15,304
Lines of credit payable	--	--
Notes payable	1,470,000	1,470,000
Total liabilities	1,534,616	1,539,260
Commitments and contingencies		
Stockholders’ equity:		
Preferred stock and paid in capital, par value $1.00 per share,		
20,000,000 shares authorized, 13,900,000 shares issued		
and outstanding in 2008 and 2007	337,790	337,790
Common stock and paid in capital, par value $1.00 per share,		
200,000,000 shares authorized, 101,341,289 and 101,082,717		
shares issued and outstanding in 2008 and 2007, respectively	1,548,052	1,545,037
Distributions in excess of net income	(377,521)	(344,735)
Total stockholders’ equity	1,508,321	1,538,092
Total liabilities and stockholders’ equity	$ 3,042,937	$ 3,077,352

The accompanying notes to consolidated financial statements are an integral part of these statements.

REALTY INCOME CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

For the three and six months ended June 30, 2008 and 2007
(dollars in thousands, except per share data)
(unaudited)

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
REVENUE				
Rental	$ 82,352	$ 70,112	$ 163,948	$ 138,895
Other	80	213	1,529	2,365
	82,432	70,325	165,477	141,260
EXPENSES				
Interest	23,929	13,029	47,315	25,449
Depreciation and amortization	22,916	18,414	45,830	36,435
General and administrative	5,924	5,838	11,467	10,929
Property	1,093	958	2,354	1,816
Income taxes	218	353	615	598
	54,080	38,592	107,581	75,227
Income from continuing operations	28,352	31,733	57,896	66,033
Income from discontinued operations:				
Real estate acquired for resale by Crest	1,295	4,282	1,101	6,030
Real estate held for investment	3,404	921	3,816	1,197
	4,699	5,203	4,917	7,227
Net income	33,051	36,936	62,813	73,260
Preferred stock cash dividends	(6,063)	(6,063)	(12,127)	(12,127)
Net income available to common stockholders	$ 26,988	$ 30,873	$ 50,686	$ 61,133
Amounts available to common stockholders per common share:				
Income from continuing operations, basic and diluted	$ 0.22	$ 0.26	$ 0.46	$ 0.54
Net income:				
Basic	$ 0.27	$ 0.31	$ 0.51	$ 0.61
Diluted	$ 0.27	$ 0.31	$ 0.50	$ 0.61
Weighted average common shares outstanding:				
Basic	100,346,512	100,133,094	100,326,039	100,111,734
Diluted	100,394,431	100,246,112	100,420,692	100,304,617

The accompanying notes to consolidated financial statements are an integral part of these statements.

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REALTY INCOME CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the six months ended June 30, 2008 and 2007
(dollars in thousands)(unaudited)

	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 62,813	$ 73,260
Adjustments to net income:		
Depreciation and amortization	45,830	36,435
Income from discontinued operations:		
Real estate acquired for resale	(1,101)	(6,030)
Real estate held for investment	(3,816)	(1,197)
Gain on sales of land	(236)	(1,806)
Amortization of share-based compensation	2,853	2,196
Cash provided by (used in) discontinued operations:		
Real estate acquired for resale	4	(536)
Real estate held for investment	442	829
Investment in real estate acquired for resale	(8)	--
Proceeds from sales of real estate acquired for resale	26,920	65,786
Change in assets and liabilities:		
Accounts receivable and other assets	(232)	990
Accounts payable, accrued expenses and other liabilities	(4,277)	2,330
Net cash provided by operating activities	129,192	172,257
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales of investment properties:		
Continuing operations	439	3,842
Discontinued operations	822	1,493
Acquisition of and improvements to investment properties	(185,309)	(97,672)
Intangibles acquired in connection with acquisitions of investment properties	(397)	(319)
Restricted escrow funds acquired in connection with acquisitions of investment properties	--	(2,648)
Net cash used in investing activities	(184,445)	(95,304)
CASH FLOWS FROM FINANCING ACTIVITIES		
Cash distributions to common stockholders	(83,310)	(76,863)
Cash dividends to preferred stockholders	(12,127)	(12,457)
Debt issuance costs	(3,200)	--
Borrowings from lines of credit	--	135,400
Payments under lines of credit	--	(125,400)
Proceeds from other stock issuances	162	708
Net cash used in financing activities	(98,475)	(78,612)
Net decrease in cash and cash equivalents	(153,728)	(1,659)
Cash and cash equivalents, beginning of period	193,101	10,573
Cash and cash equivalents, end of period	$ 39,373	$ 8,914

For supplemental disclosures, see note 12.

The accompanying notes to consolidated financial statements are an integral part of these statements.

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REALTY INCOME CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2008
(unaudited)

1. Management Statement

The consolidated financial statements of Realty Income Corporation ("Realty Income", the "Company", "we" or "our") were prepared from our books and records without audit and include all adjustments (consisting of only normal recurring accruals) necessary to present a fair statement of results for the interim period presented. Certain of the 2007 balances have been reclassified to conform to the 2008 presentation. Readers of this quarterly report should refer to our audited financial statements for the year ended December 31, 2007, which are included in our 2007 Annual Report on Form 10-K, as certain disclosures that would substantially duplicate those contained in the audited financial statements have not been included in this report.

At June 30, 2008, we owned 2,367 properties, located in 49 states, containing over 19.2 million leasable square feet, along with 8 properties owned by our wholly-owned taxable REIT subsidiary, Crest Net Lease, Inc. ("Crest"). Crest was created to buy and sell properties, primarily to individual investors who are involved in tax-deferred exchanges under Section 1031 of the Internal Revenue Code of 1986, as amended (the "Tax Code").

2. Summary of Significant Accounting Policies and Procedures and Recent Accounting Pronouncements

A. The accompanying consolidated financial statements include the accounts of Realty Income, Crest and other entities for which we make operating and financial decisions (i.e., control), after elimination of all material intercompany balances and transactions. All of Realty Income's and Crest's subsidiaries are wholly-owned. We have no unconsolidated or off-balance sheet investments in variable interest entities.

B. We have elected to be taxed as a real estate investment trust ("REIT") under the Tax Code. We believe we have at all times in the past qualified and do continue to qualify as a REIT. Under the REIT operating structure, we are permitted to deduct distributions paid to our stockholders and generally are not required to pay federal corporate income taxes on such income. Accordingly, no provision has been made for federal income taxes in the accompanying consolidated financial statements, except for the federal income taxes of Crest, which are included in discontinued operations.

C. We recognize an allowance for doubtful accounts relating to accounts receivable for amounts deemed uncollectible. We consider tenant specific issues such as financial stability and ability to pay rent when determining collectibility of accounts receivable and appropriate allowances to record. The allowance for doubtful accounts was $707,000 at June 30, 2008 and $795,000 at December 31, 2007.

D. Other assets consist of the following (dollars in thousands) at:	June 30, 2008	December 31, 2007
Notes issued in conjunction with Crest property sales	$ 22,338	$ 3,132
Deferred bond financing costs, net	14,054	14,940
Value of in-place and above-market leases, net	11,073	11,211
Escrow deposits for Section 1031 tax-deferred exchanges	6,901	--
Prepaid expenses	3,589	3,803
Unamortized credit facility fees, net	3,125	434
Corporate assets, net of accumulated depreciation and amortization	1,379	1,356
Settlements on treasury lock agreements	324	759
Other items	11	13

$	62,794	$	35,648

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E. Accounts payable and accrued expenses consist of the following (dollars in thousands) at:		June 30, 2008		December 31, 2007
Bond interest payable	$	27,049	$	24,987
Other items		10,328		13,125
	$	37,377	$	38,112

F. Other liabilities consist of the following (dollars in thousands) at:		June 30, 2008		December 31, 2007
Rent received in advance	$	5,619	$	10,626
Security deposits		3,845		2,818
Value of in-place below-market leases, net		1,769		1,860
	$	11,233	$	15,304

G. Impact of Recent Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board ("FASB") issued Statement No. 141R (revised 2007), Business Combinations. Effective January 1, 2009, Statement No. 141R will change the accounting treatment and disclosures for certain specific items in a business combination. Under Statement No. 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. We do not expect Statement No. 141R to have an impact on our financial position or results of operations.

In June 2008, the FASB issued FASB Staff Position (“FSP”) EITF No. 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities. FSP EITF No. 03-6-1 clarified that all outstanding nonvested share-based payment awards that contain rights to nonforfeitable dividends are considered “participating securities,” as defined by FSP EITF No. 03-6-1,which require the two-class method of computing basic and diluted earnings per share to be applied. FSP EITF No. 03-6-1 is effective for fiscal years beginning after December 15, 2008. We are currently assessing the impact of FSP EITF No. 03-6-1 on our calculation of basic and diluted earnings per share.

3. Retail Properties Acquired

We acquire land, buildings and improvements that are used by retail operators.

A. During the first six months of 2008, Realty Income invested $184.2 million in 107 new retail properties and properties under development with an initial weighted average contractual lease rate of 8.7%. These 107 properties are located in 14 states, will contain over 711,000 leasable square feet, and are 100% leased with an average lease term of 20.6 years. The initial weighted average contractual lease rate is computed by dividing the estimated aggregate base rent for the first year of each lease by the estimated total cost of the properties.

In comparison, during the first six months of 2007, Realty Income invested $98.3 million in 46 new retail properties and properties under development. These 46 properties are located in 12 states, contain over 554,000 leasable square feet, and are 100% leased with an average lease term of 19.1 years.

B. During the first six months of 2008 and 2007, Crest did not invest in any new retail properties.

C. Crest's property inventory at June 30, 2008 consisted of eight properties with a total investment of $10.4 million and at December 31, 2007 consisted of 30 properties with a total investment of $56.2 million. These amounts are included on our consolidated balance sheets in "real estate held for sale, net."

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D. Of the $184.2 million invested by Realty Income in the first six months of 2008, $10.0 million was used to acquire two properties with existing leases with retail tenants. In accordance with Statement No. 141, Realty Income recorded $397,000 as the intangible value of the in-place leases. This amount is recorded to “other assets” on our consolidated balance sheets and amortized over the life of the leases.

Of the $98.3 million invested by Realty Income in the first six months of 2007, $7.1 million was used to acquire one property with an existing lease with a retail tenant. In accordance with Statement No. 141, Realty Income recorded $1.0 million as the intangible value of the in-place lease and $689,000 as the intangible value of the below-market rents. These amounts are recorded to “other assets” and “other liabilities,” respectively, on our consolidated balance sheets and are amortized over the life of the lease.

4. Credit Facility

In May 2008, we entered into a new $355 million acquisition credit facility replacing our existing $300 million acquisition credit facility that was scheduled to expire in October 2008. The term of the new credit facility is for three years until May 2011, plus two, one-year extension options. Under the new credit facility, our investment grade credit ratings provide for financing at LIBOR (London Interbank Offered Rate) plus 100 basis points with a facility commitment fee of 27.5 basis points, for all-in drawn pricing of 127.5 basis points over LIBOR.

As a result of entering into our new credit facility in May 2008, we expensed $235,000 of unamortized credit facility origination costs from our prior credit facility in the second quarter of 2008, which are included in interest expense.

We did not utilize our credit facility during the first six months of 2008. The effective borrowing rate at June 30, 2008 was 3.5%. Our average borrowing rate on our credit facility during the first six months of 2007 was 6.0%. Our current and prior credit facilities are subject to various leverage and interest coverage ratio limitations. We are and have been in compliance with these covenants.

Our credit facility is unsecured and, accordingly, we have not pledged any assets as collateral for this obligation.

5. Notes Payable

Our senior unsecured note obligations consist of the following, sorted by maturity date at both June 30, 2008 and December 31, 2007 (dollars in millions):

8.25% notes, issued in October 1998 and due in November 2008	$	100.0
8% notes, issued in January 1999 and due in January 2009		20.0
5.375% notes, issued in March 2003 and due in March 2013		100.0
5.5% notes, issued in November 2003 and due in November 2015		150.0
5.95% notes, issued in September 2006 and due in September 2016		275.0
5.375% notes, issued in September 2005 and due in September 2017		175.0
6.75% notes, issued in September 2007 and due in August 2019		550.0
5.875% bonds, issued in March 2005 and due in March 2035		100.0
	$	1,470.0

We anticipate paying off the notes due in 2008 and 2009 by using cash on hand, utilizing our credit facility or issuing new securities.

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6. Fair Value of Financial Assets and Liabilities

FASB Statement No. 157, Fair Value Measurements, became effective for us at the beginning of 2008 and did not have an impact on our financial position or results of operations. In February 2008, the FASB delayed the effective date of Statement No. 157 for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis, to the beginning of 2009.

Statement No. 157 defines fair value as the price that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, and establishes a framework for measuring fair value. Statement No. 157 also establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. A financial instrument's categorization within this hierarchy is based upon the lowest level of input that is significant to the fair value measurement. This statement applies to fair value measurements and disclosures that are already required or permitted by most existing FASB accounting standards.

We believe that the carrying values reflected in the consolidated balance sheets at June 30, 2008 and December 31, 2007 reasonably approximate the fair values for cash and cash equivalents, accounts receivable, and all liabilities, due to their short-term nature, except for notes payable. In making these assessments, we used estimates. The estimated fair value of the notes payable at June 30, 2008 is $1.349 billion and at December 31, 2007 is $1.413 billion, based upon the closing market price per note or indicative price per each note at June 30, 2008 and December 31, 2007, respectively.

7. Gain on Sales of Real Estate Acquired for Resale by Crest

During the second quarter of 2008, Crest sold seven properties for $28.6 million, which resulted in a gain of $1.7 million. As part of two sales during the second quarter and first six months of 2008, Crest provided buyer financing of $19.2 million. In comparison, during the second quarter of 2007, Crest sold 26 properties for $56.2 million, which resulted in a gain of $5.3 million. In the second quarter of 2007, as part of one sale, Crest provided buyer financing of $619,000. Crest's gains on sales are reported before income taxes and are included in discontinued operations.

During the first six months of 2008, Crest sold 22 properties for $46.1 million, which resulted in a gain of $4.4 million. In comparison, during the first six months of 2007, Crest sold 31 properties for $69.5 million, which resulted in a gain of $6.6 million. In the first six months of 2007, as part of two sales, Crest provided buyer financing of $3.8 million.

8. Gain on Sales of Investment Properties by Realty Income

During the second quarter of 2008, we sold eight investment properties for $7.4 million, which resulted in a gain of $3.3 million. The results of operations for these properties have been reclassified as discontinued operations. Additionally, we recorded an adjustment of $203,000 from the sale of excess land from one property. This adjustment is included in "other revenue" on our consolidated statements of income because this property continues to be owned as part of our core operations.

In comparison, during the second quarter of 2007, we sold two investment properties for a total of $1.0 million, which resulted in a gain of $585,000. The results of operations for these properties have been reclassified as discontinued operations.

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During the first six months of 2008, we sold nine investment properties for $7.8 million, which resulted in a gain of $3.5 million. The results of operations for these properties have been reclassified as discontinued operations. Additionally, we received proceeds of $439,000 from a sale of excess land from one property, which resulted in a gain of $236,000. This gain is included in "other revenue" on our consolidated statements of income because this property continues to be owned as part of our core operations.

In comparison, during the first six months of 2007, we sold three investment properties for $1.5 million, which resulted in a gain of $585,000. The results of operations for these properties have been reclassified as discontinued operations. In addition, we sold excess land from three properties for $3.8 million, which resulted in a gain of $1.8 million. The gain from the land sales is reported in "other revenue" on our consolidated statements of income because these properties continue to be owned as part of our core operations.

9. Discontinued Operations

In accordance with FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, Realty Income's operations from eight investment properties classified as held for sale at June 30, 2008, plus properties sold in 2008 and 2007, are reported as discontinued operations. Their respective results of operations have been reclassified to "income from discontinued operations, real estate held for investment" on our consolidated statements of income. We do not depreciate properties that are classified as held for sale.

Crest acquires properties with the intention of reselling them rather than holding them for investment and operating the properties. Consequently, we typically classify properties acquired by Crest as held for sale at the date of acquisition and do not depreciate them. In accordance with Statement No. 144, the operations of Crest's properties are classified as "income from discontinued operations, real estate acquired for resale by Crest" on our consolidated statements of income.

No debt was assumed by buyers of our investment properties, or repaid as a result of our investment property sales, and we do not allocate interest expense to discontinued operations related to real estate held for investment. We allocate interest expense related to borrowings specifically attributable to Crest's properties. The interest expense amounts allocated to the Crest properties held for sale are included in "income from discontinued operations, real estate acquired for resale by Crest" on our consolidated statements of income.

If circumstances arise, which were previously considered unlikely and, as a result, we decide not to sell a property previously classified as held for sale, the property is reclassified as real estate held for investment. A property that is reclassified to held for investment is measured and recorded at the lower of (i) its carrying amount before the property was classified as held for sale, adjusted for any depreciation expense that would have been recognized had the property been continuously classified as held for investment, or (ii) the fair value at the date of the subsequent decision not to sell.

A provision for impairment of $953,000 was recorded by Crest on one property held for sale in the second quarter of 2008. Provisions for impairment of $3.3 million were recorded by Crest on three properties held for sale in the first six months of 2008. No provisions for impairment were recorded by Crest in the first six months of 2007. These provisions for impairment are included in "income from discontinued operations, real estate acquired for resale by Crest." The provisions for impairment recorded in the first six months of 2008 reduced the carrying values to the estimated fair-market value of those properties, net of estimated selling costs. These three properties were leased to a subsidiary of Buffets, Inc. ("Buffets") and the leases were guaranteed by Buffets.

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The following is a summary of Crest's "income from discontinued operations, real estate acquired for resale" on our consolidated statements of income (dollars in thousands):

	Three months ended		Six months ended	
Crest's income from discontinued operations, real estate acquired for resale	June 30, 2008	June 30, 2007	June 30, 2008	June 30, 2007
Gain on sales of real estate acquired for resale	$ 1,737	$ 5,326	$ 4,444	$ 6,566
Rental revenue	598	2,310	1,634	5,188
Other revenue	138	55	208	61
Interest expense	(433)	(1,758)	(1,065)	(3,877)
General and administrative expense	(126)	(179)	(287)	