CAPITAL LEASE FUNDING INC
Form 10-Q
May 16, 2005

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 March 31, 2005

OR

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

For the transition period from ____________to _____________

Commission file number 001-32039

Capital Lease Funding, Inc.
(Exact name of registrant as specified in its charter)

Maryland	**52-2414533**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
110 Maiden Lane, New York, NY	**10005**
(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 x No o

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

As of May 16, 2005, there were 27,875,200 shares of common stock of Capital Lease Funding, Inc., $0.01 par value per share, outstanding (“Common Stock”).

Capital Lease Funding, Inc.

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PART I. **FINANCIAL INFORMATION**

Item 1. **Financial Statements**

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

	As of March 31, 2005 Unaudited	As of December 31, 2004
Assets:		
Cash and cash equivalents	$ 83,181	$ 30,721
Mortgage loans held for investment	219,002	207,347
Real estate investments, net	242,157	194,541
Securities available for sale	113,003	87,756
Structuring fees receivable	4,289	4,426
Real estate investments consolidated under FIN46	–	48,000
Prepaid expenses and other assets	27,485	7,941
Amounts due from affiliates and members	79	81
Accrued rental income	935	507
Derivative assets	189	42
Furniture, fixtures and equipment, net	370	340
Total Assets	$ 690,690	$ 581,702
Liabilities and Stockholders' Equity:		
Accounts payable and accrued expenses	$ 3,209	$ 3,479
Deposits and escrows	1,579	10,725
Due to servicer and dealers	–	4,357
Repurchase agreement obligations	8,352	133,831
Mortgages on real estate investments	147,264	111,539
Collateralized debt obligations	268,130	–
Derivative liabilities	–	7,355
Intangible liabilities on real estate investments	6,929	7,028
Dividends payable	5,018	4,124
Mortgage on real estate investments consolidated under FIN46	–	4,815
Total Liabilities	440,481	287,253
Minority interest in real estate investments consolidated under FIN46	–	41,185
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $.01 par value, 100,000,000 shares authorized, no shares issued and outstanding	–	–
Common stock, $0.01 par value, 500,000,000 shares authorized, 27,875,200 and 27,491,700 shares issued and outstanding, respectively	275	275
Additional paid in capital	249,445	251,786
Accumulated other comprehensive income	489	1,203
Retained earnings (deficit)	–	–
Total Stockholders' Equity	250,209	253,264
Total Liabilities and Stockholders' Equity	$ 690,690	$ 581,702

See notes to consolidated financial statements

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

	For the three months ended March 31,			
		2005		2004
Revenues:				
Interest income from mortgage loans and securities	$	6,106	$	1,923
Gain on sales of mortgage loans and securities		63		–
Rental revenue		4,336		–
Property expense recoveries		1,363		–
Other revenue		39		43
Total revenues		11,907		1,966
Expenses:				
Interest expense		3,542		426
Interest expense to affiliates		–		231
Property expenses		1,783		–
Net loss on derivatives and short sales of securities		–		724
General and administrative expenses		2,552		1,908
General and administrative expenses-stock based compensation		455		2,833
Depreciation and amortization expense on real property		1,268		–
Loan processing expenses		85		36
Total expenses		9,685		6,158
Income (loss) before provision for income taxes		2,222		(4,192)
Provision for income taxes		–		–
Net income (loss)	$	2,222	$	(4,192)
Earnings per share				
Net income per share, basic and diluted	$	0.08	$	(0.71)
Weighted average number of common shares outstanding, basic and diluted		27,526		5,887
Dividends declared per common share	$	0.18	$	-

See notes to consolidated financial statements

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

	Common Stock at Par	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings (Deficit)	Total
Balance at December 31, 2004	$ 275	$ 251,786	$ 1,203	$ –	$ 253,264
Incentive stock plan compensation expense	–	455	–	–	455
Incentive stock plan grants issued	–	–	–		–
Net income	–	–	–	2,222	2,222
Dividends declared	–	(2,796)	–	(2,222)	(5,018)
Unrealized change in value on securities available for sale	–	–	1,108	–	1,108
Unrealized change in value on derivatives	–	–	7,502	–	7,502
Realized gains (losses) on derivatives	–	–	(9,324)	–	(9,324)
Balance at March 31, 2005	$ 275	$ 249,445	$ 489	$ –	$ 250,209

See notes to consolidated financial statements

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

	For the three months ended March 31, 2005	2004
Operating activities		
Net income (loss)	$ 2,222	$ (4,192)
Adjustments to reconcile net income to cash used in operating activities:		
Depreciation and amortization	1,294	20
Amortization of stock based compensation expense	455	2,833
Amortization of below market leases	(99)	–
Gain on sale of mortgage loans and securities	(63)	–
Loss on derivatives and short sales of securities	–	724
Straight-lining of rental income	(428)	–
Changes in operating assets and liabilities:		
Funds used in hedging and risk management activities	–	(1,827)
Structuring fees receivable	137	263
Prepaid expenses and other assets	(1,994)	(807)
Accounts payable and accrued expenses	(269)	(957)
Deposits and escrows	(9,146)	609
Due to servicer and dealer	(4,360)	1,413
Net cash used in operating activities	(12,251)	(1,921)
Investing activities		
Proceeds from sale of mortgage loans	2,310	–
Principal advanced to borrowers	(9,318)	(12,399)
Principal received from borrowers	1,667	843
Loan origination costs	(70)	(9)
Purchase of securities available for sale	(30,319)	(29,290)
Sale of securities available for sale	–	20,397
Purchases of real estate investments	(48,883)	–
Deposits on potential equity investments	(2,000)	–
Return of deposit on equity investments	2,500	–
Purchases of furniture, fixtures and equipment	(56)	(11)
Net cash used in investing activities	(84,169)	(20,469)
Financing activities		
Borrowing under repurchase agreements	81,389	–
Repayments under repurchase agreements	(206,869)	(28,765)
Repayments under repurchase agreements to affiliates	–	(59,321)
Borrowings from mortgages on properties	36,000	–
Repayments of mortgages on properties	(275)	–
Borrowings from collateralized debt obligations	268,130	–
Deferred financing costs	(4,848)	–
Deposits and escrows on mortgage loans	(11,201)	–
Funds used in hedging and risk management activities	(9,324)	–
Reverse merger	–	14
Net proceeds from equity offering	–	222,818
Dividends paid	(4,124)	–

Changes in amounts due from affiliates and members		2		11
Net cash provided by financing activities		148,880		134,757
Net increase in cash		52,460		112,367
Cash and cash equivalents at beginning of period		30,721		6,522
Cash and cash equivalents at end of period	$	83,181	$	118,889
Supplemental disclosure of cash flow information				
Dividends declared but not paid	$	5,018		-
Supplemental disclosure of noncash operating and financing information				
Prepaid expenses and other assets reclassified to public offering costs		-	$	1,040
Unrealized gain (loss) on cash flow hedges	$	7,502	$	(421)
Securities reclassified to mortgage loans held for investment	$	6,180		-
Real estate investments no longer consolidated under FIN46	$	48,000		-

See notes to consolidated financial statements

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

March 31, 2005 (unaudited))

1. Organization

Capital Lease Funding, Inc. ("CLF, Inc." and collectively with its wholly-owned subsidiaries, the "Company") was incorporated in the State of Maryland during October 2003, and was formed for the purpose of continuing the existing business operations and acquiring the assets and liabilities of Caplease, LP ("LP" or the Predecessor"). CLF, Inc. completed this acquisition through a reverse merger and its initial public offering during March 2004. The Company invests in real estate mortgage loans, equity interests in real estate properties, real estate securities and other real estate assets. The Company's investments primarily consist of real estate related assets that are backed by commercial properties typically subject to long-term net leases from investment grade and near investment grade tenants.

The accompanying financial statements include the historical results of operations of the Predecessor prior to its acquisition by CLF, Inc.

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

In March 2004, CLF, Inc. sold 23 million shares of its common stock in an initial public offering at a price to the public of $10.50 per share, for net proceeds of approximately $222 million. CLF, Inc. had 27,875,200 shares of common stock outstanding at March 31, 2005.

CLF, Inc. is organized and conducts its operations to qualify as a real estate investment trust ("REIT") for federal income tax purposes. As such, it will generally not be subject to federal income tax on that portion of its income that is distributed to stockholders if it distributes at least 90% of its REIT taxable income to its stockholders by prescribed dates and complies with various other requirements. On December 20, 2004, CLF, Inc. declared a dividend of $0.15 per common share, payable on January 14, 2005, to stockholders of record as of December 31, 2004. The dividend declared in December was paid on January 14, 2005. On March 22, 2005, CLF, Inc. declared a dividend of $0.18 per common share, payable on April 15, 2005, to stockholders of record as of March 31, 2005. The dividend declared in March was paid on April 15, 2005.

The accompanying consolidated financial statements and related notes of the Company have been prepared in accordance with accounting principles generally accepted in the United States for interim financial reporting and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in the financial statements prepared under accounting principles generally accepted in the United States have been condensed or omitted. In the opinion of management, all adjustments considered necessary for a fair presentation of the Company's financial position, results of operations and cash flows have been included and are of a normal and recurring nature. The operating results presented for interim periods are not necessarily indicative of the results that may be expected for any other interim period or for the entire year. These financial statements should be read in conjunction with the Company's consolidated financial statements for the fiscal year ended December 31, 2004 and notes thereto, included in the Company's Form 10-K filed with the SEC on March 30, 2005.

2. Summary of Significant Accounting Policies

Basis of Presentation and Principles of Consolidation

The accompanying consolidated financial statements include the assets, liabilities, and results of operations of the Predecessor prior to March 24, 2004 and CLF, Inc. and its wholly-owned subsidiaries, thereafter. Results of operations of properties acquired are included in the Consolidated Statement of Operations from the date of acquisition. All significant intercompany transactions, balances and accounts have been eliminated in consolidation.

Investments in Mortgage Loans

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

Purchase Accounting for Acquisition of Real Estate

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

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

· identified intangible assets and liabilities, consisting of the value of above-market and below-market leases, the value of in-place leases and the value of tenant relationships, based in each case on their fair values.

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

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

Other intangible assets acquired include amounts for in-place lease values and tenant relationship values which are based on management's evaluation of the specific characteristics of each tenant's lease and the Company’s overall relationship with the respective tenant. Factors considered by management in its analysis of in-place lease values include an estimate of carrying costs during the hypothetical expected time it would take management to find a tenant to lease the space for the existing lease term (a “lease-up period”) considering current market conditions, and costs to execute similar leases. Management estimates carrying costs, including such factors as real estate taxes, insurance and other operating expenses during the expected lease-up period, considering current market conditions and costs to execute similar leases. In estimating costs to execute similar leases, management considers leasing commissions, legal and other related expenses. Characteristics considered by management in valuing tenant relationships include the nature and extent of the Company’s existing business relationships with the tenant, growth prospects for developing new business with the tenant, the tenant's credit quality and expectations of lease renewals. The value of in-place leases is amortized to expense over the remaining initial terms of the respective leases. The value of tenant relationship intangibles is amortized to expense over the anticipated life of the relationships.

Interest expense on properties that are under development is capitalized in accordance with the Financial Accounting Standards Board (“FASB”) Statement of Financial Accounting Standards (“SFAS”) No. 34 *Capitalization of Interest Cost*.

Depreciation is determined by the straight-line method over the remaining estimated economic useful lives of the properties. The Company generally depreciates buildings and building improvements over periods not exceeding 40

years. Direct costs incurred in acquiring properties are capitalized. Expenditures for maintenance and repairs are charged to operations as incurred. Significant renovations which extend the useful life of the properties are capitalized.

Securities Available for Sale

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

Deferred Origination Costs

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

Revenue Recognition

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

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

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

Advisory fees receivable are recognized upon the completion of the advisory services when the amount is estimable and collection is probable. The value of the receivable is based on the present value of the expected cash flows and amortized as advisory fee payments are received.

The Company may periodically receive breakup fees on contracts in connection with its investments in real estate. The Company recognizes revenues from contract breakup fees when the contractual conditions have occurred to trigger the receipt of such a fee, when the amounts of such revenue can be reasonably determined, and when collection is probable.

Income Taxes

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

Earnings per Share

In accordance with the Statement of Financial Accounting Standards No. 128 ("SFAS No. 128"), the Company presents both basic and diluted earnings per share ("EPS"). Basic EPS excludes dilution and is computed by dividing net income allocable to common shareholders by the weighted average number of shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock, where such exercise or conversion would result in a lower EPS amount.

For the three months ended March 31, 2005, EPS and weighted average shares outstanding include the 510,602 non-vested shares issued under CLF, Inc.'s stock incentive plan. For the three months ended March 31, 2005, EPS is computed based on the net income divided by the weighted average shares outstanding during the period of 27,525,639. For the three months ended March 31, 2004, EPS and weighted average shares outstanding include the 254,186 non-vested shares issued under CLF, Inc.'s stock incentive plan. For the three months ended March 31, 2004, earnings per share is computed based on the net income (loss) divided by the weighted average shares outstanding during the period of 5,887,132. There were no potentially dilutive shares of common stock outstanding for the three months ended March 31, 2005 and 2004.

Recently Issued Accounting Pronouncements

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

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

Reclassification

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

3. Cash and Cash Equivalents

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

4. Mortgage Loan Held for Investment

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

	Mar 31, 2005 Unaudited	Dec 31, 2004
Principal	$ 217,559	$ 206,735
Premium (discount)	1,919	1,158
Carrying amount of mortgages	219,478	207,893
Deferred origination fees, net	(476)	(546)
Total	$ 219,002	$ 207,347

At March 31, 2005, the mortgage loans carried interest rates ranging from 5.40% to 10.00% and at December 31, 2004, the mortgage loans carried interest rates ranging from 4.71% to 10.00%, respectively. At March 31, 2005 and December 31, 2004, the weighted average effective interest rate on the mortgage loans, as measured against our cost basis, was 6.72%% and 6.56%, respectively.

5. Real Estate Investments

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

	Mar 31, 2005 Unaudited	Dec 31, 2004
Real estate investments, at cost:		
Land and improvements	$ 43,226	$ 28,226
Building and improvements	187,962	154,078
Intangible assets under SFAS 141	13,518	13,518
Less: Accumulated depreciation	(2,549)	(1,281)
Real estate investments, net	$ 242,157	$ 194,541
Intangible liabilities on real estate investments	$ 6,929	$ 7,028

Some leases provide for scheduled rent increases throughout the lease term. Such amounts are recognized on a straight-line basis over the terms of the leases. For the three months ended March 31, 2005, the Company recognized $428 of such revenue. At March 31, 2005, the balance of accrued rental income was $935. Amortization of intangible assets on real estate investments totaled $306 for the three months ended March 31, 2005 and is included in "Depreciation and amortization expense" on the Company's Consolidated Statement of Operations. Amortization of intangible liabilities on real estate investments totaled $99 for the three months ended March 31, 2005, and is included in "Rental revenue" on the Company's Consolidated Statement of Operations.

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

	Intangible Assets	Intangible Liabilities
9 months ending December 31, 2005	$ 918	$ 297
2006	1,224	396
2007	1,224	396
2008	1,224	396
2009	1,224	396
Thereafter	7,102	5,048
	$ 12,916	$ 6,929

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

During the three months ended March 31, 2005, the Company completed the following real estate acquisition:

Month Acquired	Tenant or Guarantor	Location	Acquisition Cost	Lease Expires	Net Rentable Square Feet
January	Cadbury Schweppes PLC	Hanover, New Jersey	$48.1 million	2021	149,475

While the lease term on the above property has commenced and monthly rent payments commenced in April 2005, Cadbury, who is responsible for the construction of the building on the site, has not yet completed construction of the building. The Company will begin recognizing rental income and recording depreciation and other expenses associated with the property (such as interest expense on borrowings) upon substantial completion of the building and its readiness for occupancy. Interest expense of $574 was capitalized for three months ended March 31, 2005.

6. Securities Available for Sale and Structuring Fees Receivable

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

	Mar 31, 2005 Unaudited	Dec 31, 2004
Face amount-BSCMS 1999 CLF1, Class E (rated BB)	$ 3,326	$ 3,326
Face amount-BSCMS 1999 CLF1, Class F (rated B-)	2,494	2,494
Face amount-CALFS 1997-CTL1, Class D (rated BBB)	5,000	3,000
Face amount-CMLBC 2001-CMLB-1 Class E (rated BBB+)	9,526	9,526
Face amount-CMLBC 2001-CMLB-1 Class G (rated BBB-)	9,526	9,526
Face amount-CMLBC 2001-CMLB-1, Class H (rated BB-)	11,907	11,907
Face amount-CMLBC 2001-CMLB-1, Class J (rated B-)	7,144	7,144
Face amount-CMLBC 2001-CMLB-1, Class K (not rated)	4,766	4,766
Face amount-NLFC 1999 LTL1, Class D (rated BBB)	5,000	5,000
Face amount-NLFC-99LTL 1, Class E (rated BB-)	11,082	11,081
Cost-NLFC-99LTL 1, Class X/IO (rated AAA)	9,138	9,908
Face amount-Yahoo, Inc 6.65% Certificates (tenant rated BBB-)	31,996	16,999
180 Maiden Lane 5.49% Nov 2009	15,000	–
CVS Pass Through Certificates (tenant rated A-) (1)	–	6,180
Face amount-BACMS 2002-2, Class V-1 (tenant rated BBB)	369	361
Face amount-BACMS 2002-2, Class V-2 (tenant rated BBB-)	564	553
Unearned discount	(25,153)	(24,224)
Cost basis	101,685	77,547
Unrealized appreciation on securities held for sale	11,318	10,209
Total	$ 113,003	$ 87,756

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

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

	Mar 31, 2005 Unaudited	Dec 31, 2004
Unrealized gains on securities available for sale	11,963	10,246
Unrealized losses on securities available for sale	(645)	(57)

At March 31, 2005 and December 31, 2004, the effective interest rate (yield to maturity on adjusted cost basis) on securities available for sale was 9.0% and 9.9%, respectively. There were no sales of securities during the three months ended March 31, 2005. During the three months ended March 31, 2004, the Company sold $20.4 million of corporate securities at cost that were held as temporary investments.

Structuring fees receivable of $4,289 and $4,426 at March 31, 2005 and December 31, 2004, respectively, were earned by the Company in conjunction with the structuring and subsequent sale of certain net lease loans. Such fees are payable to the Company monthly without interest through March 2020 and, accordingly, have been discounted based on imputed interest rates estimated by management to approximate market. Structuring fees receivable are shown at their amortized cost.

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7. Prepaid Expenses and Other Assets

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

	Mar 31, 2005 Unaudited	Dec 31, 2004
Mortgage note escrows & deposits	$ 13,551	$ 2,350
Deferred financing costs	5,191	343
Deposits on acquisitions	2,000	500
Accrued interest receivable	1,446	1,128
Funds collected by servicers	3,382	2,467
Other	1,914	1,153
Total	$ 27,485	$ 7,941

8. Repurchase Agreements

As of March 31, 2005, the Company had a repurchase agreement in place for short-term liquidity requirements with Wachovia Bank, N.A. On March 1, 2005, the Company's repurchase agreement with Bank of America expired unused.

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

	March 31, 2005 Unaudited		December 31, 2004		
	Wachovia	Total	BofA	Wachovia	Total
Collateral face					
Mortgage loans	$ –	$ –	$ 22,800	$ 136,477	$ 159,277
CMBS	9,138	9,138	–	41,130	41,130
Total	$ 9,138	$ 9,138	$ 22,800	$ 177,607	$ 200,407
Financing					
Mortgage loans	$ –	$ –	$ –	$ 102,288	$ 102,288
CMBS	8,352	8,352	–	31,543	31,543
Total	$ 8,352	$ 8,352	$ –	$ 133,831	$ 133,831

During the quarter ended March 31, 2005, we repaid approximately $206.9 million of borrowings under our Wachovia credit facility, primarily with a portion of the proceeds from our first CDO financing (see Note 10). Weighted average interest rates on the Company's credit facilities for the three months ended March 31, 2005 and 2004 are as follows:

	Mar 31, 2005	Mar 31, 2004
Bank of America-mortgage loan repurchase agreements	N/A	2.59%
Bank of America-CMBS repurchase agreements	N/A	1.89%
Wachovia-mortgage loan repurchase agreements	3.37%	2.09%
Wachovia-CMBS repurchase agreements	3.15%	3.09%

As of March 31, 2005 and 2004, the 1-month LIBOR rate was 2.87% and 1.09%, respectively. As of March 31, 2005, the Company was in compliance with the terms of the repurchase agreement with its warehouse lender.

The Company's credit facilities generally carry maturities of less than one year. The Company does not anticipate any issues with renewing its existing credit facility with Wachovia when it matures in September 2005. In addition, the Company has a strong history of negotiating credit facilities with lenders, and management is confident that it can find replacement credit facilities if the need arises.

9. Risk Management Transactions

Prior to CLF, Inc.'s conversion to a REIT on March 24, 2004, the Company used risk management transactions consisting of U.S. Treasury and Agency lock transactions ("Locks") to hedge the interest rate risk associated with owning fixed rate mortgage loan assets financed by floating rate debt. Subsequent to REIT conversion, the Company changed the way it hedges to comply with the REIT tax requirements and began using forward starting interest rate swaps to hedge the variability of changes in the interest-related cash outflows on forecasted future borrowings. As of March 31, 2005, the Company was hedging its exposure to such variability through December 2015. In accordance with SFAS 133, the Locks and interest rate swaps, to the extent that they have been designated and qualify as part of a hedging relationship, are treated as fair value hedges and cash flow hedges, respectively, for accounting purposes.

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

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

	March 31, 2005 Unaudited		December 31, 2004	
Description	Notional Amount	Fair value	Notional Amount	Fair value
Interest rate swaps	$ 20,942	$ 189	$ 228,182	$ (7,312)

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

	Mar 31, 2005 Unaudited	Dec 31, 2004
Future borrowings (principal amount)	$ 20,942	$ 228,182

At March 31, 2005 and December 31, 2004, respectively, derivatives with a fair value of $0 and $7,355 were included in derivative liabilities on the Company's balance sheet. At March 31, 2005 and December 31, 2004, respectively, derivatives with a fair value of $189 and $42 were included in derivative assets on the Company's balance sheet. For the three months ended March 31, 2005 and 2004, the Company had realized losses of $9,324 and realized gains of $912, respectively, related to cash flow hedges that are included in Other Comprehensive Income. The realized losses of $9,324 will be amortized as part of interest expense on the Company's Consolidated Statement of Operations over the expected term of the Company's CDO issuance. The change in net unrealized gains and losses of $7,502 in the 2005 period for derivatives designated as cash flow hedges is separately disclosed in the statement of changes in stockholders' equity.

We recognized no expense due to hedge ineffectiveness for the three months ended March 31, 2005 and 2004. For the three months ended March 31, 2005 and 2004, the Company reclassified $90 and $0, respectively, from accumulated other comprehensive loss into interest expense related to the underlying debt issuances.

10. Long-Term Debt

Our long-term debt consists of the following:

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

Mortgages Notes on Real Estate Investments

Mortgage notes payable collateralized by the respective properties (aggregating $202,393 at March 31, 2005 and $153,690 at December 31, 2004) and assignment of leases are as follows:

Property Level Debt - Fixed Rate	Mar 31, 2005 Unaudited	Dec 31, 2004	Interest Rate	Maturity
Choice, Silver Spring, MD	$ 32,517	32,625	5.30%	May-13
AON Corporation, Glenview, IL	64,800	64,800	5.23%	Nov-14
Cadbury Schweppes, Hanover Township, NJ	36,000	–	5.26%	Mar-15
GSA, Ponce, PR (a)	8,015	8,117	6.47%	Apr-16
Walgreen Co., Pennsauken, NJ (b)	2,313	2,347	6.06%	Oct-16
Walgreen Co., Portsmouth, VA (c)	3,619	3,650	6.19%	Jul-18
Total	$ 147,264	$ 111,539		

(a) Face amount of the debt outstanding at March 31 is $7,633, at a coupon of 7.30%. The carrying amount on the financial statements reflects a prepayment premium of $382 which was received from the seller at the time of purchase. The interest rate shown in the above table reflects the effective interest rate to the Company, as adjusted for the impact of the prepayment premium.
(b) Face amount of the debt outstanding at March 31 is $2,134, at a coupon of 7.65%. The carrying amount on the financial statements

reflects a premium of $179 based on the fair value of the debt assumed at the purchase date. The interest rate shown in the above table reflects the effective interest rate to the Company, as adjusted for the impact of the fair value adjustment.

(c) Face amount of the debt outstanding at March 31 is $3,384, at a coupon of 7.20%. The carrying amount on the financial statements reflects a premium of $235 based on the fair value of the debt assumed at the purchase date. The interest rate shown in the above table reflects the effective interest rate to the Company, as adjusted for the impact of the fair value adjustment.

Collateralized Debt Obligations

On March 10, 2005, we issued to third party investors two classes (Classes A and B) of investment grade collateralized debt obligations, or CDOs, through a newly formed wholly-owned subsidiary, Caplease CDO, 2005-1, Ltd, or Caplease CDO-1. Caplease CDO-1 issued three additional classes of investment grade notes (Classes C, D and E) that were purchased by us through another newly-formed wholly-owned subsidiary. We also purchased all equity interests in Caplease CDO-1, including preferred shares with a principal amount of $15.0 million. We consolidate Caplease CDO-1 into our financial statements.

Each class of notes pays a fixed coupon rate. The notes are non-recourse to us but are secured by the collateral described below. Certain terms of the notes are summarized in the following table:

Class of Notes		Principal Amount/Face Amount as of Closing Date	Ratings Moody's/S&P	Stated Maturity	Stated Coupon Rate
A	$	252,000,000	Aaa/AAA	January 2040	4.926%
B		16,500,000	Aa2/AA	January 2040	5.036%
C		9,000,000	A2/A-	January 2040	5.406%
D		4,500,000	Baa2/BBB	January 2040	6.206%
E		3,000,000	Baa3/ BBB-	January 2040	6.606%
Total	$	285,000,000			

The expected maturity date of the notes is January 2015, when the notes become subject to an auction call procedure. Under that procedure, the notes will be redeemed if a successful auction of the collateral underlying the notes is completed (generally, the cash purchase price for the collateral is at least equal to the amount necessary to redeem the notes and the preferred stock).

Caplease CDO-1 was structured to match fund the cash flows from a significant portion of our existing assets. Proceeds from the sale of the notes were used to purchase a $299.3 million portfolio of assets from our operating partnership, Caplease, LP. The assets purchased by Caplease CDO-1 serve as collateral for the notes and are summarized in the following table:

Asset Type		Face Amount	Percentage
Long-term credit tenant loans	$	199,148,746	66.53%
Corporate credit notes		23,893,987	7.98%
Structured interests in net lease assets		61,285,399	20.48%
Mezzanine loan		15,000,000	5.01%
Total	$	299,328,132	100.00%

Under a reinvestment feature in the governing documents of the notes, until October 2009, principal proceeds from repayment and/or sale of the collateral may be reinvested in qualifying replacement assets.

We received net proceeds in the transaction of approximately $263.1 million (after approximately $5.0 million of expenses and escrows), approximately $205.5 million of which was used to repay our borrowings under our short-term warehouse facility with Wachovia Bank, N.A. We incurred $13.3 million of debt issuance and hedging costs in the transaction and these costs will be amortized on a level yield basis over the expected life of Caplease CDO-1. Our effective blending financing rate (inclusive of original issue discount, debt issuance and hedge costs) on the Class A and Class B notes (the classes we did not retain) is approximately 5.66%.

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

	Scheduled	Balloon	Total

	Amortization	Payments	
9 months ending December 31, 2005	$ 860	$ –	$ 860
2006	1,675	–	1,675
2007	2,149	–	2,149
2008	3,367	–	3,367
2009	3,793	–	3,793
Thereafter	105,474	298,076	403,550
	$ 117,318	$ 298,076	$ 415,394

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11. Commitments and Contingencies

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

The Company is obligated under a letter of credit with respect to one of its 1999 securitization transactions (BSCMS 1999-CLF1). The maximum potential amount of future required payments under the letter of credit is $2,850. The letter of credit expires on February 18, 2009. The trustee may draw the letter of credit if there are realized losses on the mortgage loans that would create a shortfall in the interest or principal on any investment grade certificate. The letter of credit may be withdrawn when the ratings of the investment grade certificates are no longer dependent upon the credit support provided by the letter of credit. During February 2005, one of the mortgage loans on a property net leased to Winn-Dixie defaulted, as a result of the bankruptcy of Winn-Dixie. However, management does not expect any draw on the letter of credit as a result of this mortgage default, or otherwise. Letter of credit fees included in interest expense were $26 and $25 for the three months ended March 31, 2005 and 2004, respectively.

The Company had outstanding commitments to fund loans of approximately $1,979 related to certain of its development or joint-venture loans as of March 31, 2005. As of March 31, 2005, advances of $987 had been made against these commitments.

12. Stock Based Compensation

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

During the three months ended March 31, 2005, CLF, Inc. granted 383,500 shares of common stock to employees and directors. None of these shares were vested on the date of grant. An aggregate of 183,500 shares vest in three equal installments beginning on the first anniversary of the grant date. An aggregate of 200,000 shares vest over three years if a combination of objective and subjective performance criteria, as determined by the CLF, Inc. Compensation Committee, are attained. For the three months ended March 31, 2005, compensation expense of $12 was recorded in the Company's Consolidated Statement of Operations under "General and administrative-stock based compensation expense" related to these awards.

During the three months ended March 31, 2004, CLF, Inc. granted 383,766 shares of common stock to employees and directors, simultaneous with the completion of its public equity offering. The following table summarizes the vesting schedule of these shares.

Shares vested upon grant	129,580	
Shares forfeited during 2004	3,630	*
Shares vested on March 24, 2005	125,276	
Unvested shares as of March 31, 2005	125,280	**
Total	383,766	

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

** 8,833 shares are scheduled to vest on May 1, 2005 and 116,447 shares are scheduled to vest on March 24, 2006.

During the three months ended March 31, 2005 and 2004, compensation expense of $337 and $1,386, respectively, was recorded in the Company’s Consolidated Statements of Operations under “General and administrative-stock based compensation expense” related to these awards.

On November 17, 2003, CLF, Inc. sold 139,134 shares to certain current and former employees of the Predecessor for $0.10 per share. The Company recorded no compensation expense in connection with the issuance of the 139,134 shares, since the fair value of the stock on the date of sale was equal to the $0.10 per share purchase price. Upon completion of CLF, Inc.’s initial public offering on March 24, 2004, the difference between the public offering price per share of $10.50 and the price at which these individuals purchased the shares was recognized as a $1,447 expense (a component of General and administrative-stock based compensation expense) in the Company's Consolidated Statement of Operations.

13. Rental Income

CLF, Inc., through its wholly-owned subsidiaries, is the lessor to tenants under operating leases with expiration dates ranging from 2010 to 2021. 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 us for the occupancy and operating costs of the properties, or in certain cases reimburse us 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, 2005 for the properties are as follows (in thousands):

9 months ending December 31, 2005	$	14,176
2006		19,143
2007		19,442
2008		19,637
2009		19,171
Thereafter		145,671
	$	237,240

14. Pro Forma Condensed Consolidated Income Statements (Unaudited)

The accompanying unaudited Pro Forma Condensed Consolidated Income Statements are presented as if, at January 1, 2004, the Company acquired the Cadbury property described in Note 5-Real Estate Investments (the only property acquisition during the quarter) and all real properties purchased during 2004. Earnings per share are presented using the weighted average shares outstanding during the relevant periods. In management's opinion, all adjustments necessary to reflect the effects of the above transactions have been made.

The inclusion of the Cadbury acquisition as of January 1, 2004 has no impact on the Company's unaudited Pro Forma Condensed Consolidated Financial Statements because, as of March 31, 2005, Cadbury has not yet completed construction of the building (see Note 5).

The unaudited Pro Forma Condensed Consolidated Income Statements are not necessarily indicative of what the actual results of operations would have been assuming the acquisition transactions had occurred at the dates indicated above, nor do they purport to represent our future results of operations.

	For the three months ended March 31,			
	2005		2004	
Total revenues	$	11,907	$	7,537
Income (loss) from continuing operations	$	2,222	$	(2,955)
Income (loss) per basic and diluted common share from continuing operations	$	0.08	$	(0.50)

15. Segment Reporting

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

Selected results of operations for the three months ended March 31, 2005 and March 31, 2004 are as follows:

	Corporate / Unallocated		Operating Net Lease Real Estate		Lending Investments	
	3/31/2005	3/31/2004	3/31/2005	3/31/2004	3/31/2005	3/31/2004
Total revenues	$ 172	$ 88	$ 5,749	$ –	$ 5,986	$ 1,878
Total expenses	3,009	4,741	4,530	–	2,146	1,417
Net income	(2,837)	(4,653)	1,219	–	3,840	461
Total assets	84,154	119,755	263,561	–	342,975	140,179

16. Other Comprehensive Income

The components of other comprehensive income for the three months ended March 31, 2005 and 2004 are as follows (also see Notes 6 and 9):

	For the three months ended March 31, 2005	2004
Net income (loss)	$ 2,222	$ (4,192)
Unrealized change in value on securities available for sale	1,109	321
Unrealized gain (loss) on derivatives	7,502	(421)
Realized gain (loss) on derivatives	(9,324)	912
Other comprehensive income (loss)	$ 1,509	$ (3,380)

17. Variable Interest Entities

Under FASB Interpretation Number 46, "Consolidation of Variable Interest Entities," we were required to consolidate the Cadbury property we acquired in January 2005 during December 2004. The fair value of the property, representing the purchase price we agreed to pay, was reported on our balance sheet as "Real estate investments consolidated under FIN 46." Liabilities of the entity owning the property were $4.8 million at December 31, 2004, and were reported on our balance sheet as "Mortgage on real estate investments consolidated under FIN 46." The net balance of the assets and liabilities consolidated under FIN 46 for this VIE is reported on our balance sheet as "Minority interest in real estate investments consolidated under FIN 46." During January 2005, we closed on the acquisition of this property. As a result, this investment is now included as a component of real estate investments, net, on our balance sheet.

As part of our developer loan program, we fund loans to an entity that owns an undeveloped property. These loans are used to finance pre-construction costs related to the property, such as due diligence costs and land acquisition contract deposits, rather than costs to build on the property. We have funded five such loans as of March 31, 2005, with an aggregate unpaid principal amount of approximately $1.0 million as of that date. We have determined that our borrowers are VIEs under FIN 46. However, because part of our collateral for these loans is a personal guarantee from each entity's equity owner, we are not considered the primary beneficiary of these entities and, therefore, we are not required to consolidate them under FIN 46.

During 2004, we also funded a long-term credit tenant loan to an entity owning a property leased to Home Depot USA, Inc. in Westminster, Colorado. Our carry value on this loan was approximately $8.6 million as of March 31, 2005. In connection with funding the loan, we acquired the right to participate in any gain upon sale of the underlying property. The borrower entity similarly meets the criteria for a VIE under FIN 46, because the equity owners of the entity are required to share 25% of their expected residual returns with us. However, because we are not the primary beneficiary, we are not required to consolidate it.

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

The following discussion should be read in conjunction with the consolidated financial statements and the notes to those financial statements, included elsewhere in this filing. Where appropriate, the following discussion includes analysis of our predecessor entity.

General

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

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

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

In connection with our initial public offering, we raised net proceeds after all related expenses of approximately $221.8 million on top of an existing book equity of approximately $34.0 million. As of March 31, 2005, we had invested those proceeds into approximately $578.5 million of net lease assets and have begun to leverage our existing portfolio utilizing our existing floating rate warehouse credit facilities, fixed rate first mortgage debt, and collateralized debt obligations.

Summary of Closed Transactions in First Quarter 2005

The following highlights our closed transactions during the first quarter ended March 31, 2005:

- We added net assets to our portfolio of approximately $84 million, including the acquisition of an office and technology center in Morris County, New Jersey net leased to Cadbury Schweppes Holdings (U.S.), for $48.1

million, the origination of mortgage and development loans aggregating $9.3 million and the purchase of CMBS securities of $30.3 million.

· In February 2005, we financed our acquisition of the Cadbury property with a $36.0 million mortgage loan from Wachovia Bank and an approximately $4.0 million corporate credit note from our operating partnership, Caplease, LP. The $4.0 million corporate credit note represents intercompany debt, and is eliminated in consolidation.

· In March 2005, we closed our first CDO financing. The transaction was entirely fixed rate with a principal amount of approximately $300.0 million. We issued five classes of investment grade notes with an aggregate face amount of $285.0 million and preferred stock with a principal amount of $15.0 million. We retained $31.5 million in face amount of the notes offered, comprised of the entire face amount of the three most junior note classes and the preferred shares. We received net proceeds in the transaction of approximately $263.1 million (after approximately $5.0 million of expenses and escrows), $205.5 million of which was used to repay our borrowings under our short-term credit facility with Wachovia Bank. See "Liquidity and Capital Resources—Long-Term Liquidity and Financing."

Application of Critical Accounting Policies

A summary of our critical accounting policies is included in our Annual Report on Form 10-K for the year ended December 31, 2004 in Management's Discussion and Analysis of Financial Condition and Results of Operations. There have been no significant changes to those policies during the first quarter of 2005.

Business Segments

We conduct our business through two operating segments:

· lending investments (including our loan business as well as our investments in structured interests and structuring fees receivable); and

· operating net lease real estate (including our property acquisition business).

Segment data for the first quarters of 2005 and 2004 are as follows:

	Corporate / Unallocated		Operating Net Lease Real Estate		Lending Investments	
	3/31/2005	3/31/2004	3/31/2005	3/31/2004	3/31/2005	3/31/2004
Total revenues	$ 172	$ 88	$ 5,749	$ –	$ 5,986	$ 1,878
Total expenses	3,009	4,741	4,530	–	2,146	1,417
Net income	(2,837)	(4,653)	1,219	–	3,840	461
Total assets	84,154	119,755	263,561	–	342,975	140,179

A discussion of the comparison of segment performance is not included herein as we were under a gain on sale (rather than portfolio) business model prior to our initial public offering and we had no real property acquisitions during the first quarter 2005.

Results of Operations

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

Comparison of the Quarter Ended March 31, 2005 to the Quarter Ended March 31, 2004

The following discussion compares our operating results for the quarter ended March 31, 2005 to the comparable period in 2004.

Revenue.

Total revenue increased $9.9 million, or 506%, to $11.9 million. The increase was primarily attributable to increases in interest income from mortgage loans and securities and increases in rental revenue, including property operating expense recoveries.

Interest income increased $4.2 million, or 218%, to $6.1 million. The increase was due to larger overall asset investments, including both mortgage loans and CMBS investments.

Rental income and property expense recoveries, in the aggregate, increased $5.7 million to $5.7 million, as we did not own any investments in real estate during the comparable period in 2004.

Expenses.

Total expenses increased $3.5 million, or 57%, to $9.7 million. The increase in expenses was primarily attributable to higher levels of interest expense, general and administrative expenses, property expenses and depreciation and amortization expense on real property, offset in part by reductions in both stock based compensation expense and net losses on derivatives and short sales of securities.

Interest expense, including interest expense to affiliates, increased $2.9 million, or 439%, from $0.7 million to $3.5 million. There was no interest expense to affiliates in the 2005 period. The increase in 2005 primarily consisted of $1.2 million of additional interest expense related to property mortgages originated or assumed in 2004 and 2005, and $0.8 million related to collateralized debt obligations issued in 2005. In addition, interest expense on our borrowings under our secured warehouse lines of credit (repurchase agreement obligations), increased $0.9 million, or 139%, from $0.7 million to $1.6 million. This was the result of increased average borrowing levels in 2005. After the completion of our initial public offering in March 2004, we repaid all of the amounts outstanding under our credit facilities. We began borrowing under these facilities again during August 2004.

Property expenses increased from $0 to $1.8 million. We did not own any investments in real estate during the comparable period in 2004.

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

General and administrative expense increased $0.7 million, or 34%, from $1.9 million to $2.6 million, due primarily to increased expenses associated with operating as a public company, including liability insurance. General and administrative expense for the 2005 period also included approximately $0.1 million of accrued severance expense.

General and administrative expense-stock based compensation decreased $2.4 million, or 84%, to $0.5 million. The expense recognized during the 2004 period included the expense from stock grants which were vested at the initial public offering date and shares issued in November 2003 at a discount to the initial public offering price.

Depreciation and amortization expense on real property increased $1.3 million, as we did not own any investments during the comparable period in 2004.

Net income (loss).

Net income (loss) increased from $(4.2) million to $2.4 million, as a result of the factors discussed above.

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 a REIT. FFO does not represent cash generated from operating activities in accordance with GAAP and is not indicative of cash available to fund cash needs. FFO should not be considered as an alternative to net income or earnings per share determined in accordance with GAAP as an indicator of 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 (computed in accordance with GAAP) excluding gains (or losses) from sales of property, plus depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures.

The following table reconciles our net income to FFO for the quarters ended March 31, 2005 and March 31, 2004.

	Total		Per Share(1)	
	March 31, 2005	**March 31, 2004**	**March 31, 2005**	**March 31, 2004**
	(in thousands, except per share amounts)			
Net income	$ 2,222	$ (4,192)	$ 0.08	$ 0.71
Adjustments:				
Add: Depreciation and amortization expense on real property	1,268	0	0.05	0.00
Funds from operations	$ 3,490	$ (4,192)	$ 0.13	$ 0.71

(1) The weighted average number of shares outstanding for the 2005 period was 27,526 (basic and diluted) and for the 2004 period was 5,887 (basic and diluted).

Liquidity and Capital Resources

As of March 31, 2005, we had $83.2 million in available cash and cash equivalents. As a REIT, we will be required to distribute at least 90% of our taxable income to our stockholders on an annual basis, and we intend to distribute all or substantially all of our REIT taxable income in order to comply with the distribution requirements of the Code and to avoid federal income tax and the nondeductible excise tax. We declared a dividend of $0.18 per share during the quarter ended March 31, 2005.

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

Short-Term Liquidity and Financing.

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

We had $8.4 million outstanding as of March 31, 2005 under our Wachovia credit facility, which borrowings were secured by CMBS with a fair value of $9.1 million. As of March 31, 2005, we had $241.6 million available under our Wachovia credit facility. Our Bank of America facility expired unused on March 1, 2005.

As of March 31, 2005, we were in compliance with the terms of the agreement with Wachovia Bank. We do not currently anticipate any difficulty in maintaining compliance with these terms in future periods. We believe our

relationship with Wachovia Bank is excellent. However, because our secured credit facility with Wachovia Bank is uncommitted and is generally terminable at will by the lender, we cannot make any assurance that this facility will continue to be available to us.

Long-Term Liquidity and Financing.

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

We finance our investments through short-term financing arrangements and, as soon as practicable thereafter, we obtain long-term financing for these investments, generally on a secured basis. Long-term financing can be in the form of traditional mortgage debt, CDOs or other debt mechanisms. As of March 31, 2005, we have financed an aggregate of $200.3 million of assets in portfolio on a long-term basis through the issuance or assumption of long-term mortgage debt of $147.3 million and collateralized debt obligations of $268.1 million. We expect our leverage to average 70% to 85% of our assets in portfolio.

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

The issuer used the proceeds of the note offering, after payment of fees and expenses and amounts owing in respect of pre-closing financing and hedging arrangements, to acquire a portfolio of assets from our wholly-owned subsidiary, Caplease, LP. We received net proceeds in the transaction of approximately $263.1 million (after approximately $5.0 million of expenses and escrows), approximately $205.5 million of which was used to repay our borrowings under our short-term credit facility with Wachovia Bank, N.A. Wachovia Bank is an affiliate of Wachovia Capital Markets, LLC, the initial purchaser of the Class A and Class B notes in the CDO transaction.

The classes of the notes are summarized in the following table:

Class of Notes	**Principal Amount/Face Amount as of Closing Date**	**Percentage of all Securities**	**Ratings Moody's/S&P**	**Stated Maturity**	**Stated Coupon Rate**
A	$ 252,000,000	84.0%	Aaa/AAA	January 2040	4.926%
B	16,500,000	5.5%	Aa2/AA	January 2040	5.036%
C	9,000,000	3.0%	A2/A-	January 2040	5.406%
D	4,500,000	1.5%	Baa2/BBB	January 2040	6.206%
E	3,000,000	1.0%	Baa3/ BBB-	January 2040	6.606%
	$ 285,000,000				

Our effective blended financing rate (inclusive of original issue discount, debt issuance and hedge costs) on the Class A and Class B notes (the classes we did not retain) is approximately 5.66%.

Class designations are descriptive of the security's relative priority among the notes (with letters reflecting descending priority). It is anticipated that the notes will be paid well in advance of the stated maturity date in accordance with the priority of payments in the note indenture. The expected maturity date of the notes is in January 2015, when the notes become subject to the auction call procedure described below.

The notes are non-recourse debt obligations of the issuer and co-issuer. The issuer has pledged its rights under the assets acquired from us and certain other assets as security for payment of principal and interest on the notes.

Payments of principal and interest on the notes will be made quarterly. The aggregate amount available for these payments and for certain expenses of the issuer and co-issuer on any payment date will be the sum of interest proceeds and principal proceeds received on the pledged assets during the relevant collection period.

The initial portfolio of pledged assets are summarized below:

Asset Type	Face Amount	Percentage
Long-term credit tenant loans	$ 199,148,746	66.53%
Corporate credit notes	23,893,987	7.98%
Structured interests in net lease assets	61,285,399	20.48%
Mezzanine loan	15,000,000	5.01%
	$ 299,328,132	100.00%

Until October 2009, principal proceeds and sale proceeds of the pledged assets may be reinvested in qualifying replacement assets, subject to the satisfaction of certain conditions set forth in the indenture.

When we sold the pledged assets to the issuer, we made representations and warranties regarding the assets sold. If any of these representations and warranties are inaccurate, we may be compelled to repurchase the subject assets for the sale price plus accrued interest and certain additional charges, if any.

One of our wholly-owned subsidiaries will act as collateral manager of the issuer’s assets and will be entitled to a management fee of .20% per annum of the issuer’s outstanding portfolio balance. The payment of 50% of the management fee is senior to payments on the notes and the remaining payment of 50% is junior to payments on the notes.

Subject to certain conditions described in the indenture, in January 2008, and on any interest payment date thereafter, the issuer has the option to redeem the notes and the preferred shares, in whole but not in part, at the direction of holders of at least a majority of the aggregate outstanding notional amount of the preferred shares.

The notes are also subject to a mandatory redemption on any interest payment date on which certain coverage tests set forth in the note indenture are not satisfied. Any mandatory redemption of the notes is to be paid from interest and principal proceeds of the pledged assets in accordance with the priority or payments set forth in the indenture, until the applicable coverage tests are satisfied.

As a result of the above mandatory redemption provisions, we are subject to the risk, as owner of the Class C notes, Class D notes and Class E notes, that interest and principal that would otherwise be payable on these subordinate classes may be redirected to pay principal and interest on the senior note classes.

Beginning in January 2015, the notes and the preferred shares may be redeemed (in whole but not in part) if a successful auction of the underlying collateral is completed in accordance with the terms of the indenture (which requires, among other things, that the cash purchase price for such collateral, together with the balance of eligible investments and cash in certain accounts pledged to secure payment of the notes, is at least equal to the amount necessary to redeem the notes and pay certain other required amounts under the priority of payments set forth in the indenture).

If the notes are not redeemed prior to January 2018, interest that would otherwise become payable on the preferred shares will be redirected to the notes in accordance with the priority or payments set forth in the indenture until the notes are paid in full.

The note indenture includes customary events of default, including upon failure to pay principal or interest when due on the notes and a default in the performance of any covenant or other agreement of the issuer or co-issuer (subject to notice and a cure period). If an event of default occurs and is continuing, the trustee may (and will be required to if directed by a majority in outstanding principal amount of each class of notes, voting as separate classes), declare the principal of, and accrued and unpaid interest on, the notes immediately due and payable.

If an event of default and an acceleration of the notes occur and are continuing, the trustee will:

· retain the assets and collect all payments on the assets and continue making payments in accordance with the priority among the notes described in the indenture; or

· if directed to do so by two-thirds of each class of notes (other than notes owned by us), liquidate the assets and make payments on the notes in accordance with the priority among the notes described in the indenture.

To the extent the assets are insufficient to meet payments due on the notes, the obligations of the issuer and the co-issuer will be extinguished.

Statement of Cash Flows

The net cash flow provided by (used in) operating activities decreased from $(1.9) million in the three months ended March 31, 2004, to $(12.3) million for the three months ended March 31, 2005. Our net cash provided by (used in) operating activities reflects adjustments for non-cash items of expenses for amortization of stock-based compensation ($0.4 million and $2.8 million in the periods ended March 31, 2005 and 2004, respectively) and depreciation and amortization ($1.3 million and $0, in the periods ended March 31, 2005 and 2004, respectively). The change from 2004 to 2005 was primarily driven by reductions in deposits and escrows and amounts due to servicers and dealers, partially offset by greater net income (net of the non-cash items discussed above). As part of our CDO issuance, we transferred a number of loan deposits and other escrows to the CDO trustee.

Investing activities used $84.2 million during the period ended March 31, 2005, which primarily resulted from net investments in real estate of $48.9 million, net advances to borrowers of $9.3 million and net investments in CMBS of $30.3 million. Investing activities used $20.5 million during the period ended March 31, 2004, which resulted primarily from advances to borrowers of $12.4 million and purchases of corporate bonds of $29.3 million, partially offset by the redemption of $20.4 million of securities.

Cash provided by financing activities during the period ended March 31, 2005 was $148.9 million, which primarily resulted from borrowings under collateralized debt obligations of $268.1 million, borrowings under mortgages on real estate investments, net of deposits and escrows, of $24.8 million, partially offset by net repayments on repurchase agreements of $125.5 million and funds used in hedging and risk management activities of $9.3 million. Cash provided by financing activities during the period ended March 31, 2004 was $134.8 million, reflecting net proceeds from our initial public offering of $222.8 million (before prepaid offering expenses of approximately $1.0 million) and repayments of our repurchase agreements of $88.1 million.

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

Derivative and Other Risk Management Transactions

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

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

In the quarter ended March 31, 2005, we had no gains or losses on short sales and derivative transactions. In the quarter ended March 31, 2004, we had $0.7 million in loss on short sales and derivative transactions with no sales of net lease loans.

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

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

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

- our ability to invest in additional net lease assets in a timely manner or on acceptable terms;
- our ability to obtain long-term financing for our asset investments at the spread levels we project when we invest in the asset;
- adverse changes in the financial condition of the tenants underlying our net lease investments;
- increases in our financing costs and/or our general and administrative costs;
- changes in our industry, the industries of our tenants, interest rates or the general economy;
- the success of our hedging strategy;
- our ability to raise additional capital to invest in net lease assets;
- the completion of pending net lease loans and/or other net lease investments;
- demand for our products;
- impairments in the value of the collateral underlying our investments;
- the degree and nature of our competition; and
- legislative or regulatory changes, including changes to laws governing the taxation of REITs.

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Interest Rate Exposure.

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

rental income earned and the interest expense on the liabilities associated with the properties. Changes in the level of interest rates may also affect, among other things, our ability to originate or acquire mortgage loans and securities, real estate properties, and the value of our mortgage loans and other assets.

Credit Spread Curve Exposure.

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

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

Tenant Credit Rating Exposure.

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

Equity Price Risk Exposure.

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

Fair Values.

For certain of our financial instruments, fair values are not readily available since there are no active trading markets as characterized by current exchanges between willing parties. Accordingly, we derive or estimate fair values using various valuation techniques, such as computing the present value of estimated future cash flows using discount rates commensurate with the risks involved. However, the determination of estimated cash flows may be subjective and imprecise. Changes in assumptions or estimation methodologies can have a material affect on these estimated fair values. The fair values indicated below are indicative of the interest rate and credit spread environment as of March 31, 2005, and may not take into consideration the effects of subsequent interest rate, credit spread fluctuations, or changes in the ratings of the tenants under related net leases.

The following summarizes certain data regarding our interest rate sensitive instruments as of March 31, 2005:

	Carrying Amount	Notional Amount	Weighted Average Effective Interest Rate	Maturity Date	Fair Value
			(dollars in thousands)		
Assets:					
Mortgage loans held for investment (1)	$ 219,002	$ 217,559	6.72%	Various	$ 223,966
Securities available for sale-CMBS (2)	113,003	126,838	8.99%	2009-2028	113,003
Structuring fees receivable (2)	4,289	N/A	8.10%	2010-2020	4,289
Derivative assets (3)	189	20,942	N/A	N/A	189
Liabilities:					
Repurchase agreements (4)	8,352	8,352	3.17%	Short term	8,352
Mortgage notes payable (5)	147,264	146,468	5.36%	2013-2018	143,550
Collateralized debt obligations (5)	268,130	268,500	5.66%	2015	260,933
Derivative liabilities (3)	—	—	N/A	N/A	—

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

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

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

(4) Our repurchase agreements bear interest at floating rates, and we believe that for similar financial instruments with comparable credit risks, the effective rates approximate market value. Accordingly, the carrying amounts outstanding are believed to approximate fair value.

(5) We estimate the fair value of mortgage notes payable and collateralized debt obligations using a discounted cash flow analysis, based on our estimates of market interest rates. For mortgages where we have an early payment right, we also consider the prepayment amount to evaluate the fair value.

Scheduled maturities of interest rate sensitive instruments as of March 31, 2005 are as follows:

	Expected Maturity Dates					
	2005	**2006**	**2007**	**2008**	**2009**	**thereafter**
	(in thousands, notional amounts where appropriate, otherwise carrying amounts)					
Mortgage loans held for investment	$ 9,356	$ 18,712	$ 13,558	$ 4,730	$ 13,731	$ 157,472
Securities available for sale-CMBS	598	797	868	951	16,007	107,617
Structuring fees receivable	426	609	659	713	772	1,110
Derivative assets	189	—	—	—	—	—
Repurchase agreements	8,352	—	—	—	—	—
Mortgage notes payable	802	1,621	2,099	3,322	3,754	134,870
Collateralized debt obligations	—	—	—	—	—	268,500

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

Item 4. Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

We carried out an evaluation, with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective.

There has been no change in our internal control over financial reporting during the quarter covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we are involved in legal proceedings in the ordinary course of business. The Company is not a party to any material litigation or legal proceedings, or to the best of its knowledge, any threatened litigation or legal proceedings, which, in the opinion of management would have a material adverse effect on its results of operations or financial condition.

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

None.

Item 3. Defaults Upon Senior Securities

None.

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

None.

Item 5. Other Information

None.

Item 6. Exhibits

a. Exhibits

10.1 Real Estate Purchase and Sale Agreement, dated March 2, 2005, by and among Capital Property Associates Limited Partnership, 6116 GP LLC, Capital Property Acceptance LLC, and Caplease, LP

10.2 Indenture, dated as of March 10, 2005, by and among Caplease CDO 2005-1, Ltd., Caplease CDO 2005-1 Corp., Caplease Investment Management, LLC and LaSalle Bank National Association

31.1 Certification of the Registrant's Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of the Registrant's Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

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

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

SIGNATURES

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

CAPITAL LEASE FUNDING, INC.
Registrant

Date: May 16, 2005

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

Date: May 16, 2005

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