

CapLease, Inc.
Form 10-K
March 06, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K
(Mark One)

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

For the fiscal year ended December 31, 2008

OR

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

For the transition period from _____ to _____

Commission file number 001-32039

CAPLEASE, INC.
(Exact Name of Registrant as Specified in its Charter)

Maryland
(State or Other Jurisdiction of
Incorporation or Organization)

52-2414533
(I.R.S. Employer Identification No.)

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

10018
(Zip code)

(212) 217-6300
(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each Class	Name of each exchange on which registered
Common Stock, \$0.01 par value	New York Stock Exchange
8.125% Series A Cumulative Redeemable Preferred Stock, \$0.01 par value	New York Stock Exchange

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Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "accelerated filer," "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

As of June 30, 2008, the aggregate market value of the common stock, \$0.01 par value per share, of CapLease, Inc. ("Common Stock"), held by non-affiliates (outstanding shares, excluding shares held by executive officers and directors) of the registrant was approximately \$324 million, based upon the closing price of \$7.49 on the New York Stock Exchange on such date.

As of February 17, 2009, there were 47,391,790 shares of Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement for the registrant's 2009 Annual Meeting, to be filed within 120 days after the close of the registrant's fiscal year, are incorporated by reference into Part III of this Annual Report on Form 10-K.

TABLE OF CONTENTS

PART I		1
Item 1.	Business	1
Item 1A.	Risk Factors	14
Item 1B.	Unresolved Staff Comments	28
Item 2.	Properties	28
Item 3.	Legal Proceedings	29
Item 4.	Submission of Matters to a Vote of Security Holders	29
PART II		30
Item 5.	Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	30
Item 6.	Selected Financial Data	32
Item 7.	Management’s Discussion and Analysis of Financial Condition and Results of Operations	34
Item 7A.	Quantitative and Qualitative Disclosures about Market Risk	49
Item 8.	Financial Statements and Supplementary Data	54
Item 9.	Changes in and Disagreements With Accountants on Accounting and Financial Disclosure	98
Item 9A.	Controls and Procedures	98
Item 9B.	Other Information	98
PART III		99
Item 10.	Directors, Executive Officers and Corporate Governance	99
Item 11.	Executive Compensation	99
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	99
Item 13.	Certain Relationships and Related Transactions, and Director Independence	99
Item 14.	Principal Accounting Fees and Services	99
PART IV		100
Item 15.	Exhibits and Financial Statement Schedules	100
PART V		104
SIGNATURES		104

Note: Items 10, 11, 12, 13 and 14 are incorporated by reference herein from the Proxy Statement.

Except where otherwise indicated or where the context is clear, the portfolio statistics in Items 1 and 1A of this Form 10-K represent or are calculated from our carry value for financial reporting purposes before depreciation and amortization. With respect to our loan portfolio, we have adjusted our carry value to exclude a \$0.5 million general loss reserve.

PART I.

Item 1. Business.

Explanatory Note for Purposes of the “Safe Harbor Provisions” of Section 21E of the Securities Exchange Act of 1934, as amended

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, which involve certain risks and uncertainties. Our actual results or outcomes may differ materially from those projected. Important factors that we believe might cause such differences are discussed in Item 1A (Risk Factors) of this Form 10-K or otherwise accompany the forward-looking statements contained in this Form 10-K. In assessing all forward-looking statements, readers are urged to read carefully all cautionary statements contained in this Form 10-K.

Overview

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

We have two complimentary business lines: owning single tenant properties and making first mortgage loans and other debt investments on single tenant properties. Tenants underlying our investments are primarily large public companies or their significant operating subsidiaries and governmental entities with investment grade credit ratings, defined as a published senior unsecured credit rating of BBB-/Baa3 or above from one or both of Standard & Poor’s (“S&P”) and Moody’s Investors Service (“Moody’s”). We also imply an investment grade credit rating for tenants that are not publicly rated by S&P or Moody’s but (i) are 100% owned by an investment grade parent, (ii) for which we have obtained a private investment grade rating from either S&P or Moody’s, or (iii) are governmental entity branches or units of another investment grade rated governmental entity.

Our portfolio produces stable, high quality cash flows generated by long-term leases to primarily investment grade tenants. As of December 31, 2008, we had an approximately \$2.1 billion investment portfolio, including the following assets by type:

	Investment(1) (in thousands)	Percentage
Owned properties	\$ 1,656,914	78.6%
Debt investments		
Loans		
Long-term mortgage loans	250,164	11.9%
Corporate credit notes	30,095	1.4%
Mezzanine and other investments	6,804	0.3%
Commercial mortgage-backed and other real estate securities	161,842	7.7%
Other	1,863	0.1%
Total	\$ 2,107,683	100.0%

(1) Here and elsewhere in Item 1 of this Form 10-K, references to our “Investment” represent our carry value for financial reporting purposes before depreciation and amortization. With respect to our loan portfolio, we have adjusted our carry value to exclude a \$0.5 million general loss reserve.

Our primary business objective is to generate stable, long-term and attractive returns based on the spread between the yields generated by our assets and the cost of financing our portfolio. We did not make any new asset investments during the year ended December 31, 2008. As a result of market conditions, the focus of our portfolio activity during 2008 was reducing our debt and strengthening our balance sheet. During 2008, we retired \$64.2 million of principal on our debt, including \$43.6 million of borrowings to Wachovia Bank. We expect the focus of our portfolio activity during 2009 to be continued repayment and/or repurchase of our debt.

We have been in the net lease business since 1994 and completed our initial public offering in March 2004. Prior to our initial public offering, we were primarily a lender focused on originating first mortgage loans on net lease properties and selling substantially all of the loans we originated, either through whole-loan or small pool sales or through gain-on-sale commercial mortgage-backed securitizations.

Investment Strategy

We focus on the following core business strategies:

- Investing in High Quality Cash Flows. We invest primarily in owned real properties and real estate loans where the underlying tenant is of high credit quality. As of December 31, 2008, approximately 90% of our portfolio was invested in properties leased to investment grade or implied investment grade tenants and the weighted average underlying tenant credit rating on our entire portfolio was A-. Further, our top ten tenant exposures, which comprise approximately 50% of our portfolio, were all rated investment grade or implied investment grade and had a weighted average credit rating of A+. As of December 31, 2008, our portfolio had the following credit characteristics:

Credit Rating (1) (2)	Investment (in thousands)	Percentage
Investment grade rating of A- or A3 and above	\$ 935,760	44.3%
Investment grade rating of below A- or A3	707,147	33.6%
Implied investment grade rating	256,416	12.2%
Non-investment grade rating	199,952	9.5%
Unrated (3)	7,383	0.4%
	\$ 2,106,658	100.00%

(1) Reflects the tenant's or lease guarantor's actual or implied S&P rating or equivalent rating if rated only by Moody's, or in the case of our CMBS securities, actual ratings of the securities. Table does not include a development property with a total investment of \$1,025.

(2) Four of our owned real properties where our aggregate investment is \$268,156 are leased to more than one tenant and, for purposes of determining the underlying tenant's credit rating on these properties, we have considered the credit rating of only our primary tenant.

(3) Includes primarily our mezzanine and other investments as described under "Our Portfolio—Loan Investments."

- Long-Term Assets Held for Investment.** We invest in commercial real estate assets subject to long-term leases. As of December 31, 2008, the weighted average underlying tenant remaining lease term on our portfolio was approximately 10 years. We intend to hold our assets for the long-term, capturing the stable cash flows that will be produced from the underlying high credit quality tenants. On a limited and opportunistic basis, we may also continue to acquire and promptly resell assets through our taxable REIT subsidiary. During 2009, we may selectively sell assets in order to enable us to continue to reduce our debt and strengthen our liquidity position.
- Flexible Investment Approach.** We have the expertise and ability to invest at all levels the capital structure of net lease and other single tenant properties. Owned properties comprise approximately 79% of our current portfolio, and our target is to maintain a portfolio mix of 75% to 90% owned real estate, and 10% to 25% mortgage loans and other debt investments. For properties that we own, in addition to high quality tenant credit quality, we also seek to invest in strong real estate locations that will appreciate in value over time.
- Stringent Underwriting Process.** We maintain a comprehensive underwriting and due diligence process that is overseen by our investment committee, which consists of seven of our key employees, including the chief executive officer, president, chief financial officer and chief investment officer. Our investment committee formally reviews and approves each investment we make prior to funding and all portfolio divestitures. We also have an investment

oversight committee of the Board of Directors that approves investments in excess of \$50 million.

- Finance with Long-Term Fixed Rate Debt. We seek to borrow against, or finance, our assets with long-term fixed rate debt, effectively locking in the spread we expect to generate on our assets. Our financing strategy allows us to invest in a greater number of assets and enhance our asset returns. As a result of market conditions, the focus of our portfolio activity during 2008 was reducing our debt and strengthening our balance sheet. During 2008, we retired \$64.2 million of principal on our debt, including \$43.6 million of borrowings to Wachovia Bank. We expect the focus of our portfolio activity during 2009 to be continued repayment and/or repurchase of our debt.

Our Competitive Strengths

- Established Investment Capabilities. We have an experienced in-house team of investment professionals that source, structure, underwrite and close our transactions. In addition, we have developed an extensive national network of property owners, investment sale brokers, tenants, borrowers, mortgage brokers, lenders, institutional investors and other market participants that helps us to identify and originate a variety of single tenant investment opportunities.

- **Experienced Senior Management Team.** Our senior management team has worked together for more than 14 years. Over this period, we have built and maintain today a strong credit philosophy and underwriting discipline. Since our initial public offering in March 2004, we have purchased \$1.7 billion of single tenant properties. Since 1996, we have originated and underwritten more than \$4.0 billion in single tenant transactions, involving more than 500 properties with more than 100 underlying tenants.
- **Financing Expertise.** We have substantial experience in financing single tenant assets. We have developed and continue to enhance financing structures that have enabled us to efficiently finance a portion of our owned properties through term loan and securitization transactions. These financing structures enable us to enhance the returns on our portfolio without reducing credit quality in search of yield.
- **Market Expertise.** We have recognized expertise in the net lease marketplace. In February 2005, we received a U.S. patent for our 10-year credit tenant loan product. In addition to serving as one of our loan products, we use this product to finance a portion of our owned property investments. We developed the specialized lease enhancement mechanisms that are utilized in net lease lending transactions.

Our Portfolio

Owned Properties

Owned properties comprise approximately 79% of our current portfolio. All of our owned properties have been acquired since the closing of our initial public offering. We invest in most commercial property types (e.g., office, warehouse, GSA and retail), and our investment underwriting includes an analysis of the credit quality of the underlying tenant and the strength of the related lease. We also analyze the property's real estate fundamentals, including location and type of the property, vacancy rates and trends in vacancy rates in the property's market, rental rates within the property's market, recent sales prices and demographics in the property's market. We believe that over time, the value of our owned real estate will appreciate. For more detail on our underwriting process, please see "Underwriting Process" below. We target properties that have one or more of the following characteristics:

- included in primary metropolitan markets such as Philadelphia, Washington D.C., Chicago and New York/New Jersey;
 - fungible asset type that will facilitate a re-let of the property if the tenant does not renew;
- barriers to entry in the property's market, such as zoning restrictions or limited land for future development; and
 - core facility of the tenant.

As of December 31, 2008, we had an approximately \$1.7 billion owned property portfolio. We believe the strength of this portfolio is exhibited by the following:

- approximately 10.6 million rentable square feet with 99.8% occupancy;
- 63 properties in 26 states leased to 34 different tenants;
- no tenant represents more than five percent of our entire portfolio, except the United States Government at 10.3% and Nestlé Holdings, Inc. at 9.4%;
 - 94% investment grade or implied investment grade tenants;