GETTY REALTY CORP /MD/
Form 10-Q
November 09, 2007

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

FORM 10-Q

(Mark one)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended **September 30, 2007**

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 **001-13777**

GETTY REALTY CORP.
(Exact name of registrant as specified in its charter)

MARYLAND	**11-3412575**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

125 Jericho Turnpike, Suite 103
Jericho, New York 11753
(Address of principal executive offices)
(Zip Code)

(516) 478 - 5400
(Registrant's telephone number, including area code)

____

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act.
Large Accelerated Filer [ ] Accelerated Filer [X] Non-Accelerated Filer [ ]

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

Registrant had outstanding 24,764,875 shares of Common Stock, par value $.01 per share, as of November 6, 2007.

GETTY REALTY CORP.

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GETTY REALTY CORP. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)
(unaudited)

Assets:	*September 30, 2007*	*December 31, 2006*
Real Estate:		
Land	$ 222,497	$ 180,409
Buildings and improvements	251,597	203,149
	474,094	383,558
Less – accumulated depreciation and amortization	(120,586)	(116,089)
Real estate, net	353,508	267,469
Deferred rent receivable	34,219	32,297
Cash and cash equivalents	1,504	1,195
Recoveries from state underground storage tank funds, net	4,409	3,845
Mortgages and accounts receivable, net	4,612	3,440
Prepaid expenses and other assets	6,412	1,037
Total assets	$ 404,664	$ 309,283
Liabilities and Shareholders' Equity:		
Debt	$ 128,820	$ 45,194
Environmental remediation costs	19,581	17,201
Dividends payable	11,538	11,284
Accounts payable and accrued expenses	20,422	10,029
Total liabilities	180,361	83,708
Commitments and contingencies	--	--
Shareholders' equity:		
Common stock, par value $.01 per share; authorized 50,000,000 shares; issued 24,764,875 at September 30, 2007 and 24,764,765 at December 31, 2006	248	248
Paid-in capital	258,837	258,647
Dividends paid in excess of earnings	(33,558)	(32,499)
Accumulated other comprehensive loss	(1,224)	(821)
Total shareholders' equity	224,303	225,575
Total liabilities and shareholders' equity	$ 404,664	$ 309,283

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

GETTY REALTY CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(unaudited)

	Three months ended September 30,		*Nine months ended September 30,*	
	2007	*2006*	*2007*	*2006*
Revenues from rental properties	$ 20,255	$ 17,994	$ 58,823	$ 54,112
Expenses:				
Rental property expenses	2,295	2,404	7,082	7,370
Environmental expenses, net	2,838	1,638	6,862	3,528
General and administrative expenses	1,525	1,383	4,758	4,123
Depreciation and amortization expense	2,598	1,886	7,164	5,787
Total expenses	9,256	7,311	25,866	20,808
Operating income	10,999	10,683	32,957	33,304
Other income, net	1,419	809	1,809	1,367
Interest expense	(2,314)	(979)	(5,502)	(2,607)
Net earnings before income taxes and discontinued operations	10,104	10,513	29,264	32,064
Income tax benefit	-	700	-	700
Net earnings before discontinued operations	10,104	11,213	29,264	32,764
Discontinued operations:				
Net earnings from discontinued operations	144	63	272	155
Gains on dispositions of real estate from discontinued operations	2,598	-	3,771	-
Net earnings from discontinued operations	2,742	63	4,043	155
Net earnings	$ 12,846	$ 11,276	$ 33,307	$ 32,919
Basic earnings per common share:				
Net earnings before discontinued operations	$ .41	$ .46	$ 1.18	$ 1.32
Discontinued operations	.11	-	.16	.01
Net earnings	$ .52	$ .46	$ 1.34	$ 1.33
Diluted earnings per common share:				
	$ .41	$ .46	$ 1.18	$ 1.32

Net earnings before discontinued operations								
Discontinued operations		.11		-		.16		.01
Net earnings	$	.52	$	.46	$	1.34	$	1.33
Weighted average shares outstanding:								
Basic		24,765		24,739		24,765		24,727
Stock options and restricted stock units		27		25		23		25
Diluted		24,792		24,764		24,788		24,752
Dividends declared per share	$	.465	$	.455	$	1.385	$	1.365

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

GETTY REALTY CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)
(unaudited)

	Three months ended September 30,		*Nine months ended September 30,*	
	2007	*2006*	*2007*	*2006*
Net earnings	$ 12,846	$ 11,276	$ 33,307	$ 32,919
Other comprehensive loss:				
Net unrealized loss on interest rate swap	(1,033)	(1,071)	(403)	(894)
Comprehensive income	$ 11,813	$ 10,205	$ 32,904	$ 32,025

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

GETTY REALTY CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Nine months ended September 30,	
	2007	*2006*
Cash flows from operating activities:		
Net earnings	$ 33,307	$ 32,919
Adjustments to reconcile net earnings to net cash flow provided by operating activities:		
Depreciation and amortization expense	7,186	5,803
Deferred rental revenue	(1,922)	(2,345)
Net amortization of above-market and below-market leases	(942)	-
Gains on dispositions of real estate	(5,386)	(1,152)
Accretion expense	648	576
Stock-based employee compensation expense	188	137
Changes in assets and liabilities:		
Recoveries from state underground storage tank funds, net	(287)	457
Mortgages and accounts receivable, net	(1,402)	(1,000)
Prepaid expenses and other assets	323	354
Environmental remediation costs	1,455	(935)
Accounts payable and accrued expenses	474	(207)
Accrued income taxes	-	(700)
Net cash flow provided by operating activities	33,642	33,907
Cash flows from investing activities:		
Property acquisitions and capital expenditures	(89,354)	(15,512)
Collection (issuance) of mortgages receivable, net	230	(84)
Proceeds from dispositions of real estate	7,138	1,813
Net cash flow used in investing activities	(81,986)	(13,783)
Cash flows from financing activities:		
Borrowings under credit agreement, net	83,650	12,500
Cash dividends paid	(34,112)	(33,542)
Credit agreement origination costs	(863)	-
Repayment of mortgages payable	(24)	(23)
Proceeds from stock options exercised	2	647
Net cash flow provided by (used in) financing activities	48,653	(20,418)
Net increase in cash and cash equivalents	309	(294)
Cash and cash equivalents at beginning of period	1,195	1,247
Cash and cash equivalents at end of period	$ 1,504	$ 953
Supplemental disclosures of cash flow information		
Cash paid (refunded) during the year for:		

Interest	$	3,961	$	1,785
Income taxes, net		490		472
Recoveries from state underground storage tank funds		(1,244)		(1,396)
Environmental remediation costs		3,779		3,283

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

GETTY REALTY CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. General:

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (“GAAP”). The consolidated financial statements include the accounts of Getty Realty Corp. and its wholly-owned subsidiaries (the "Company"). The Company is a real estate investment trust (“REIT”) specializing in the ownership and leasing of retail motor fuel and convenience store properties and petroleum distribution terminals. The Company manages and evaluates its operations as a single segment. All significant intercompany accounts and transactions have been eliminated.

The financial statements have been prepared in conformity with GAAP, which requires the Company’s management to make its best estimates, judgments and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the period reported. While all available information has been considered, actual results could materially differ from those estimates, judgments and assumptions. Estimates, judgments and assumptions underlying the accompanying consolidated financial statements include, but are not limited to, deferred rent receivable, recoveries from state underground storage tank funds, environmental remediation costs, real estate, depreciation and amortization, impairment of long-lived assets, litigation, accrued expenses and income taxes.

The operating results and gains from certain dispositions of real estate are reclassified as discontinued operations. The operating results of such properties for the three and nine months ended September 30, 2006 have been reclassified to discontinued operations to conform to the 2007 presentation. Discontinued operations for the quarter and nine months ended September 30, 2007 are primarily comprised of gains or losses from five and seven property dispositions, respectively. The revenue from rental properties and expenses related to these properties are insignificant for the three and nine months ended September 30, 2007 and 2006.

The consolidated financial statements are unaudited but, in the Company’s opinion, reflect all adjustments (consisting of normal recurring accruals) necessary for a fair statement of the results for the periods presented. These statements should be read in conjunction with the consolidated financial statements and related notes, which appear in the Company’s Annual Report on Form 10-K for the year ended December 31, 2006.

2. Commitments and Contingencies:

In order to minimize the Company’s exposure to credit risk associated with financial instruments, the Company places its temporary cash investments with high credit quality institutions. Temporary cash investments, if any, are held in overnight bank time deposits and an institutional money market fund.

As of September 30, 2007, the Company leased eight hundred ninety-five of its one thousand eighty-five properties on a long-term net basis to Getty Petroleum Marketing Inc. (“Marketing”) under a master lease (“Master Lease”) and supplemental leases for four properties (collectively the “Marketing Leases”) (see note 2 to the consolidated financial statements which appear in the Company’s Annual Report on Form 10-K for the year ended December 31, 2006). A substantial portion of our revenues (75% for the three months ended September 30, 2007), are derived from the Marketing Leases. Marketing operated substantially all of the Company’s petroleum marketing businesses when it was spun-off to the Company’s shareholders as a separate publicly held company in March 1997 (the “Spin-off”). In December 2000, Marketing was acquired by a subsidiary of OAO Lukoil, one of Russia’s largest integrated oil companies. The Company’s financial results depend largely on rental income from Marketing, and to a lesser extent on rental income from other tenants, and are therefore materially dependent upon the ability of Marketing to meet its obligations under the Marketing Leases. A substantial portion of the deferred rent receivable, $32,041,000 of the $34,219,000 recorded as of September 30, 2007, is due to recognition of rental revenue on a straight-line basis under the Marketing Leases. Marketing’s financial results depend largely on retail petroleum marketing margins and rental income from its sub-tenants who operate their convenience store, automotive repair services or other businesses at the Company’s properties, most of whom were the Company’s tenants when Marketing was spun-off to the Company’s shareholders. The petroleum marketing industry has been and continues to be volatile and highly competitive. Marketing has made all required monthly rental payments under the Marketing Leases when due. The Company has noted a significant decline in Marketing’s annual financial results based on the financial statements and other financial data Marketing has provided to date. No assurance can be given that Marketing will have the ability to pay its debts and meet its rent and other financial obligations under the Marketing Leases as they become due. Although Marketing is wholly owned by a subsidiary of Lukoil and Lukoil has provided capital, and we believe currently provides credit enhancement, to Marketing, Lukoil is not a guarantor of the Marketing Leases and no assurance can be given that Lukoil will provide any credit enhancement or additional capital to Marketing for the remainder of the terms of the Marketing Leases or otherwise cause Marketing to fulfill any of its rental or other financial obligations under the Marketing Leases.

While the initial term of the Marketing Leases are effective through December 2015, representatives of Marketing have indicated to the Company their desire to modify the Marketing Leases to (i) remove a significant number of properties from the Marketing Leases and eliminate Marketing’s payment of rent to the Company with respect to those properties and eliminate or reduce Marketing’s direct payment of operating expenses with respect to those properties, and (ii) reduce the aggregate amount of rent paid to the Company for the properties remaining under the Marketing Leases. The effect of any such modification may significantly reduce the amount of rent we receive from Marketing and increase the Company’s operating expenses. We can not accurately predict whether or when the Marketing Leases will be modified or, what the terms of any such agreement may be if the Marketing Leases are modified.

The Company continues to believe that the deferred rent receivable recorded under the straight-line method of accounting for the Marketing Leases referred to above is collectable when due. Given the uncertainties regarding a possible modification to the Marketing Leases, the Company believes it is reasonably possible that its assumption that Marketing will make all contractual lease payments during the initial term of the Marketing Leases when due, when applying the straight-line method of accounting for rental revenue, may change, which may result in an adjustment to the deferred rent receivable that could be material to the Company’s financial condition or results of operations for any single fiscal year or interim period. Although the Company is the owner of the properties and the Getty brand and has prior experience with Marketing’s tenants, in the event that properties are removed from the Marketing Leases, the Company can not accurately predict whether, when or on what terms such properties could be re-let or sold. Accordingly, a significant modification of the Marketing Leases could materially adversely affect the Company’s financial condition, revenues, operating expenses and results of operations.

Under the Master Lease, the Company has also agreed to provide limited environmental indemnification to Marketing, capped at $4,250,000 and expiring in 2010, for certain pre-existing conditions at six of the terminals which are owned by the Company. Under the agreement, Marketing will pay the first $1,500,000 of costs and expenses incurred in connection with remediating any such pre-existing conditions, Marketing and the Company will share equally the next $8,500,000 of those costs and expenses and Marketing will pay all additional costs and expenses over $10,000,000. The Company has accrued $300,000 as of September 30, 2007 and December 31, 2006 in connection with this indemnification agreement.

The Company is subject to various legal proceedings and claims which arise in the ordinary course of its business. In addition, the Company has retained responsibility for certain legal proceedings and claims relating to the petroleum marketing business that were identified at the time of the spin-off. The Company accrues its allocable share of joint and several environmental liabilities based on its estimate of the ultimate allocation method and percentage that will be used by the responsible parties. As of September 30, 2007 and December 31, 2006 the Company had accrued $2,632,000 and $2,822,000, respectively, for certain of these matters which it believes were appropriate based on information then currently available. The Company has not accrued for approximately $950,000 in costs allegedly incurred by the current property owner in connection with removal of USTs and soil remediation at a property that was leased to and operated by Marketing. Marketing is responsible for such costs under the terms of the Master Lease but Marketing has denied its liability for the claim and its responsibility to defend against, and indemnify the Company for, the claim. It is reasonably possible that the Company’s assumption that Marketing will be ultimately responsible for the claim may change, which may result in the Company providing an accrual for this matter. Although the ultimate resolution of these matters may have a significant impact on results of operations for any single fiscal year or interim period, the Company currently believes that such matters will not have a material adverse effect on the Company’s long-term financial position.

In September 2003, the Company was notified by the State of New Jersey Department of Environmental Protection that the Company is one of approximately sixty potentially responsible parties for natural resource damages resulting from discharges of hazardous substances into the Lower Passaic River. The definitive list of potentially responsible parties and their actual responsibility for the alleged damages, the aggregate cost to remediate the Lower Passaic River, the amount of natural resource damages and the method of allocating such amounts among the potentially responsible parties have not been determined. In September 2004, the Company received a General Notice Letter from the United States Environmental Protection Agency (the “EPA”) (the “EPA Notice”), advising the Company that it may be a potentially responsible party for costs of remediating certain conditions resulting from discharges of hazardous substances into the Lower Passaic River. ChevronTexaco received the same EPA Notice regarding those same conditions. Additionally, the Company believes that ChevronTexaco is contractually obligated to indemnify the Company, pursuant to an indemnification agreement, for most of the conditions at the property identified by the New Jersey Department of Environmental Protection and the EPA. Accordingly, the ultimate legal and financial liability of the Company, if any, cannot be estimated with any certainty at this time.

From October 2003 through September 2007 the Company was notified that the Company was made party to forty-nine cases, in Connecticut, Florida, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Vermont, Virginia and West Virginia brought by local water providers or governmental agencies. These cases allege various theories of liability due to contamination of groundwater with MTBE as the basis for claims seeking compensatory and punitive damages. Each case names as defendants approximately fifty petroleum refiners, manufacturers, distributors and retailers of MTBE, or gasoline containing MTBE. The accuracy of the allegations as they relate to the Company, its defenses to such claims, the aggregate amount of damages, the definitive list of defendants and the method of allocating such amounts among the defendants have not been determined. Accordingly, the ultimate legal and financial liability of the Company, if any, cannot be estimated with any certainty at this time.

Prior to the spin-off, the Company was self-insured for workers' compensation, general liability and vehicle liability up to predetermined amounts above which third-party insurance applies. As of September 30, 2007 and December 31, 2006, the Company's consolidated balance sheets included, in accounts payable and accrued expenses, $313,000 and $332,000, respectively, relating to self-insurance obligations. The Company estimates its loss reserves for claims, including claims incurred but not reported, by utilizing actuarial valuations provided annually by its insurance carriers. The Company is required to deposit funds for substantially all of these loss reserves with its insurance carriers, and may be entitled to refunds of amounts previously funded, as the claims are evaluated on an annual basis. Although loss reserve adjustments may have a significant impact on results of operations for any single fiscal year or interim period, the Company currently believes that such adjustments will not have a material adverse effect on the Company's long-term financial position. Since the spin-off, the Company has maintained insurance coverage subject to certain deductibles.

In order to qualify as a REIT, among other items, the Company must pay out substantially all of its "earnings and profits" (as defined in the Internal Revenue Code) in cash distributions to shareholders each year. Should the Internal Revenue Service successfully assert that the Company's earnings and profits were greater than the amounts distributed, the Company may fail to qualify as a REIT; however, the Company may avoid losing its REIT status by paying a deficiency dividend to eliminate any remaining earnings and profits. The Company may have to borrow money or sell assets to pay such a deficiency dividend. The Company accrues for this and other uncertain tax matters when appropriate based on information currently available. The accrual for uncertain tax positions is adjusted as circumstances change and as the uncertainties become more clearly defined, such as when audits are settled or exposures expire. Accordingly, an income tax benefit of $700,000 was recorded in the third quarter of 2006 due to the elimination of the amount accrued for uncertain tax positions since the Company believes that the uncertainties regarding these exposures have been resolved or that it is no longer likely that the exposure will result in a liability upon review. However, the ultimate resolution of these matters may have a significant impact on the results of operations for any single fiscal year or interim period. In June 2006 the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48 ("FIN 48") "Accounting for Uncertainty in Income Taxes." FIN 48 addresses the recognition and measurement of tax positions taken or expected to be taken in a tax return. The adoption of FIN 48 in January 2007 did not have any impact on the Company's financial position or results of operation.

3. Environmental Expenses

The Company is subject to numerous existing federal, state and local laws and regulations, including matters relating to the protection of the environment such as the remediation of known contamination and the retirement and decommissioning or removal of long-lived assets including buildings containing hazardous materials, USTs and other equipment. Environmental expenses are principally attributable to remediation costs which include installing, operating, maintaining and decommissioning remediation systems, monitoring contamination, and governmental agency reporting incurred in connection with contaminated properties.

The Company enters into leases and various other agreements which define its share of joint and several environmental liabilities and commitments by establishing the percentage and method of allocating responsibility between the parties. Uncertainties related to the determination of the Company’s share of net environmental costs include, among others, determining when known environmental contamination may have occurred and the effectiveness of remediation efforts to date, determining when costs associated with asset retirement obligations will be incurred and predicting who the responsible party will be at that time and the interpretation and enforceability of, or potential modifications to, the various agreements, including the Marketing Leases. It is possible that the Company’s assumptions regarding the ultimate allocation method and its share of responsibility that are used when accruing its allocable share of joint and several environmental liabilities, may change, which may result in adjustments to the amounts recorded for environmental litigation accruals, environmental remediation liabilities and related assets. Although the ultimate resolution of these matters may have a significant impact on results of operations for any single fiscal year or interim period, the Company currently believes that such matters will not have a material adverse effect on the Company’s long-term financial position.

Environmental remediation liabilities and related assets are measured at fair value based on their expected future cash flows which have been adjusted for inflation and discounted to present value. For the three and nine months ended September 30, 2007, the net change in estimated remediation costs included in environmental expenses in the Company’s consolidated statements of operations were $1,899,000 and $4,352,000, respectively, as compared to $1,159,000 and $1,985,000, respectively, for the comparable prior year periods, which amounts were net of changes in estimated recoveries from state underground storage tank (“UST”) remediation funds. In addition to net change in estimated remediation costs, environmental expenses also include project management fees, legal fees and provisions for environmental litigation loss reserves.

In accordance with the leases with certain tenants, the Company has agreed to bring the leased properties with known environmental contamination to within applicable standards and to regulatory or contractual closure (“Closure”) in an efficient and economical manner. Generally, upon achieving Closure at each individual property, the Company’s environmental liability under the lease for that property will be satisfied and future remediation obligations will be the responsibility of the Company’s tenant. Generally the liability for the retirement and decommissioning or removal of USTs and other equipment is the responsibility of the Company’s tenants. The Company is contingently liable for these obligations in the event that the tenants do not satisfy their responsibilities. A liability has not been accrued for obligations that are the responsibility of the Company’s tenants.

Of the eight hundred ninety-five properties leased to Marketing, the Company has agreed to pay all costs relating to, and to indemnify Marketing for, certain environmental liabilities and obligations for two hundred nineteen properties that have not achieved Closure as of September 30, 2007 and are scheduled in the Master Lease. The Company will continue to seek reimbursement from state UST remediation funds related to these environmental expenditures where available.

The estimated future costs for known environmental remediation requirements are accrued when it is probable that a liability has been incurred and a reasonable estimate of fair value can be made. The environmental remediation liability is estimated based on the level and impact of contamination at each property. The accrued liability is the aggregate of the best estimate of the fair value of cost for each component of the liability. Recoveries of environmental costs from state UST remediation funds, with respect to both past and future environmental spending, are