

REALTY INCOME CORP
Form 10-Q
July 25, 2013
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2013, or

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

Commission File Number 1-13374

REALTY INCOME CORPORATION

(Exact name of registrant as specified in its charter)

Maryland

33-0580106

Edgar Filing: REALTY INCOME CORP - Form 10-Q

(State or Other Jurisdiction of
Incorporation or Organization)

(IRS Employer Identification
Number)

600 La Terraza Boulevard, Escondido, California 92025-3873

(Address of Principal Executive Offices)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, 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

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

There were 196,168,085 shares of common stock outstanding as of July 17, 2013.

Table of Contents

REALTY INCOME CORPORATION

Form 10-Q

June 30, 2013

TABLE OF CONTENTS

PART I.	<u>FINANCIAL INFORMATION</u>	<u>Page</u>
<u>Item 1:</u>	<u>Financial Statements</u>	
	<u>Consolidated Balance Sheets</u>	3
	<u>Consolidated Statements of Income</u>	4
	<u>Consolidated Statements of Cash Flows</u>	5
	<u>Notes to Consolidated Financial Statements</u>	6
<u>Item 2:</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	
	<u>Forward-Looking Statements</u>	25
	<u>The Company</u>	26
	<u>Recent Developments</u>	30
	<u>Liquidity and Capital Resources</u>	34
	<u>Results of Operations</u>	40
	<u>Funds from Operations Available to Common Stockholders (FFO) And Normalized Funds from Operations Available to Common Stockholders (Normalized FFO)</u>	46
	<u>Adjusted Funds from Operations Available to Common Stockholders (AFFO)</u>	48
	<u>Property Portfolio Information</u>	50
	<u>Impact of Inflation</u>	57
	<u>Impact of Recent Accounting Pronouncements</u>	57
	<u>Other Information</u>	57
<u>Item 3:</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	58
<u>Item 4:</u>	<u>Controls and Procedures</u>	59
<u>PART II.</u>	<u>OTHER INFORMATION</u>	
<u>Item 1:</u>	<u>Legal Proceedings</u>	60
<u>Item 1A:</u>	<u>Risk Factors</u>	60
<u>Item 2:</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	60
<u>Item 6:</u>	<u>Exhibits</u>	60
<u>SIGNATURE</u>		64

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

REALTY INCOME CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

June 30, 2013 and December 31, 2012

(dollars in thousands, except per share data)

	2013 (unaudited)	2012
ASSETS		
Real estate, at cost:		
Land	\$ 2,539,628	\$ 1,999,820
Buildings and improvements	6,672,354	3,920,865
Total real estate, at cost	9,211,982	5,920,685
Less accumulated depreciation and amortization	(998,079)	(897,767)
Net real estate held for investment	8,213,903	5,022,918
Real estate held for sale, net	16,808	19,219
Net real estate	8,230,711	5,042,137
Cash and cash equivalents	22,575	5,248
Accounts receivable, net	27,507	21,659
Acquired lease intangible assets, net	972,049	242,125
Goodwill	15,834	16,945
Other assets, net	146,857	115,249
Total assets	\$ 9,415,533	\$ 5,443,363
LIABILITIES AND EQUITY		
Distributions payable	\$ 39,280	\$ 23,745
Accounts payable and accrued expenses	77,411	70,426
Acquired lease intangible liabilities, net	116,381	26,471
Other liabilities	29,266	26,059
Lines of credit payable	701,000	158,000
Mortgages payable, net	827,109	175,868
Term loan	70,000	-
Notes payable	2,450,000	2,550,000
Total liabilities	4,310,447	3,030,569
Commitments and contingencies		
Stockholders' equity:		
Preferred stock and paid in capital, par value \$0.01 per share, 69,900,000 shares authorized and 25,150,000 shares issued and outstanding as of June 30, 2013 and December 31, 2012	609,363	609,363
Common stock and paid in capital, par value \$0.01 per share, 370,100,000 shares authorized, 196,265,884 shares issued and outstanding as of June 30, 2013 and 133,452,411 shares issued and outstanding at December 31, 2012	5,329,715	2,572,092
Distributions in excess of net income	(870,199)	(768,661)
Total stockholders' equity	5,068,879	2,412,794
Noncontrolling interests	36,207	-
Total equity	5,105,086	2,412,794

Edgar Filing: REALTY INCOME CORP - Form 10-Q

Total liabilities and equity	\$	9,415,533	\$	5,443,363
------------------------------	----	-----------	----	-----------

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

Table of Contents

REALTY INCOME CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

For the three and six months ended June 30, 2013 and 2012

(dollars in thousands, except per share data)(unaudited)

	Three Months Ended			Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012	
REVENUE					
Rental	\$ 182,354	\$ 112,528	\$ 352,104	\$ 224,020	
Other	1,965	605	3,356	858	
Total revenue	184,319	113,133	355,460	224,878	
EXPENSES					
Depreciation and amortization	77,698	34,742	147,280	69,093	
Interest	39,100	28,806	80,567	57,758	
General and administrative	12,075	9,273	23,688	18,440	
Property	3,283	1,746	6,899	3,668	
Income taxes	722	405	1,393	810	
Merger-related costs	605	-	12,635	-	
Total expenses	133,483	74,972	272,462	149,769	
Income from continuing operations	50,836	38,161	82,998	75,109	
Income from discontinued operations	3,911	5,246	43,562	7,562	
Net income	54,747	43,407	126,560	82,671	
Net income attributable to noncontrolling interests	(77)	-	(86)	-	
Net income attributable to the Company	54,670	43,407	126,474	82,671	
Preferred stock dividends	(10,482)	(10,457)	(20,965)	(19,953)	
Excess of redemption value over carrying value of preferred shares redeemed (see note 10)	-	-	-	(3,696)	
Net income available to common stockholders	\$ 44,188	\$ 32,950	\$ 105,509	\$ 59,022	
Amounts available to common stockholders per common share:					
Income from continuing operations:					
Basic	\$ 0.21	\$ 0.21	\$ 0.34	\$ 0.39	
Diluted	\$ 0.21	\$ 0.21	\$ 0.34	\$ 0.39	
Net income:					
Basic	\$ 0.23	\$ 0.25	\$ 0.57	\$ 0.44	
Diluted	\$ 0.23	\$ 0.25	\$ 0.57	\$ 0.44	
Weighted average common shares outstanding:					
Basic	195,574,014	132,592,939	183,714,191	132,643,698	
Diluted	196,099,610	132,828,540	184,165,700	132,785,213	

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

Table of Contents

REALTY INCOME CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the six months ended June 30, 2013 and 2012

(dollars in thousands)(unaudited)

	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 126,560	\$ 82,671
Adjustments to net income:		
Depreciation and amortization	147,280	69,093
Income from discontinued operations	(43,562)	(7,562)
Amortization of share-based compensation	7,498	5,550
Amortization of net premiums on mortgages payable	(4,441)	(168)
Other non-cash adjustments	-	(301)
Cash provided by discontinued operations	2,777	5,489
Change in assets and liabilities:		
Accounts receivable and other assets	(2,424)	1,820
Accounts payable, accrued expenses and other liabilities	(12,255)	(659)
Net cash provided by operating activities	221,433	155,933
CASH FLOWS FROM INVESTING ACTIVITIES		
Acquisition of investment properties, net of cash received	(748,374)	(219,554)
Improvements to real estate, including leasing costs	(3,294)	(2,405)
Proceeds from sales of real estate:		
Continuing operations	8	-
Discontinued operations	76,333	18,549
Loans receivable	(9,584)	(3,795)
Restricted escrow deposits for Section 1031 tax-deferred exchanges, pending acquisitions and other deposits	(14,448)	(6,449)
Net cash used in investing activities	(699,359)	(213,654)
CASH FLOWS FROM FINANCING ACTIVITIES		
Cash distributions to common stockholders	(191,669)	(116,552)
Cash dividends to preferred stockholders	(20,965)	(18,480)
Borrowings on line of credit	1,533,200	377,400
Payments on line of credit	(990,200)	(431,200)
Principal payment on notes payable	(100,000)	-
Principal payments on mortgages	(2,674)	(10,952)
Proceeds from term loan	70,000	-
Proceeds from common stock offering, net	755,136	-
Proceeds from preferred stock offerings, net	-	395,377
Redemption of preferred stock	-	(127,500)
Repayment of line of credit, previously belonging to ARCT	(317,207)	-
Repayment of term loan, previously belonging to ARCT	(235,000)	-
Distributions to noncontrolling interests	(287)	-
Debt issuance costs	(511)	(7,058)
Proceeds from dividend reinvestment and stock purchase plan, net	1,912	1,548
Other items	(6,482)	(2,963)
Net cash provided by financing activities	495,253	59,620
Net increase in cash and cash equivalents	17,327	1,899
Cash and cash equivalents, beginning of period	5,248	4,165
Cash and cash equivalents, end of period	\$ 22,575	\$ 6,064

For supplemental disclosures, see note 18.

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

Table of Contents

REALTY INCOME CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(unaudited)

1. Management Statement

The consolidated financial statements of Realty Income Corporation (Realty Income , the Company , we , our or us) were prepared from our books and records without audit and include all adjustments (consisting of only normal recurring accruals) necessary to present a fair statement of results for the interim periods presented. Readers of this quarterly report should refer to our audited consolidated financial statements for the year ended December 31 , 2012, which are included in our 2012 Annual Report on Form 10-K, as certain disclosures that would substantially duplicate those contained in the audited financial statements have not been included in this report.

We report, in discontinued operations, the results of operations of properties that have either been sold or are classified as held for sale. Additionally, due to materiality thresholds, we have separately reported acquired lease intangible assets and liabilities, which were previously reported as a portion of other assets, net and other liabilities, net, respectively, on our consolidated balance sheets. As a result, certain of the 2012 balances have been reclassified to conform to the 2013 presentation.

At June 30, 2013, we owned 3,681 properties, located in 49 states and Puerto Rico, containing over 58.3 million leasable square feet, along with four properties owned by our wholly-owned taxable REIT subsidiary, Crest Net Lease, Inc., or Crest.

2. Summary of Significant Accounting Policies and Procedures

A. The accompanying consolidated financial statements include the accounts of Realty Income and other entities for which we make operating and financial decisions (i.e., control), after elimination of all material intercompany balances and transactions. We consolidate entities that we control and record a noncontrolling interest for the portion that we do not own. Noncontrolling interest that was created or assumed as part of a business combination was recognized at fair value as of the date of the transaction (see notes 4 and 12). We have no unconsolidated investments.

B. We have elected to be taxed as a real estate investment trust, or REIT, under the Internal Revenue Code of 1986, as amended, or the Code. We believe we have qualified and continue to qualify as a REIT. Under the REIT operating structure, we are permitted to deduct dividends paid to our stockholders in determining our taxable income. Assuming our dividends equal or exceed our net income, we generally will not be required to pay federal corporate income taxes on such income. Accordingly, no provision has been made for federal income taxes in the accompanying consolidated financial statements, except for federal income taxes of our

Edgar Filing: REALTY INCOME CORP - Form 10-Q

taxable REIT subsidiaries, which are included in discontinued operations. The income taxes recorded on our consolidated statements of income represent amounts paid by Realty Income for city and state income and franchise taxes.

C. We recognize an allowance for doubtful accounts relating to accounts receivable for amounts deemed uncollectible. We consider tenant specific issues, such as financial stability and ability to pay rent, when determining collectability of accounts receivable and appropriate allowances to record. The allowance for doubtful accounts was \$399,000 at June 30, 2013 and \$448,000 at December 31, 2012.

D. We assign a portion of goodwill to our property sales, which results in a reduction of the carrying amount of our goodwill. In order to allocate goodwill to the carrying amount of properties that we sell, we utilize a relative fair value approach based on the original methodology for assigning goodwill. As we sell properties, our goodwill will likely continue to gradually decrease over time.

Table of Contents

E. Under the amendments issued in conjunction with *ASU No. 2011-08, Intangibles - Goodwill and Other (Topic 350)*, an entity, through an assessment of qualitative factors, is not required to calculate the estimated fair value of a reporting unit, in connection with two-step goodwill impairment test, unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. Despite the issuance of ASU No. 2011-08, we elected to continue testing goodwill for impairment during the second quarter of each year as well as when events or circumstances occur, indicating that our goodwill might be impaired. During our tests for impairment of goodwill during the second quarters of 2013 and 2012, we determined that the estimated fair values of our reporting units exceeded their carrying values. We did not have an impairment on our existing goodwill in 2013 and 2012.

3. Supplemental Detail for Certain Components of Consolidated Balance Sheets

A. Other assets, net, consist of the following (dollars in thousands) at:	June 30,	December 31,
	2013	2012
Loans receivable	\$ 48,886	\$ 35,126
Deferred financing costs on notes payable, net	27,923	29,687
Restricted escrow deposits	14,448	1,805
Notes receivable issued in connection with property sales	19,250	19,300
Prepaid expenses	13,017	9,489
Note receivable issued in connection with acquisition	8,780	8,780
Credit facility origination costs, net	7,031	8,188
Impounds related to mortgages payable	4,415	-
Deferred financing costs on mortgages payable, net	1,488	1,541
Corporate assets, net	1,157	909
Deferred financing costs on term loan, net	264	-
Other items	198	424
	\$ 146,857	\$ 115,249
B. Acquired lease intangible assets, net, consist of the following (dollars in thousands) at:	June 30,	December 31,
	2013	2012
Acquired in-place leases	\$ 886,587	\$ 235,914
Accumulated amortization of acquired in-place leases	(62,927)	(29,601)
Acquired above-market leases	158,629	40,389
Accumulated amortization of acquired above-market leases	(10,240)	(4,577)
	\$ 972,049	\$ 242,125
C. Distributions payable consist of the following declared distributions (dollars in thousands) at:	June 30,	December 31,
	2013	2012
Common stock distributions	\$ 35,630	\$ 20,251
Preferred stock dividends	3,494	3,494
Noncontrolling interests distributions	156	-
	\$ 39,280	\$ 23,745
D. Accounts payable and accrued expenses consist of the following (dollars in thousands) at:	June 30,	December 31,
	2013	2012
Note interest payable	\$ 41,790	\$ 40,061
Accrued costs on properties under development	9,430	8,595
Mortgage interest payable	2,963	648
Other items	23,228	21,122
	\$ 77,411	\$ 70,426

Table of Contents

E. Acquired lease intangible liabilities, net, consist of the following (dollars in thousands) at:		June 30, 2013		December 31, 2012
Acquired below-market leases	\$	123,141	\$	28,975
Accumulated amortization of acquired below-market leases		(6,760)		(2,504)
	\$	116,381	\$	26,471
F. Other liabilities consist of the following (dollars in thousands) at:		June 30, 2013		December 31, 2012
Rent received in advance	\$	16,809	\$	20,929
Preferred units issued upon acquisition of ARCT		6,750		-
Security deposits		5,707		5,130
	\$	29,266	\$	26,059

4. American Realty Capital Trust, Inc. (ARCT)

A. Acquisition

On January 22, 2013, we completed our acquisition of ARCT for approximately \$3.2 billion. Each outstanding share of ARCT common stock was converted into the right to receive a combination of: (i) \$0.35 in cash and (ii) 0.2874 shares of our common stock, resulting in the issuance of a total of 45,573,144 shares of our common stock to ARCT shareholders, valued at a per share amount of \$44.04, which was the closing price of our common stock on January 22, 2013. In connection with the closing of the ARCT acquisition, we repaid and terminated the amounts then outstanding of approximately \$552.9 million under ARCT's revolving credit facility and term loan.

The acquisition of ARCT is expected to provide immediate and long-term benefits to Realty Income, including growth in the size of our real estate portfolio, diversification of industries and property type, accretion to net earnings, increase in the percentage of investment grade tenants, and larger size and scope of our company, which increases competitive advantages in the net-lease marketplace.

With this acquisition, we added 515 properties to our portfolio. The preliminary allocation of the purchase price reflects aggregate consideration of approximately \$2.1 billion, as calculated below (in thousands):

Consideration associated with equity issued (1)	\$	2,027,753
Cash consideration paid to previous owners of ARCT		56,216
Total preliminary purchase consideration	\$	2,083,969

(1) Includes the value associated with the issuance of the Tau Operating Partnership units discussed in 4.C. below.

We have accounted for the ARCT acquisition in accordance with *ASC 805, Business Combinations*, and are in the process of completing our allocation of the purchase price for this acquisition, which we expect to finalize later this year. The following table summarizes our preliminary purchase price allocation, which represents our current best estimate of acquisition date fair values of the assets acquired and liabilities assumed (in thousands):

Table of Contents

Assets:		
Real estate	\$	2,621,842
Acquired lease intangible assets		611,672
Cash and cash equivalents, accounts receivable, and other assets, net		42,334
Total Assets		3,275,848
Liabilities:		
Lines of credit payable		317,207
Term loan		235,000
Mortgages payable		538,960
Acquired lease intangible liabilities		76,043
Accounts payable, accrued expenses, and other liabilities, net		24,669
Total Liabilities		1,191,879
Estimated fair value of net assets acquired	\$	2,083,969

The final allocation of the purchase price will be based on our assessment of the fair value of the acquired assets and liabilities using both Level 2 and 3 inputs. The final purchase price allocation may be significantly different from the estimates above.

Investments in Real Estate Properties. We will estimate the fair value generally by applying an income approach methodology using both direct capitalization and discounted cash flow analysis. Key assumptions include capitalization and discount rates. Our valuations will be based, in part, on valuations prepared by an independent valuation firm.

Acquired Lease Intangibles. The fair value of in-place leases will be calculated based upon our estimate of the costs to obtain tenants in each of the applicable markets. An asset or liability will be recognized for acquired leases with favorable or unfavorable rents based on our estimate of current market rents in each of the applicable markets. Our valuations of the intangible assets will be based, in part, on valuations prepared by an independent valuation firm.

Debt. The fair value of debt will be estimated based on contractual future cash flows discounted using borrowing spreads and market interest rates that would be available to us for the issuance of debt with similar terms and remaining maturities.

B. Transaction Costs

In connection with our acquisition of ARCT, we expect to incur total merger-related transaction costs of approximately \$21 million, which includes, but are not limited to, advisor fees, legal fees, accounting fees, printing fees and transfer taxes. During the first six months of 2013, we incurred \$12.6 million of the estimated \$21 million of total merger-related transaction costs, which are included in income from continuing operations. In 2012, we incurred \$7.9 million of these total merger-related transaction costs.

C. Noncontrolling interests and preferred units

Consideration associated with equity issued includes the value of issued common and preferred partnership units issued in Tau Operating Partnership, L.P., or Tau Operating Partnership, the consolidated subsidiary which owns properties acquired through the

ARCT acquisition. Since the date of acquisition, Realty Income and its subsidiaries hold a 99.3% interest in the Tau Operating Partnership.

Table of Contents

The common units do not have voting rights, are entitled to monthly distributions equal to the amount paid to common stockholders of Realty Income, and are redeemable in cash or Realty Income common stock at our option and at a conversion ratio of one to one. Noncontrolling interests with redemption provisions that permit the issuer to settle in either cash or common stock at the option of the issuer were evaluated to determine whether temporary or permanent equity classification on the balance sheet was appropriate. We evaluated this guidance and determined that the common units meet the requirements to qualify for presentation as permanent equity. See note 12 for the change in the carrying value of these common units from January 22, 2013 through June 30, 2013.

The Tau Operating Partnership preferred units have also been recorded at fair value as of the date of acquisition. Since they are redeemable at a fixed price on a determinable date, we have classified them in other liabilities, net on our consolidated balance sheet. Payments on these preferred units are made monthly at a rate of 2% per annum and are included in interest expense. As of June 30, 2013, the preferred units have a carrying value of \$6.75 million.

D. Litigation

There have been no material developments to our legal proceedings disclosure previously reported under Part I, Item 3 Legal Proceedings in our Annual Report on Form 10-K for the year ended December 31, 2012.

5. Investments in Real Estate

We acquire the land, buildings and improvements that are necessary for the successful operations of commercial enterprises.

A. Acquisitions during the First Six Months of 2013 and 2012

During the first six months of 2013, we invested \$866.5 million in 206 new properties and properties under development or expansion (excluding ARCT), with an estimated initial weighted average contractual lease rate of 7.0%. The 206 new properties and properties under development or expansion are located in 35 states, will contain over 5.1 million leasable square feet, and are 100% leased with a weighted average lease term of 13.8 years. The tenants of the new properties acquired operate in 17 industries: aerospace, automotive collision services, automotive parts, convenience stores, crafts and novelties, dollar stores, drug stores, equipment services, food processing, general merchandise, health and fitness, health care, restaurants-casual dining, restaurants-quick service, sporting goods, transportation services, and wholesale clubs.

During the first six months of 2013, we also completed our acquisition of ARCT for \$3.2 billion, which added 515 properties to our real estate portfolio. The 515 properties are located in 44 states and Puerto Rico, contain over 16.0 million leasable square feet, and are 100% leased with a weighted average lease term of 12.2 years. The 69 tenants occupying the 515 properties acquired operate in 28 industries: aerospace, apparel stores, automotive parts, automotive tire services, automotive services, consumer appliances, consumer goods, convenience stores, crafts and novelties, dollar stores, drug stores, financial services, food processing, general merchandise, government services, grocery stores, health care, home furnishings, home improvement, jewelry, other manufacturing, pet supplies and services, restaurants casual dining, restaurants quick service, shoe stores, telecommunications, transportation services, and wholesale clubs. We recorded ARCT merger-related transaction costs of \$12.6 million in the first six months of 2013.

Our combined total investment in real estate assets, including the ARCT acquisition, during the first six months of 2013, was \$4.0 billion. None of our investments during the first six months of 2013 caused any one tenant to be 10% or more of our total assets at June 30, 2013.

Table of Contents

Our aggregate acquisitions, during the first six months of 2013, were allocated as follows: \$553.4 million to land, \$2.78 billion to buildings and improvements, \$771.3 million to intangible assets, \$13.7 million to other assets, net, and \$93.5 million to intangible and assumed liabilities. We also recorded mortgage premiums of \$28.4 million associated with the mortgages acquired. There was no contingent consideration associated with these acquisitions.

The properties acquired during the first six months of 2013 generated total revenues of \$86.0 million and income from continuing operations of \$16.0 million.

The purchase price allocation for \$3.9 billion of the \$4.0 billion invested by us in the first six months of 2013 is based on a preliminary measurement of fair value that is subject to change. The allocation for these properties represents our current best estimate of fair value and we expect to finalize the valuations and complete the purchase price allocations in 2013. In the first six months of 2013, we finalized the purchase price allocations for \$106.4 million invested in the second half of 2012 and \$93.0 million invested in the first six months of 2013. There were no material changes to our consolidated income statement for the first six months of 2013 as a result of these purchase price allocation adjustments.

The estimated initial weighted average contractual lease rate is computed as estimated contractual net operating income (in a net-leased property that is equal to the aggregate base rent) for the first full year of each lease, divided by the total cost of the property. Since it is possible that a tenant could default on the payment of contractual rent, we cannot provide assurance that the actual return on the funds invested will remain at the percentages listed above.

In the case of a property under development, the initial weighted average contractual lease rate is computed as follows: estimated net operating income (which is calculated by multiplying a predetermined capitalization rate by our projected total investment in the property, including land, construction and capitalized interest) for the first full year of each lease, divided by the total cost of the property. Of the \$4.0 billion we invested in the first six months of 2013, \$18.8 million was invested in 19 properties under development or expansion with an estimated initial weighted average contractual lease rate of 8.6%.

During the first six months of 2012, we invested \$221.5 million in 156 new properties and properties under development or expansion, with an estimated initial weighted average contractual lease rate of 7.2%. These 156 new properties and properties under development or expansion, are located in 29 states, contain over 1.4 million leasable square feet, and are 100% leased with a weighted average lease term of 14.6 years. The tenants of these properties operate in seven industries: automotive collision services, crafts and novelties, drug stores, general merchandise, health and fitness, restaurants quick service, and transportation services.

B. Acquisition Transaction Costs

Acquisition transaction costs of \$818,000 were recorded to general and administrative expense on our consolidated statement of income for the six months ended June 30, 2013. Acquisition transaction costs of \$634,000 were recorded to general and administrative expense on our consolidated statement of income for the six months ended June 30, 2012.

C. *Investments in Existing Properties*

During the first six months of 2013, we capitalized costs of \$3.3 million on existing properties in our portfolio, consisting of \$774,000 for re-leasing costs and \$2.5 million for building and tenant improvements. In comparison, during the first six months of 2012, we capitalized costs of \$2.4 million on existing properties in our portfolio, consisting of \$698,000 for re-leasing costs and \$1.7 million for building and tenant improvements.

Table of Contents*D. Properties with Existing Leases*

Of the \$4.0 billion we invested in the first six months of 2013, approximately \$3.97 billion was used to acquire 712 properties with existing leases. Associated with these 712 properties, we recorded \$650.4 million as the intangible value of the in-place leases, \$120.9 million as the intangible value of above-market leases and \$93.5 million as the intangible value of below-market leases. The value of the in-place and above-market leases is recorded to acquired lease intangible assets, net on our consolidated balance sheet, and the value of the below-market leases is recorded to acquired lease intangible liabilities, net on our consolidated balance sheet. The values recorded to a majority of these intangible values, during the first six months of 2013, are based on a preliminary measurement of fair value that is subject to change.

The value of the in-place leases is amortized as depreciation and amortization expense. The amounts amortized to expense for all of our in-place leases, for the first six months of 2013 and 2012, were \$33.3 million and \$6.7 million, respectively.

The value of the above-market and below-market leases is amortized as rental revenue on our consolidated statements of income. All of these amounts are amortized over the term of the respective leases. The amounts amortized as a net decrease to rental revenue for capitalized above-market and below-market leases for the first six months of 2013 and 2012 were \$1.4 million and \$964,000, respectively. If a lease were to be terminated prior to its stated expiration, all unamortized amounts relating to that lease would be recorded to revenue or expense as appropriate.

The following table presents the impact during the next five years and thereafter related to the net decrease to rental revenue from the amortization of the acquired above-market and below-market lease intangibles and the increase to amortization expense from the amortization of the in-place lease intangibles for properties owned at June 30, 2013 (in thousands):

	Net decrease to rental revenue		Increase to amortization expense
2013	\$ (1,763)	\$	40,811
2014	(3,602)		81,148
2015	(3,546)		80,271
2016	(3,535)		79,992
2017	(3,500)		78,707
Thereafter	(16,061)		462,731
Totals	\$ (32,007)	\$	823,660

E. Pro Forma Information

The following pro forma total revenue and income from continuing operations, for the first six months of 2013 and 2012, assumes all of our property acquisitions for the first six months of 2013 occurred on January 1, 2012. This pro forma supplemental information does not include: (1) the impact of any synergies or lower borrowing costs that we have or may achieve as a result of the acquisitions, or any strategies that management has or may consider in order to continue to efficiently manage our operations, and (2) ARCT's historical operational costs, including general and administrative costs and property expenses. Additionally, this information does not purport to be indicative of what our operating results would have been, had the acquisitions occurred on January 1, 2012, and may not be indicative of future operating results. For purposes of calculating these pro-forma amounts, we assumed that merger-related costs of approximately \$12.1 million, which represent the estimated merger-related costs incurred after consummation of our ARCT acquisition, occurred on January 1, 2012. Other than the item specified above, no material,

non-recurring pro-forma adjustments were included in the calculation of this information.

Table of Contents

Dollars in millions		Total revenue		Income from continuing operations
Supplemental pro forma for the six months ended June 30, 2013	\$	388.2	\$	105.4
Supplemental pro forma for the six months ended June 30, 2012	\$	341.6	\$	83.7

6. Credit Facility

We have a \$1 billion unsecured acquisition credit facility, with an initial term that expires in May 2016, and includes, at our election, a one-year extension option. Under this credit facility, our current investment grade credit ratings provide for financing at the London Interbank Offered Rate, commonly referred to as LIBOR, plus 1.075% with a facility commitment fee of 0.175%, for all-in drawn pricing of 1.25% over LIBOR. The borrowing rate is not subject to an interest rate floor or ceiling. We also have other interest rate options available to us under this credit facility. Our credit facility is unsecured and, accordingly, we have not pledged any assets as collateral for this obligation.

At June 30, 2013, credit facility origination costs of \$7.0 million are included in other assets, net, on our consolidated balance sheet. These costs are being amortized over the remaining term of our current \$1 billion credit facility.

At June 30, 2013, we had a borrowing capacity of \$299.0 million available on our credit facility (subject to customary conditions to borrowing) and an outstanding balance of \$701.0 million, as compared to an outstanding balance of \$158.0 million at December 31, 2012. In July 2013, we issued \$750.0 million of 4.65% senior unsecured notes due 2023, and the proceeds were used to repay all outstanding borrowings on the credit facility on July 16, 2013.

The weighted average interest rate on outstanding borrowings under our credit facility was 1.3% during the first six months of 2013 and 1.9% during the first six months of 2012. At June 30, 2013, the effective interest rate was 1.3%. Our current and prior credit facilities are and were subject to various leverage and interest coverage ratio limitations. At June 30, 2013, we remain in compliance with these covenants.

7. Mortgages Payable

During the first six months of 2013, we assumed mortgages totaling \$630.0 million, excluding net premiums. The mortgages are secured by the properties on which the debt was placed. Of the \$630.0 million of mortgages assumed during the first six months of 2013, approximately \$608.8 million is considered non-recourse with limited customary exceptions for items such as bankruptcy, misrepresentation, fraud, misapplication of payments, environmental liabilities, failure to pay taxes, insurance premiums, liens on the property and uninsured losses. Approximately \$6.6 million has full recourse to Realty Income, and the remaining \$14.6 million of the assumed debt is not guaranteed by Realty Income. We expect to pay off the mortgages as soon as prepayment penalties have declined to a level that will make it economically feasible to do so. We intend to continue to primarily identify property acquisitions that are free from mortgage indebtedness.

Edgar Filing: REALTY INCOME CORP - Form 10-Q

During the first six months of 2013, aggregate net premiums totaling \$28.4 million were recorded upon assumption of the mortgages for above-market interest rates, as compared to net premiums totaling \$10.0 million recorded in 2012. Amortization of these net premiums is recorded as a reduction to interest expense over the remaining term of the respective mortgages, using a method that approximates the effective-interest method.

These mortgages contain customary covenants, such as limiting our ability to further mortgage each applicable property or to discontinue insurance coverage, without the prior consent of the lender. At June 30, 2013, we remain in compliance with these covenants.

Table of Contents

As a result of assuming mortgages payable in the first six months of 2013 and in all of 2012, we incurred deferred financing costs of \$211,000 and \$1.1 million, respectively, which were classified as part of other assets, net, on our consolidated balance sheets. The balance of these deferred financing costs was \$1.5 million at June 30, 2013 and at December 31, 2012, which is being amortized over the remaining term of each mortgage.

The following is a summary of all our mortgages payable as of June 30, 2013 and December 31, 2012, respectively (dollars in thousands):

As Of	Number of Properties(1)	Weighted Average Stated Interest Rate(2)	Weighted Average Effective Interest Rate(3)	Weighted Average Remaining Years Until Maturity	Remaining Principal Balance	Unamortized Premium Balance	Mortgage Payable Balance
6/30/13	229	5.4%	3.9%	4.5	\$ 793,217	\$ 33,892	\$ 827,109
12/31/12	11	5.8%	4.4%	4.8	\$ 165,927	\$ 9,941	\$ 175,868

(1) At June 30, 2013, there were 51 mortgages on 229 properties, while at December 31, 2012, there were 13 mortgages on 11 properties. The mortgages require monthly payments, with principal payments due at maturity. The mortgages are at fixed interest rates, except for: (1) a \$23.6 million mortgage maturing on June 10, 2015 with a floating variable interest rate calculated as the sum of the current one month LIBOR plus 4.5%, not to exceed an all-in interest rate of 5.5%, (2) a \$8.3 million mortgage maturing on September 3, 2021, with a floating interest rate calculated as the sum of the current one month LIBOR plus 2.4%, and (3) a \$32.4 million mortgage maturing on April 10, 2017, which is fixed at 5.07% through December 28, 2015, but is reset to the greater of 4.0%, or the two-year swap rate plus 2.75% thereafter. As part of the \$8.3 million mortgage payable assumed in 2012, we also acquired an interest rate swap which essentially fixes the interest rate on this mortgage payable at 6.0%. As part of the \$32.4 million mortgage payable assumed in 2013, we have the opportunity to prepay the mortgage at par on December 28, 2015, prior to the variable interest rate reset. As part of two mortgages totaling \$8.8 million and maturing on December 28, 2013, we also acquired an \$8.8 million note receivable, upon which we receive interest income at a stated rate of 8.1% through December 28, 2013.

(2) Stated interest rates ranged from 2.5% to 8.3% at June 30, 2013, while stated interest rates ranged from 2.6% to 8.3% at December 31, 2012.

(3) Effective interest rates ranged from 2.4% to 9.3% at June 30, 2013, while effective interest rates ranged from 2.7% to 8.3% at December 31, 2012.

The following table summarizes the maturity of mortgages payable, excluding net premiums of \$33.9 million, as of June 30, 2013 (dollars in millions):

Year of Maturity	
2013	\$ 24.3
2014	64.4
2015	125.5
2016	248.4
2017	133.0
Thereafter	197.6
Totals	\$ 793.2

8. Term Loan

In January 2013, in conjunction with our acquisition of ARCT, we entered into a \$70 million senior unsecured term loan maturing January 21, 2018. Borrowing under the term loan bears interest at the current one month LIBOR, plus 1.2%. In conjunction with this term loan, we also acquired an interest rate swap, which essentially fixes our per annum interest rate on the term loan at 2.15%. As a result of entering into our term loan, we incurred deferred financing costs of \$288,000, which are being amortized over the remaining term of the term loan. The net balance of these deferred financing costs was \$264,000, which are classified as part of other assets, net, on our consolidated balance sheet at June 30, 2013.

Table of Contents**9. Notes Payable***A. General*

Our senior unsecured notes and bonds consist of the following, sorted by maturity date (dollars in millions):

	June 30, 2013		December 31, 2012
5.375% notes, issued in March 2003 and due in March 2013	\$ -	\$	100
5.5% notes, issued in November 2003 and due in November 2015	150		150
5.95% notes, issued in September 2006 and due in September 2016	275		275
5.375% notes, issued in September 2005 and due in September 2017	175		175
2.0% notes, issued in October 2012 and due in January 2018	350		350
6.75% notes, issued in September 2007 and due in August 2019	550		550
5.75% notes, issued in June 2010 and due in January 2021	250		250
3.25% notes, issued in October 2012 and due in October 2022	450		450
5.875% bonds, \$100 issued in March 2005 and \$150 issued in June 2011, both due in March 2035	250		250
	\$ 2,450	\$	2,550

As of June 30, 2013, the weighted average interest rate of our notes and bonds payable was 4.97% and the weighted average remaining years until maturity was 7.5 years.

B. Note Repayment

On their maturity date in March 2013, using proceeds from our March 2013 common stock offering and our credit line, we repaid the \$100 million of outstanding 5.375% notes we issued in March 2003 at a price equal to 100% of the principal amount, plus accrued and unpaid interest.

C. Note Issuance

See note 23 which discusses the notes issued in July 2013.

10. Issuance and Redemption of Preferred Stock

A. In February 2012, we issued 14.95 million shares of our 6.625% Monthly Income Class F Cumulative Redeemable Preferred Stock at a price of \$25.00 per share, including 1.95 million shares purchased by the underwriters upon the exercise of their overallotment option. In April 2012, we issued an additional 1.4 million shares of our Class F preferred stock at a price of \$25.2863 per share. After aggregate underwriting discounts and other offering costs of \$13.8 million, we received net proceeds of \$395.4 million for the February and April offerings combined, of which \$127.5 million was used to redeem all of our outstanding 7.375% Monthly Income Class D Cumulative Redeemable Preferred Stock and the balance was used to repay a portion of the borrowings

Edgar Filing: REALTY INCOME CORP - Form 10-Q

under our credit facility. Beginning February 15, 2017, the Class F preferred shares are redeemable, at our option, for \$25 per share. The initial dividend of \$0.1702257 per share was paid on March 15, 2012 and covered 37 days. Thereafter, dividends of \$0.138021 per share are paid monthly in arrears on the Class F preferred stock.

B. We redeemed all of the 5.1 million shares of our 7.375% Monthly Income Class D Cumulative Redeemable Preferred Stock in March 2012 for \$25.00 per share, plus accrued dividends. We incurred a charge of \$3.7 million for the first six months of 2012, representing the Class D preferred stock original issuance costs that we paid in 2004.

Table of Contents

11. Issuance of Common Stock

In March 2013, we issued 17,250,000 shares of common stock at a price of \$45.90 per share, including 2,250,000 shares purchased by the underwriters upon the exercise of their overallotment option. After underwriting discounts and other offering costs of \$36.6 million, the net proceeds of \$755.1 million were used to redeem our 5.375% notes in March 2013 and repay borrowings under our acquisition credit facility, which were used to fund property acquisitions, including our acquisition of ARCT.

In connection with our January 2013 acquisition of ARCT, as described in note 4, we issued a total of 45,573,144 shares of our common stock to ARCT shareholders and we received 208,709 shares of our common stock that were previously held by ARCT. The closing price per share of our common stock on the date of the ARCT acquisition was \$44.04. The total value of the 45,573,144 common shares was approximately \$2 billion.

12. Noncontrolling Interests

In June 2013, we completed the acquisition of a portfolio of properties by issuing units in a newly formed entity, Realty Income, L.P. The units issued as consideration for the acquisition represent a 2.2% ownership in Realty Income, L.P. at June 30, 2013. Realty Income holds the remaining 97.8% interests in this entity, and consolidates the entity.

The Realty Income, L.P. units do not have voting rights, are entitled to monthly distributions equal to the amount paid to common stockholders of Realty Income, and are redeemable in cash or Realty Income common stock, at our option, and at a conversion ratio of one to one, subject to certain exceptions. Noncontrolling interests with redemption provisions that permit the issuer to settle in either cash or common stock at the option of the issuer were evaluated to determine whether temporary or permanent equity classification on the balance sheet was appropriate. We evaluated this guidance and determined that the units meet the requirements to qualify for presentation as permanent equity.

The following table represents the change in the carrying value of all noncontrolling interests, including Tau Operating Partnership units which are discussed in note 4, through June 30, 2013 (dollars in thousands):

Tau Operating	Realty Income, L.P.
----------------------	----------------------------