

REALTY INCOME CORP  
Form 10-Q  
November 06, 2006

**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 **September 30, 2006**, 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

(State or other jurisdiction of incorporation or organization)

33-0580106

(I.R.S. Employer Identification No.)

220 West Crest Street, Escondido, California 92025

(Address of principal executive offices)

(760) 741-2111

(Registrant's telephone number)

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Act Rule 12b-2 of the Exchange Act).

Large accelerated filer  Accelerated filer  Non-accelerated filer

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There were 99,844,420 shares of common stock outstanding as of October 31, 2006.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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**REALTY INCOME CORPORATION**

Form 10-Q

September 30, 2006

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## PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

## REALTY INCOME CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

September 30, 2006 and December 31, 2005  
(dollars in thousands, except per share data)

|                                                                                                                                                                              | 2006<br>(Unaudited) | 2005         |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------|--------------|
| <b>ASSETS</b>                                                                                                                                                                |                     |              |
| Real estate, at cost:                                                                                                                                                        |                     |              |
| Land                                                                                                                                                                         | \$ 821,303          | \$ 746,016   |
| Buildings and improvements                                                                                                                                                   | 1,515,826           | 1,350,140    |
|                                                                                                                                                                              | 2,337,129           | 2,096,156    |
| Less accumulated depreciation and amortization                                                                                                                               | (381,048)           | (341,193)    |
| Net real estate held for investment                                                                                                                                          | 1,956,081           | 1,754,963    |
| Real estate held for sale, net                                                                                                                                               | 40,073              | 47,083       |
| Net real estate                                                                                                                                                              | 1,996,154           | 1,802,046    |
| Cash and cash equivalents                                                                                                                                                    | 113,374             | 65,704       |
| Accounts receivable                                                                                                                                                          | 5,270               | 5,044        |
| Goodwill                                                                                                                                                                     | 17,206              | 17,206       |
| Other assets                                                                                                                                                                 | 28,186              | 30,988       |
| Total assets                                                                                                                                                                 | \$ 2,160,190        | \$ 1,920,988 |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                                                                  |                     |              |
| Distributions payable                                                                                                                                                        | \$ 12,205           | \$ 10,121    |
| Accounts payable and accrued expenses                                                                                                                                        | 20,483              | 20,391       |
| Other liabilities                                                                                                                                                            | 9,740               | 9,562        |
| Line of credit payable                                                                                                                                                       |                     | 136,700      |
| Notes payable                                                                                                                                                                | 920,000             | 755,000      |
| Total liabilities                                                                                                                                                            | 962,428             | 931,774      |
| Commitments and contingencies                                                                                                                                                |                     |              |
| Stockholders' equity:                                                                                                                                                        |                     |              |
| Preferred stock and paid in capital, par value \$1.00 per share, 20,000,000 shares authorized, 5,100,000 shares issued and outstanding                                       | 123,804             | 123,804      |
| Common stock and paid in capital, par value \$1.00 per share, 200,000,000 shares authorized, 93,846,803 and 83,696,647 issued and outstanding in 2006 and 2005, respectively | 1,366,504           | 1,134,300    |
| Distributions in excess of net income                                                                                                                                        | (292,546)           | (268,890)    |
| Total stockholders' equity                                                                                                                                                   | 1,197,762           | 989,214      |
| Total liabilities and stockholders' equity                                                                                                                                   | \$ 2,160,190        | \$ 1,920,988 |

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

## REALTY INCOME CORPORATION AND SUBSIDIARIES

**CONSOLIDATED STATEMENTS OF INCOME**

For the three and nine months ended September 30, 2006 and 2005

(dollars in thousands, except per share data)

(unaudited)

|                                                                                  | <b>Three<br/>Months<br/>Ended<br/>9/30/06</b> | <b>Three<br/>Months<br/>Ended<br/>9/30/05</b> | <b>Nine<br/>Months<br/>Ended<br/>9/30/06</b> | <b>Nine<br/>Months<br/>Ended<br/>9/30/05</b> |
|----------------------------------------------------------------------------------|-----------------------------------------------|-----------------------------------------------|----------------------------------------------|----------------------------------------------|
| <b>REVENUE</b>                                                                   |                                               |                                               |                                              |                                              |
| Rental                                                                           | \$ 59,062                                     | \$ 48,751                                     | \$ 169,895                                   | \$ 142,248                                   |
| Other                                                                            | 245                                           | 136                                           | 1,097                                        | 308                                          |
|                                                                                  | 59,307                                        | 48,887                                        | 170,992                                      | 142,556                                      |
| <b>EXPENSES</b>                                                                  |                                               |                                               |                                              |                                              |
| Interest                                                                         | 12,530                                        | 10,228                                        | 37,657                                       | 29,080                                       |
| Depreciation and amortization                                                    | 14,641                                        | 11,226                                        | 42,961                                       | 33,098                                       |
| General and administrative                                                       | 4,083                                         | 4,166                                         | 12,683                                       | 11,927                                       |
| Property                                                                         | 787                                           | 1,002                                         | 2,332                                        | 2,876                                        |
| Income taxes                                                                     | 96                                            | 202                                           | 558                                          | 603                                          |
| Loss on extinguishment of debt                                                   | 1,555                                         |                                               | 1,555                                        |                                              |
|                                                                                  | 33,692                                        | 26,824                                        | 97,746                                       | 77,584                                       |
| Income from continuing operations                                                | 25,615                                        | 22,063                                        | 73,246                                       | 64,972                                       |
| Income from discontinued operations:                                             |                                               |                                               |                                              |                                              |
| Real estate acquired for resale by Crest                                         | 99                                            | 566                                           | 1,515                                        | 1,695                                        |
| Real estate held for investment                                                  | 844                                           | 493                                           | 3,324                                        | 4,624                                        |
|                                                                                  | 943                                           | 1,059                                         | 4,839                                        | 6,319                                        |
| Net income                                                                       | 26,558                                        | 23,122                                        | 78,085                                       | 71,291                                       |
| Preferred stock cash dividends                                                   | (2,351)                                       | (2,351)                                       | (7,052)                                      | (7,052)                                      |
| Net income available to common stockholders                                      | \$ 24,207                                     | \$ 20,771                                     | \$ 71,033                                    | \$ 64,239                                    |
| Amounts available to common stockholders per common share,<br>basic and diluted: |                                               |                                               |                                              |                                              |
| Income from continuing operations                                                | \$ 0.26                                       | \$ 0.25                                       | \$ 0.76                                      | \$ 0.73                                      |
| Net income                                                                       | \$ 0.27                                       | \$ 0.26                                       | \$ 0.82                                      | \$ 0.81                                      |
| Weighted average common shares outstanding:                                      |                                               |                                               |                                              |                                              |
| Basic                                                                            | 89,166,429                                    | 79,779,808                                    | 86,936,161                                   | 79,653,608                                   |
| Diluted                                                                          | 89,267,138                                    | 79,843,553                                    | 87,084,545                                   | 79,727,036                                   |

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

## REALTY INCOME CORPORATION AND SUBSIDIARIES

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

For the nine months ended September 30, 2006 and 2005  
(dollars in thousands)(unaudited)

|                                                                                              | 2006       | 2005       |
|----------------------------------------------------------------------------------------------|------------|------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                                  |            |            |
| Net income                                                                                   | \$ 78,085  | \$ 71,291  |
| Adjustments to net income:                                                                   |            |            |
| Depreciation and amortization                                                                | 42,961     | 33,098     |
| Income from discontinued operations:                                                         |            |            |
| Real estate acquired for resale                                                              | (1,515 )   | (1,695 )   |
| Real estate held for investment                                                              | (3,324 )   | (4,624 )   |
| Cash from discontinued operations:                                                           |            |            |
| Real estate acquired for resale                                                              | 84         | (666 )     |
| Real estate held for investment                                                              | 370        | 1,222      |
| Investment in real estate acquired for resale                                                | (9,937 )   | (52,690 )  |
| Intangibles acquired in connection with acquisitions of real estate acquired for resale      |            | (1,780 )   |
| Proceeds from sales of real estate acquired for resale                                       | 16,807     | 16,955     |
| Collection of mortgage note receivable by Crest                                              | 1,333      |            |
| Gain on reinstatement of property carrying value                                             | (716 )     |            |
| Gain on sale of real estate held for investment                                              |            | (14 )      |
| Amortization of stock compensation                                                           | 2,280      | 1,627      |
| Amortization of stock option costs                                                           | 17         | 11         |
| Provisions for impairment on real estate held for investment                                 |            | 151        |
| Change in assets and liabilities:                                                            |            |            |
| Accounts receivable and other assets                                                         | 5,033      | 617        |
| Accounts payable, accrued expenses and other liabilities                                     | (3,636 )   | 6,752      |
| Net cash provided by operating activities                                                    | 127,842    | 70,255     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                                  |            |            |
| Proceeds from sales of investment properties, continuing operations                          |            | 84         |
| Proceeds from sales of investment properties, discontinued operations                        | 9,804      | 17,504     |
| Acquisition of and additions to investment properties                                        | (244,586 ) | (347,067 ) |
| Intangibles acquired in connection with acquisitions of investment properties                | (937 )     | (9,494 )   |
| Net cash used in investing activities                                                        | (235,719 ) | (338,973 ) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                                  |            |            |
| Borrowings from lines of credit                                                              | 279,900    | 234,600    |
| Payments under lines of credit                                                               | (416,600 ) | (242,700 ) |
| Proceeds from stock offerings, net of offering costs of \$11,931 in 2006 and \$4,879 in 2005 | 229,566    | 92,660     |
| Proceeds from notes issued, net of offering costs of \$3,003 in 2006 and \$4,604 in 2005     | 271,997    | 270,396    |
| Principal payment on notes                                                                   | (110,000 ) |            |
| Cash distributions to common stockholders                                                    | (92,605 )  | (79,543 )  |
| Cash dividends to preferred stockholders                                                     | (7,052 )   | (7,052 )   |
| Proceeds from other common stock issuances                                                   | 341        | 460        |
| Net cash provided by financing activities                                                    | 155,547    | 268,821    |
| Net increase in cash and cash equivalents                                                    | 47,670     | 103        |
| Cash and cash equivalents, beginning of period                                               | 65,704     | 2,141      |
| Cash and cash equivalents, end of period                                                     | \$ 113,374 | \$ 2,244   |

For supplemental disclosures, see note 13.

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



REALTY INCOME CORPORATION AND SUBSIDIARIES

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

September 30, 2006

(Unaudited)

**1. Management Statement**

The consolidated financial statements of Realty Income Corporation ( Realty Income , the Company , we or our ) were prepared from our books and records without audit and include all adjustments (consisting of only normal recurring accruals) necessary to present a fair statement of results for the interim periods presented. Certain of the 2005 balances have been reclassified to conform to the 2006 presentation. Readers of this quarterly report should refer to our audited financial statements for the year ended December 31, 2005, which are included in our 2005 Annual Report on Form 10-K, as certain disclosures that would substantially duplicate those contained in the audited financial statements have not been included in this report.

At September 30, 2006, we owned 1,766 properties, located in 48 states, containing over 15.0 million leasable square feet, along with 13 properties owned by our wholly-owned taxable REIT subsidiary, Crest Net Lease, Inc. ( Crest ). Crest was created to buy, own and sell properties, primarily to individual investors, many of whom are involved in tax-deferred exchanges, under Section 1031 of the Internal Revenue Code of 1986, as amended (the Tax Code ).

**2. Summary of Significant Accounting Policies and Procedures**

A. The accompanying consolidated financial statements include the accounts of Realty Income, Crest and other entities for which we make operating and financial decisions (control), after elimination of all material intercompany balances and transactions. All of Realty Income and Crest s subsidiaries are wholly-owned.

B. We have elected to be taxed as a Real Estate Investment Trust ( REIT ) under the Tax Code. We believe we have qualified and continue to qualify as a REIT. Under the REIT operating structure we are permitted to deduct distributions paid to our stockholders and 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 Crest, which are included in discontinued operations.

**3. Retail Properties Acquired**

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

A. During the first nine months of 2006, Realty Income and Crest invested \$259.1 million, in aggregate, in 138 new retail properties and properties under development. These 138 properties are located in 24 states, will contain over 1.7 million leasable square feet, and are 100% leased with an average initial lease term of 13.7 years. Of the \$259.1 million invested in the first nine months of 2006, \$6.0 million was used to acquire one property with an existing lease already in-place with a retail tenant. In accordance with SFAS 141, Realty Income recorded \$1.6 million as the value of the in-place lease and \$628,000 as the value of below-market rents. These amounts are recorded to other assets and other liabilities , respectively, on our consolidated balance sheet and are amortized over the lives of the respective lease.

In comparison, during the first nine months of 2005, Realty Income and Crest invested \$412.1 million, in aggregate, in 104 new retail properties and properties under development. Of the \$412.1 million invested in the first nine months of 2005, \$95.1 million was used to acquire 34 properties with existing leases already in-place with existing retail tenants. In accordance with SFAS 141, Realty Income recorded \$10.1 million and Crest recorded \$1.8 million as the value of the in-place leases and Realty Income recorded \$183,000 as the value of above-market rents. In addition Realty Income recorded \$756,000 and Crest



recorded \$66,000 as the value of below-market rents on these leases. These amounts are recorded to other assets and other liabilities on our consolidated balance sheet and are amortized over the lives of the respective leases. Such amounts recorded by Crest are included in the calculation of gain on sales of properties.

B. During the first nine months of 2006, Realty Income invested \$249.2 million in 133 new retail properties and properties under development with an initial weighted average contractual lease rate of 8.7%. These 133 properties are located in 24 states, will contain over 1.6 million leasable square feet, and are 100% leased with an average initial lease term of 13.6 years. The initial weighted average contractual lease rate is computed by dividing the estimated aggregate base rent for the first year of each lease by the estimated total cost of the properties.

In comparison, during the first nine months of 2005, Realty Income invested \$357.6 million in 86 new retail properties and properties under development with an initial weighted average contractual lease rate of 8.4%.

C. During the first nine months of 2006, Crest invested \$9.9 million in five new retail properties.

In comparison, during the first nine months of 2005, Crest invested \$54.5 million in 18 new retail properties and properties under development.

D. Crest's property inventory at September 30, 2006 consisted of 13 properties with a total investment of \$40.3 million and at December 31, 2005 consisted of 17 properties with a total investment of \$45.7 million. These amounts are included on our consolidated balance sheets in real estate held for sale, net, except for \$219,000 which is included in other assets.

#### **4. Credit Facility**

We have a \$300 million acquisition credit facility that expires in October 2008, unless extended as provided for in the agreement. Under the terms of the credit facility, which commenced in October 2005, the borrowing rate is LIBOR (London Interbank Offered Rate) plus 65 basis points with a facility fee of 15 basis points, for all-in drawn pricing of 80 basis points over LIBOR, based on our current credit ratings. The credit facility offers us other interest rate options as well.

The average borrowing rate on our credit facility during the first nine months of 2006 was 5.5%, compared to 4.0% in the first nine months of 2005 on our previous \$250 million credit facility, which expired in October 2005. The increase in the average borrowing rate is due to an increase in LIBOR since the beginning of 2005. Our current credit facility is subject to various leverage and interest coverage ratio limitations. The Company is and has been in compliance with these covenants.

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

#### **5. Note Offerings**

In September 2006, we issued \$275 million in aggregate principal amount of 5.95% senior unsecured notes due 2016 (the 2016 Notes). The price to the investor for the 2016 Notes was 99.74% of the principal amount for an effective yield of 5.985%. The net proceeds of approximately \$272.0 million from this offering were used to redeem our notes due in 2007 (see note 6) and other corporate purposes. Interest on the 2016 Notes is paid semiannually.

**6. Note Redemption**

In September 2006, we redeemed all of our outstanding \$110 million, 7-<sup>3</sup>/<sub>4</sub>% unsecured notes due May 2007 (the 2007 Notes ). The 2007 Notes were redeemed at a redemption price equal to 100% of the principal amount of the 2007 Notes, plus accrued and unpaid interest of \$3.2 million, as well as a make-whole payment of \$1.6 million. We recorded a loss on extinguishment of debt totaling \$1.6 million related to the make-whole payment associated with the 2007 Notes.

**7. Common Stock Offerings**

In September 2006, we issued 4.715 million shares of common stock at a price of \$24.32 per share. The net proceeds of approximately \$109.1 million were used to fund new property acquisitions, repay borrowings under our credit facility and for other general corporate purposes.

In March 2006, we issued 5.2 million shares of common stock at a price of \$24.39 per share. The net proceeds of approximately \$120.5 million were used to fund new property acquisitions and for other general corporate purposes.

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

During the third quarter of 2006, Crest sold four properties for \$6.6 million, which resulted in a gain of \$313,000. In comparison, during the third quarter of 2005, Crest sold two properties for \$5.8 million, which resulted in a gain of \$713,000. Crest's gains on sales are reported before income taxes and are included in discontinued operations.

During the first nine months of 2006, Crest sold nine properties for \$16.8 million, which resulted in a gain of \$1.7 million. In comparison, during the first nine months of 2005, Crest sold nine properties for \$17.0 million, which resulted in a gain of \$2.4 million.

In December 2005, Crest provided the buyer of one property financing in the form of a \$1.3 million promissory note, which was paid in full in February 2006.

**9. Gain on Sales of Investment Properties by Realty Income**

During the third quarter of 2006, we sold or exchanged three investment properties for \$4.0 million, which resulted in a gain of \$843,000. In comparison, during the third quarter of 2005, we sold four investment properties and a portion of land from one property for \$3.0 million, which resulted in a gain of \$303,000.

As part of one sale during the second quarter of 2006, we provided the buyer financing in the form of a \$1.3 million promissory note, which was paid in full in September 2006. Interest of 8% per annum accrued on this note.

During the first nine months of 2006, we sold or exchanged 13 investment properties for \$10.7 million, which resulted in a gain of \$3.0 million. In comparison, during the first nine months of 2005, we sold 15 investment properties and a portion of land from one property for \$17.6 million, which resulted in a gain of \$3.8 million. These gains are included in discontinued operations except for \$14,000, which is included in other revenue for the first nine months of 2005.

**10. Discontinued Operations**

In accordance with Financial Accounting Standards Board Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* ( SFAS 144 ), Realty Income's operations from investment properties sold in 2006 and 2005, were reported as discontinued operations. Their respective results of operations were reclassified to income from discontinued operations, real estate held for investment. We classify properties as held for sale in accordance with SFAS 144. We do not depreciate properties that are classified as held for sale. No investment properties were classified as held for sale at September 30, 2006.

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Crest acquires properties with the intention of reselling them rather than holding them for investment and operating the properties. Consequently, we classify properties acquired by Crest as held for sale at the date of acquisition and do not depreciate them. In accordance with SFAS 144, the operations of Crest's properties are classified as income from discontinued operations, real estate acquired for resale by Crest.

No debt was assumed by buyers of our investment properties or repaid as a result of our investment property sales and we have elected not to allocate interest expense to discontinued operations related to real estate held for investment.

In accordance with Emerging Issues Task Force No. 87-24, we allocate interest expense related to borrowings specifically attributable to Crest's properties. The interest expense amounts allocated to the Crest properties are included in income from discontinued operations, real estate acquired for resale by Crest.

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

|                                                                                 | <b>Three<br/>months<br/>ended<br/>9/30/06</b> | <b>Three<br/>months<br/>ended<br/>9/30/05</b> | <b>Nine<br/>months<br/>ended<br/>9/30/06</b> | <b>Nine<br/>months<br/>ended<br/>9/30/05</b> |
|---------------------------------------------------------------------------------|-----------------------------------------------|-----------------------------------------------|----------------------------------------------|----------------------------------------------|
| Crest's income from discontinued operations,<br>real estate acquired for resale |                                               |                                               |                                              |                                              |
| Gain on sales of real estate acquired for resale                                | \$ 313                                        | \$ 713                                        | \$ 1,739                                     | \$ 2,361                                     |
| Rental revenue                                                                  | 913                                           | 514                                           | 3,007                                        | 1,083                                        |
| Interest expense                                                                | (711 )                                        | (320 )                                        | (2,175 )                                     | (630 )                                       |
| General and administrative expense                                              | (73 )                                         | (137 )                                        | (227 )                                       | (410 )                                       |
| Property expenses                                                               | (17 )                                         | (9 )                                          | (50 )                                        | (59 )                                        |
| Provision for impairments                                                       | (308 )                                        |                                               | (308 )                                       |                                              |
| Income taxes                                                                    | (18 )                                         | (195 )                                        | (471 )                                       | (650 )                                       |
| Income from discontinued operations, real estate acquired for resale by Crest   | \$ 99                                         | \$ 566                                        | \$ 1,515                                     | \$ 1,695                                     |

The following is a summary of Realty Income's income from discontinued operations, real estate held for investment (dollars in thousands):

|                                                                                         | <b>Three<br/>months<br/>ended<br/>9/30/06</b> | <b>Three<br/>months<br/>ended<br/>9/30/05</b> | <b>Nine<br/>months<br/>ended<br/>9/30/06</b> | <b>Nine<br/>months<br/>ended<br/>9/30/05</b> |
|-----------------------------------------------------------------------------------------|-----------------------------------------------|-----------------------------------------------|----------------------------------------------|----------------------------------------------|
| Realty Income's income from discontinued<br>operations, real estate held for investment |                                               |                                               |                                              |                                              |
| Gain on sales of investment properties                                                  | \$ 843                                        | \$ 303                                        | \$ 3,036                                     | \$ 3,767                                     |
| Rental revenue                                                                          | 68                                            | 358                                           | 453                                          | 1,424                                        |
| Other revenue                                                                           | 25                                            | 1                                             | 33                                           | 1                                            |
| Depreciation and amortization                                                           | (20 )                                         | (89 )                                         | (82 )                                        | (330 )                                       |
| Property expenses                                                                       | (72 )                                         | (65 )                                         | (116 )                                       | (203 )                                       |
| Provision for impairment                                                                |                                               | (15 )                                         |                                              | (35 )                                        |
| Income from discontinued operations, real estate held for investment                    | \$ 844                                        | \$ 493                                        | \$ 3,324                                     | \$ 4,624                                     |

The following is a summary of our total discontinued operations (dollars in thousands):

|                                          | <b>Three<br/>months<br/>ended<br/>9/30/06</b> | <b>Three<br/>months<br/>ended<br/>9/30/05</b> | <b>Nine<br/>months<br/>ended<br/>9/30/06</b> | <b>Nine<br/>months<br/>ended<br/>9/30/05</b> |
|------------------------------------------|-----------------------------------------------|-----------------------------------------------|----------------------------------------------|----------------------------------------------|
| Income from discontinued operations:     |                                               |                                               |                                              |                                              |
| Real estate acquired for resale by Crest | \$ 99                                         | \$ 566                                        | \$ 1,515                                     | \$ 1,695                                     |
| Real estate held for investment          | 844                                           | 493                                           | 3,324                                        | 4,624                                        |
| Income from discontinued operations      | \$ 943                                        | \$ 1,059                                      | \$ 4,839                                     | \$ 6,319                                     |
| Per common share, basic and diluted      | \$ 0.01                                       | \$ 0.01                                       | \$ 0.06                                      | \$ 0.08                                      |

## 11. Distributions Paid and Payable

A. We pay monthly distributions to our common stockholders. The following is a summary of the monthly cash distributions per common share paid during the first nine months of 2006 and 2005:

| Month     | <b>2006</b> | <b>2005</b> |
|-----------|-------------|-------------|
| January   | \$ 0.116250 | \$ 0.110000 |
| February  | 0.116250    | 0.110000    |
| March     | 0.116250    | 0.110000    |
| April     | 0.116875    | 0.110625    |
| May       | 0.116875    | 0.110625    |
| June      | 0.116875    | 0.110625    |
| July      | 0.117500    | 0.111250    |
| August    | 0.117500    | 0.111250    |
| September | 0.125250    | 0.115000    |
| Total     | \$ 1.059625 | \$ 0.999375 |

At September 30, 2006, a distribution of \$0.125875 per common share was payable and was paid on October 16, 2006.

B. In May 2004 and October 2004, in aggregate, we issued a total of 5.1 million shares of 7-3/8% Monthly Income Class D preferred stock. Beginning May 27, 2009, the Class D preferred shares are redeemable at our option for \$25.00 per share. During the first nine months of 2006 and 2005, we paid nine monthly dividends to holders of our Class D preferred stock of \$0.1536459 per share, totaling \$7.1 million.

## 12. Net Income per Common Share

Basic net income per common share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during each period. Diluted net income per common share is computed by dividing net income available to common stockholders for the period by the number of common shares that would have been outstanding assuming the issuance of common shares for all potentially dilutive common shares outstanding during the reporting period.

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The following is a reconciliation of the denominator of basic net income per common share computation to the denominator of diluted net income per common share computation:

|                                                                                    | <b>Three<br/>months<br/>ended<br/>9/30/06</b> | <b>Three<br/>months<br/>ended<br/>9/30/05</b> | <b>Nine<br/>months<br/>ended<br/>9/30/06</b> | <b>Nine<br/>months<br/>ended<br/>9/30/05</b> |
|------------------------------------------------------------------------------------|-----------------------------------------------|-----------------------------------------------|----------------------------------------------|----------------------------------------------|
| Weighted average shares used for the basic net income per share computation        | 89,166,429                                    | 79,779,808                                    | 86,936,161                                   | 79,653,608                                   |
| Incremental shares from share-based compensation                                   | 100,709                                       | 63,745                                        | 148,384                                      | 73,428                                       |
| Adjusted weighted average shares used for diluted net income per share computation | 89,267,138                                    | 79,843,553                                    | 87,084,545                                   | 79,727,036                                   |

No stock options were anti-dilutive for the three and nine months ended September 30, 2006 and 2005. We had nonvested shares from share-based compensation that were anti-dilutive of 243,325 and 243,725 for the three and nine months ended September 30, 2006, respectively. No nonvested shares were anti-dilutive for the three and nine months ended September 30, 2005.

### 13. Supplemental Disclosures of Cash Flow Information

Interest paid during the first nine months of 2006 was \$45.3 million and for the first nine months of 2005 was \$25.6 million.

Interest capitalized to properties under development in the first nine months of 2006 was \$1.9 million and in the first nine months of 2005 was \$1.2 million.

Income taxes paid by Realty Income and Crest in the first nine months of 2006 totaled \$606,000 and in the first nine months of 2005 totaled \$1.3 million.

The following non-cash investing and financing activities are included in the accompanying consolidated financial statements:

A. Stock based compensation for the first nine months of 2006 was \$2.3 million and for the first nine months of 2005 was \$1.6 million.

B. In 2006, we exchanged one of our properties for a different property that was leased to the same tenant. As part of this transaction, accumulated depreciation was reduced by \$67,000 and a gain of \$67,000 was recorded. The value of the property exchanged was \$900,000. This transaction had no impact to land and building and improvements.

C. In 2004, we recorded a loss of \$716,000 on one property to reduce its carrying value to zero. This loss was the result of a dispute with the original owner and tenant in their bankruptcy proceeding. Our title insurance company failed to timely record the deed on this property upon our original acquisition, which resulted in a claim by the bankruptcy trustee that Realty Income did not have legal title to the property. In the second quarter of 2006, this issue was resolved and we obtained title to the property. At that time we reinstated the original carrying value adjusted for depreciation on our balance sheet and recorded other revenue of \$716,000. We also reversed accrued liabilities and property expenses of \$133,000 associated with this property. As part of the settlement, these costs became the responsibility of the title insurance company.

D. Accrued costs on properties under development resulted in an increase in buildings and accounts payable of \$3.3 million in 2006 and \$2.5 million in 2005.

E. Distributions payable on our balance sheets is comprised of accruals for the following (dollars in thousands):

|                            | 9/30/06   | 12/31/05 |
|----------------------------|-----------|----------|
| Common stock distributions | \$ 11,813 | \$ 9,729 |
| Preferred stock dividends  | \$ 392    | \$ 392   |

#### 14. Segment Information

We evaluate performance and make resource allocation decisions on an industry by industry basis. For financial reporting purposes, we have grouped our tenants into 30 industry and activity segments (including properties owned by Crest that are grouped together). All of the properties are incorporated into one of the applicable segments. Because almost all of our leases require the tenant to pay operating expenses, revenue is the only component of segment profit and loss we measure.

The following tables set forth certain information regarding the properties owned by us, classified according to the business of the respective tenants as of September 30, 2006 (dollars in thousands):

|                                | Three months ended 9/30/06 | Three months ended 9/30/05 | Nine months ended 9/30/06 | Nine months ended 9/30/05 |
|--------------------------------|----------------------------|----------------------------|---------------------------|---------------------------|
| Revenue                        |                            |                            |                           |                           |
| Segment rental revenue:        |                            |                            |                           |                           |
| Automotive parts               | \$ 1,621                   | \$ 1,623                   | \$ 4,919                  | \$ 4,929                  |
| Automotive service             | 5,283                      | 3,715                      | 12,659                    | 11,067                    |
| Automotive tire services       | 3,473                      | 3,467                      | 10,418                    | 10,641                    |
| Child care                     | 6,256                      | 6,230                      | 18,555                    | 18,494                    |
| Convenience stores             | 9,572                      | 9,416                      | 28,672                    | 27,177                    |
| Drug stores                    | 1,787                      | 1,628                      | 5,043                     | 3,964                     |
| Health and fitness             | 2,647                      | 1,854                      | 7,452                     | 5,437                     |
| Home furnishings               | 1,881                      | 1,806                      | 5,557                     | 5,532                     |
| Home improvement               | 1,741                      | 532                        | 5,158                     | 1,591                     |
| Motor vehicle dealerships      | 2,112                      | 1,246                      | 5,870                     | 3,494                     |
| Restaurants                    | 5,755                      | 4,440                      | 16,173                    | 12,794                    |
| Sporting goods                 | 1,687                      | 1,687                      | 5,060                     | 5,060                     |
| Theaters                       | 5,574                      | 1,645                      | 16,497                    | 4,834                     |
| 17 non-reportable segments (1) | 9,673                      | 9,462                      | 27,862                    | 27,234                    |
| Other revenue                  | 245                        | 136                        | 1,097                     | 308                       |
| Total revenue                  | \$ 59,307                  | \$ 48,887                  | \$ 170,992                | \$ 142,556                |

(1) Crest's revenues appear in income from discontinued operations, real estate acquired for resale by Crest.

| <b>Assets, as of:</b>                | <b>September 30,<br/>2006</b> | <b>December 31,<br/>2005</b> |
|--------------------------------------|-------------------------------|------------------------------|
| Segment net real estate:             |                               |                              |
| Automotive parts                     | \$ 38,072                     | \$ 39,550                    |
| Automotive service                   | 103,402                       | 106,602                      |
| Automotive tire services             | 126,489                       | 129,314                      |
| Child care                           | 97,397                        | 101,826                      |
| Convenience stores                   | 337,064                       | 342,404                      |
| Drug stores                          | 78,964                        | 65,846                       |
| Health and fitness                   | 99,942                        | 87,426                       |
| Home furnishings                     | 54,842                        | 56,218                       |
| Home improvement                     | 71,996                        | 17,846                       |
| Motor vehicle dealerships            | 103,575                       | 71,035                       |
| Restaurants                          | 238,507                       | 166,231                      |
| Sporting goods                       | 56,696                        | 57,913                       |
| Theaters                             | 265,368                       | 250,214                      |
| 17 other non-reportable segments     | 323,840                       | 309,621                      |
| <b>Total segment net real estate</b> | <b>1,996,154</b>              | <b>1,802,046</b>             |
| Other intangible assets Drug stores  | 8,009                         | 8,489                        |
| Other intangible assets Theaters     | 2,877                         | 1,419                        |
| Other corporate assets               | 153,150                       | 109,034                      |
| <b>Total assets</b>                  | <b>\$ 2,160,190</b>           | <b>\$ 1,920,988</b>          |

## 15. Common Stock Incentive Plan

Effective January 1, 2002, we adopted the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and starting January 1, 2002 expensed costs for all stock option awards granted, modified, or settled. Stock option awards under the plan vest over periods ranging from one to five years.

Effective January 1, 2006, we adopted FASB Statement No. 123R, *Share-Based Payments*. Statement No. 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees.

In 2003, our Board of Directors adopted, and stockholders approved, the 2003 Incentive Award Plan of Realty Income Corporation (the *Stock Plan*) to enable us to attract and retain the services of directors, employees and consultants, considered essential to our long-term success, by offering them an opportunity to own stock in Realty Income and/or rights that will reflect our growth, development and financial success. The *Stock Plan* was amended and restated by our Board of Directors on February 21, 2006. Under the terms of this plan, the aggregate number of shares of our common stock subject to options, stock purchase rights (SPR), stock appreciation rights (SAR) and other awards will be no more than 3,428,000 shares. The maximum number of shares that may be subject to options, stock purchase rights, stock appreciation rights and other awards granted under the plan to any individual in any calendar year may not exceed 1,600,000 shares. This plan has a term of 10 years from the date it was adopted by our Board of Directors, which was March 12, 2003. To date, we have not issued any SPR or SAR.

The amount of share-based compensation costs charged against income during the third quarter of 2006 were \$654,000, during the third quarter of 2005 were \$546,000, during the first nine months of 2006 were \$2.3 million and during the first nine months of 2005 were \$1.6 million.

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Stock options were granted with an exercise price equal to the underlying stock's fair market value at the date of grant. Stock options expire ten years from the date they were granted and vest over service periods of one, three, four and five years. No stock options were granted in 2006 or 2005.

The following table summarizes our stock option activity:

|                                 | For the nine months ended Sept. 30, 2006 |                                 | For the year ended December 31, 2005 |                                 |
|---------------------------------|------------------------------------------|---------------------------------|--------------------------------------|---------------------------------|
|                                 | Number of Shares                         | Weighted Average Exercise Price | Number of Shares                     | Weighted Average Exercise Price |
| Outstanding, beginning of year  | 135,348                                  | \$ 13.02                        | 176,130                              | \$ 13.01                        |
| Options exercised               | (26,772 )                                | 12.75                           | (40,352 )                            | 12.93                           |
| Options forfeited               |                                          |                                 | (430 )                               | 14.70                           |
| Outstanding, end of each period | 108,576                                  | \$ 13.09                        | 135,348                              | \$ 13.02                        |

At September 30, 2006, the options outstanding had exercise prices ranging from \$10.63 to \$14.70, with a weighted average price of \$13.09 and expiration dates ranging from June 2007 to December 2011 with a weighted average remaining term of 2.8 years. At September 30, 2006, there were 106,183 options exercisable with exercise prices ranging from \$10.63 to \$14.70 and a weighted average price of \$13.05. Options exercisable at December 31, 2005 totaled 119,924.

The following table summarizes our common stock grant activity under our Stock Plan for 2006 and 2005. The grants vest over periods ranging from immediately to 10 years.

|                                                  | For the nine months ended September 30, 2006 |                            | For the year ended December 31, 2005 |                            |
|--------------------------------------------------|----------------------------------------------|----------------------------|--------------------------------------|----------------------------|
|                                                  | Number of Shares                             | Weighted Average Price (1) | Number of Shares                     | Weighted Average Price (1) |
| Outstanding nonvested shares, beginning of year  | 788,722                                      | \$ 17.83                   | 626,868                              | \$ 14.98                   |
| Shares granted                                   | 210,132                                      | 21.71                      | 306,241                              | 25.20                      |
| Shares vested                                    | (211,734 )                                   | 20.39                      | (92,811 )                            | 16.69                      |
| Shares forfeited                                 | (1,748 )                                     | 20.80                      | (51,576 )                            | 17.31                      |
| Outstanding nonvested shares, end of each period | 785,372                                      | \$ 20.76                   | 788,722                              | \$ 17.83                   |

(1) Grant date fair value.

During the first nine months of 2006, we issued 210,132 shares of common stock under the Stock Plan. These shares vest over the following service periods: 16,000 vested upon issuance, 4,000 vest over a service period of one year, 4,000 vest over a service period of four years, 15,000 vest over a service period of five years and 171,132 vest over a service period of 10 years.



As of September 30, 2006, the remaining unamortized stock compensation expense totaled \$16.3 million, which is being amortized over the service period of each applicable award. The amount of deferred stock compensation is based on the fair value of the stock at the grant date. We define the grant date as the date the recipient and the Company have a mutual understanding of the key terms and condition of the award and the recipient of the grant begins to benefit from, or be adversely affected by subsequent changes in the price of the shares.

## 16. Commitments and Contingencies

In the ordinary course of business, we are party to various legal actions which we believe are routine in nature and incidental to the operation of our business. We believe that the outcome of the proceedings will not have a material adverse effect upon our consolidated financial statements taken as a whole.

At September 30, 2006, we have committed to pay estimated unfunded development costs of \$25.5 million on properties under development. In addition, we have contingent payments for tenant improvements and leasing costs of \$804,000 as well as a \$6 million commitment to fund the construction costs of two buildings, which are not currently under construction, and construction is dependent upon the tenant's commitment to build the buildings prior to September 30, 2007.

## 17. Subsequent Events

In October 2006, we issued 6.0 million shares of common stock at a price of \$26.40 per share. The net proceeds of approximately \$150.7 million were used to fund a portion of the purchase price of the Buffets/Ryan's properties on November 1, 2006.

On November 1, 2006, Realty Income and Crest acquired 144 Buffets/Ryan's restaurant properties for approximately \$349 million. The properties are leased under 20-year, triple-net lease agreements. These properties were acquired subsequent to a merger between Buffets, Inc. and Ryan's Restaurant Group. This acquisition was funded with cash and cash equivalents held at September 30, 2006, proceeds from our October 2006 stock offering and borrowings under our credit facility. At September 30, 2006, we had committed to acquire these 144 restaurant properties.

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

### FORWARD-LOOKING STATEMENTS

This quarterly report on Form 10-Q, including documents incorporated by reference, contains forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. When used in this quarterly report, the words "estimated", "anticipated", "expect", "believe", "intend" and similar expressions are intended to identify forward-looking statements. Forward-looking statements are subject to risks, uncertainties, and assumptions about Realty Income Corporation, including, among other things:

- Our anticipated growth strategies;
- Our intention to acquire additional properties and the timing of these acquisitions;
- Our intention to sell properties and the timing of these property sales;
- Our intention to re-lease vacant properties;
- Anticipated trends in our business, including trends in the market for long-term net-leases of freestanding, single-tenant retail properties;
- Future expenditures for development projects; and
- Profitability of our subsidiary, Crest Net Lease, Inc.



Future events and actual results, financial and otherwise, may differ materially from the results discussed in the forward-looking statements. In particular, some of the factors that could cause actual results to differ materially are:

- Our continued qualification as a real estate investment trust;
- General business and economic conditions;
- Competition;
- Fluctuating interest rates;
- Access to debt and equity capital markets;
- Other risks inherent in the real estate business including tenant defaults, potential liability relating to environmental matters, illiquidity of real estate investments, and potential damages from natural disasters;
- Impairments in the value of our real estate assets;
- Changes in the tax laws of the United States of America;
- The outcome of any legal proceedings to which we are a party; and
- Acts of terrorism and war.

Additional factors that may cause risks and uncertainties include those discussed in the sections entitled *Business*, *Risk Factors* and *Management's Discussion and Analysis of Financial Condition and Results of Operations* in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

Readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date that this quarterly report was filed with the Securities and Exchange Commission, or SEC. We undertake no obligation to publicly release the results of any revisions to these forward-looking statements that may be made to reflect events or circumstances after the date of this quarterly report or to reflect the occurrence of unanticipated events. In light of these risks and uncertainties, the forward-looking events discussed in this quarterly report might not occur.

#### **THE COMPANY**

Realty Income Corporation, The Monthly Dividend Company®, is a Maryland corporation organized to operate as an equity real estate investment trust, or REIT. Our primary business objective is to generate dependable monthly cash distributions from a consistent and predictable level of funds from operations, or FFO per share. The monthly distributions are supported by the cash flow from our portfolio of retail properties leased to regional and national retail chains. We have in-house acquisition, leasing, legal, retail research, real estate research, portfolio management and capital markets expertise. Over the past 37 years, Realty Income and its predecessors have been acquiring and owning freestanding retail properties that generate rental revenue under long-term lease agreements (primarily 15- to 20-years).

In addition, we seek to increase distributions to stockholders and FFO per share through both active portfolio management and the acquisition of additional properties. Our portfolio management focus includes:

- Contractual rent increases on existing leases;
- Rent increases at the termination of existing leases when market conditions permit; and
- The active management of our property portfolio, including re-leasing vacant properties and selective sales of properties.



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In acquiring additional properties, we adhere to a focused strategy of primarily acquiring properties that are:

- Freestanding, single-tenant, retail locations;
- Leased to regional and national retail chains; and
- Leased under long-term, net-lease agreements.

At September 30, 2006, we owned a diversified portfolio:

- Of 1,766 retail properties;
- With an occupancy rate of 98.8%, or 1,745 properties occupied of the 1,766 properties in the portfolio;
- Leased to 101 different retail chains doing business in 29 separate retail industries;
- Located in 48 states;
- With over 15.0 million square feet of leasable space; and
- With an average leasable retail space per property of approximately 8,500 square feet.

Of the 1,766 properties in the portfolio, 1,759, or 99.6%, are single-tenant, retail properties and the remaining seven are multi-tenant, distribution and office properties. At September 30, 2006, 1,739, or 98.9%, of the 1,759 single-tenant properties were leased with a weighted average remaining lease term (excluding extension options) of approximately 12.2 years.

In addition, at September 30, 2006, our wholly-owned taxable REIT subsidiary, Crest Net Lease, Inc. ( Crest ) had invested \$40.3 million in 13 properties, which are classified as held for sale. Crest was created to buy, own and sell properties, primarily to individual investors, many of whom are involved in tax-deferred exchanges under Section 1031 of the Internal Revenue Code of 1986, as amended (the Tax Code ).

We typically acquire retail properties under long-term leases with retail chain store operators. These transactions generally provide capital to owners of retail real estate and retail chains for expansion or other corporate purposes. Our acquisition and investment activities are concentrated in well-defined target markets and generally focus on retail chains providing goods and services that satisfy basic consumer needs.

Our net-lease agreements generally:

- Are for initial terms of 15 to 20 years;
- Require the tenant to pay minimum monthly rents and property operating expenses (taxes, insurance and maintenance); and
- Provide for future rent increases (typically subject to ceilings) based on increases in the consumer price index, fixed increases, or to a lesser degree, additional rent calculated as a percentage of the tenants gross sales above a specified level.

### **Investment Philosophy**

We believe that owning an actively managed, diversified portfolio of retail properties under long-term, net leases produces consistent and predictable income. Under a net-lease agreement, the tenant agrees to pay monthly rent and property operating expenses (taxes, maintenance and insurance) plus, typically, future rent increases (generally subject to ceilings) based on increases in the consumer price index, fixed increases, or to a lesser degree, additional rent calculated as a percentage of the tenants gross sales above a specified level. We believe that a portfolio of properties owned under long-term leases, coupled with the tenant s responsibility for property expenses, generally produces a more predictable income stream than many other types of real estate portfolios, while continuing to offer the potential for growth in rental income.



### **Credit Strategy**

We generally provide sale-leaseback financing to less than investment grade retail chains. We typically acquire and lease back properties to regional and national retail chains and believe that within this market we can achieve an attractive risk-adjusted return on the financing we provide to retailers. Since 1970, our overall weighted average occupancy rate at the end of each year has been 98.5%, and the occupancy rate at the end of each year has never been below 97.5%.

### **Acquisition Strategy**

We seek to invest in industries in which several, well-organized, regional and national chains are capturing market share through service, quality control, economies of scale, advertising and the selection of prime retail locations. We execute our acquisition strategy by acting as a source of capital to regional and national retail chain store owners and operators, doing business in a variety of industries, by acquiring and leasing back retail store locations. We undertake thorough research and analysis to identify appropriate industries, tenants and property locations for investment. Our research expertise is instrumental to uncovering net-lease opportunities in markets where our real estate financing program adds value. In selecting real estate for potential investment, we generally seek to acquire properties that have the following characteristics:

- Freestanding, commercially-zoned property with a single tenant;
- Properties that are important retail locations for regional and national retail chains;
- Properties that are located within attractive demographic areas relative to the businesses of our tenants;
- Properties with high visibility and easy access to major thoroughfares; and
- Properties that can be purchased with the simultaneous execution or assumption of long-term, net-lease agreements, offering both current income and the potential for rent increases.

## **RECENT DEVELOPMENTS**

### **Redemption of 2007 Notes**

In September 2006, we redeemed all of our outstanding \$110 million 7-<sup>3</sup>/<sub>4</sub>% unsecured notes due May 2007 (the 2007 Notes). The 2007 Notes were redeemed at a redemption price equal to 100% of the principal amount of the 2007 Notes, plus accrued and unpaid interest of \$3.2 million, as well as a make-whole payment of \$1.6 million. We recorded a loss on extinguishment of debt related to the make-whole payment associated with the 2007 Notes. The make-whole payment represented approximately \$0.017 per diluted share during the third quarter of 2006.

### **Issuance of 10-Year Senior Unsecured Notes**

In September 2006, we issued \$275 million in aggregate principal amount of 5.95% senior unsecured notes due 2016 (the 2016 Notes). The price to the investor for the 2016 Notes was 99.74% of the principal amount for an effective yield of 5.985%. The net proceeds of approximately \$272.0 million from this offering were used to redeem the 2007 Notes and for other corporate purposes. Interest on the 2016 Notes is paid semiannually.

### **Issuances of Common Stock**

In October 2006, we issued 6.0 million shares of common stock at a price of \$26.40 per share. The net proceeds of approximately \$150.7 million were used to fund a portion of the purchase price of the Buffets/Ryan's properties. See the section below for a discussion regarding the acquisition of \$349 million of Buffets/Ryan's restaurants.

In September 2006, we issued 4.715 million shares of common stock at a price of \$24.32 per share. The net proceeds of approximately \$109.1 million from this offering were used to fund new property acquisitions, repay borrowings under our credit facility and for other general corporate purposes.

In March 2006, we issued 5.2 million shares of common stock at a price of \$24.39 per share. The net proceeds of approximately \$120.5 million were used to fund new property acquisitions and for other general corporate purposes.

#### **Acquisition of \$349 million of Buffets/Ryan's restaurants on November 1, 2006**

On November 1, 2006, Realty Income and Crest acquired 144 Buffets/Ryan's restaurant properties for approximately \$349 million. The properties are leased under 20-year, triple-net lease agreements. These properties were acquired subsequent to a merger between Buffets, Inc. and Ryan's Restaurant Group. This acquisition was funded with cash and cash equivalents held at September 30, 2006, proceeds from our October 2006 stock offering and borrowings under our credit facility.

Of the 144 restaurant properties, 116 were acquired by Realty Income and 28 were acquired by Crest. The restaurants have, on average, approximately 10,300 leasable square feet and are situated on an average lot size of approximately 2.86 acres. In general, the properties are existing locations that, on average, have been operating for 11 years.

#### **Pizza Hut Acquisition**

On August 25, 2006, we announced in a press release that we had entered into an agreement to acquire a portfolio of 89 Pizza Hut properties for \$59 million from NPC international, Inc. and an additional 11-unit portfolio. Through September 30, 2006 we had acquired 75 Pizza Hut properties for approximately \$49.6 million.

#### **Credit Ratings Upgrade**

In February 2006, Moody's Investors Service, Inc. affirmed its ratings on our senior unsecured debt rating of Baa2 and our preferred stock rating of Baa3 and raised the outlook to positive from stable.

#### **Acquisitions During the Third Quarter of 2006**

During the third quarter of 2006, Realty Income and Crest invested \$104.2 million, in aggregate, in 87 new properties and properties under development. These 87 properties are located in 18 states and are 100% leased with an initial average lease term of 11.1 years. As described below, Realty Income acquired 85 properties and Crest acquired two properties.

Included in the \$104.2 million is \$103.0 million invested by Realty Income in 85 new properties and properties under development, with an initial weighted average contractual lease rate of 8.6%. These 85 properties are located in 18 states, are 100% leased with an initial average lease term of 11.2 years and will contain over 471,000 leasable square feet. The 85 new properties acquired by Realty Income are net-leased to eight different retail chains in the following seven industries: convenience store, drug store, general merchandise, health and fitness, motor vehicle dealership, restaurant, and theater.

Also included in the \$104.2 million is \$1.2 million invested by Crest in two new restaurant properties.

#### **Acquisitions During the First Nine Months of 2006**

During the first nine months of 2006, Realty Income and Crest invested \$259.1 million, in aggregate, in 138 new properties and properties under development. These 138 properties are located in 24 states and are 100% leased with an initial average lease term of 13.7 years. As described below, Realty Income acquired 133 properties and Crest acquired five properties.



Included in the \$259.1 million is \$249.2 million invested by Realty Income in 133 new properties and properties under development, with an initial weighted average contractual lease rate of 8.7%. These 133 properties are located in 24 states, are 100% leased with an initial average lease term of 13.6 years and will contain over 1.6 million leasable square feet. The 133 new properties acquired by Realty Income are net-leased to 13 different retail chains in the following ten industries: automotive collision services, convenience store, drug store, general merchandise, health and fitness, home improvement, motor vehicle dealership, private education, restaurant, and theater.

Also included in the \$259.1 million is \$9.9 million invested by Crest in five new retail properties.

At September 30, 2006, Realty Income had invested \$55.9 million in 10 properties that were leased and under contract for development by the tenant (with development costs funded by Realty Income). Rent on these properties is scheduled to begin at various times during the next twelve months. At September 30, 2006, we had outstanding commitments to pay estimated unfunded development costs totaling \$25.5 million.

### **Investments in Existing Properties**

In the third quarter of 2006, we capitalized costs of \$323,000 on existing properties in our portfolio, consisting of \$247,000 for re-leasing costs and \$76,000 for building improvements.

In the first nine months of 2006, we capitalized costs of \$561,000 on existing properties in our portfolio, consisting of \$382,000 for re-leasing costs and \$179,000 for building improvements.

### **Net Income Available to Common Stockholders**

Net income available to common stockholders was \$24.2 million in the third quarter of 2006 versus \$20.8 million in the same quarter of 2005, an increase of \$3.4 million. On a diluted per common share basis, net income was \$0.27 per share in the third quarter of 2006 compared to \$0.26 in the third quarter of 2005.

Net income available to common stockholders was \$71.0 million in the first nine months of 2006 versus \$64.2 million in the same period of 2005, an increase of \$6.8 million. On a diluted per common share basis, net income was \$0.82 per share in the third quarter of 2006 compared to \$0.81 in the first nine months of 2005.

The calculation to determine net income available to common stockholders includes gains from the sale of properties. The amount of gains varies from period to period based on the timing of property sales and can significantly impact net income available to common stockholders.

The gain recognized from the sales of investment properties during the third quarter of 2006 was \$843,000 as compared to \$303,000 million for the third quarter of 2005. The gain recognized from the sales of investment properties during the first nine months of 2006 was \$3.0 million as compared to \$3.8 million for the first nine months of 2005.

### **Funds from Operations (FFO)**

In the third quarter of 2006, our FFO increased by \$6.3 million, or 19.9%, to \$38.0 million versus \$31.7 million in the third quarter of 2005. On a diluted per common share basis, FFO was \$0.43 in the third quarter of 2006 compared to \$0.40 for the third quarter of 2005, an increase of \$0.03, or 7.5%.

In the first nine months of 2006, our FFO increased by \$17.1 million, or 18.2%, to \$110.9 million versus \$93.8 million in the first nine months of 2005. On a diluted per common share basis, FFO was \$1.27 in the first nine months of 2006 compared to \$1.18 for the first nine months of 2005, an increase of \$0.09, or 7.6%.

See our discussion of FFO later in this section for a reconciliation of net income available to common stockholders to FFO.

### **Crest Property Sales**

During the third quarter of 2006, Crest sold four properties from its inventory for an aggregate of \$6.6 million, which resulted in a gain of \$313,000. Crest's gains are included in income from discontinued operations, real estate acquired for resale by Crest.

During the first nine months of 2006, Crest sold nine properties from its inventory for an aggregate of \$16.8 million, which resulted in a gain of \$1.7 million.

### **Crest Property Inventory**

Crest's property inventory at September 30, 2006 totaled \$40.3 million and at December 31, 2005 totaled \$45.7 million.

### **Increases in Monthly Distributions to Common Stockholders**

We continue our 37-year policy of paying distributions monthly. Monthly distributions per share were increased in April 2006 by \$0.000625 to \$0.116875, in July 2006 by \$0.000625 to \$0.1175, in September 2006 by \$0.00775 to \$0.12525 and in October by \$0.000625 to \$0.125875. The increase in October 2006 was our 36th consecutive quarterly increase and the 41st increase in the amount of our dividend since our listing on the NYSE in 1994. In the first nine months of 2006, we paid three monthly cash distributions per share in the amount of \$0.11625, three in the amount of \$0.116875, two in the amount of \$0.1175 and one in the amount of \$0.12525, totaling \$1.059625. In September 2006 and October 2006, we declared distributions of \$0.125875 per share, which were paid on October 16, 2006 and will be paid on November 15, 2006, respectively.

The monthly distribution of \$0.125875 per share represents a current annualized distribution of \$1.5105 per share, and an annualized distribution yield of approximately 5.7% based on the last reported sale price of our common stock on the NYSE of \$26.40 on October 31, 2006. Although we expect to continue our policy of paying monthly distributions, we cannot guarantee that we will maintain the current level of distributions that we will continue our pattern of increasing distributions per share, or what the actual distribution yield will be in any future period.

## **LIQUIDITY AND CAPITAL RESOURCES**

### **Cash Reserves**

Realty Income is organized to operate as an equity REIT that acquires and leases properties and distributes to stockholders, in the form of monthly cash distributions, a substantial portion of its net cash flow generated from leases on its retail properties. We intend to retain an appropriate amount of cash as working capital. At September 30, 2006, we had cash and cash equivalents totaling \$113.4 million.

We believe that our cash and cash equivalents on hand, cash provided from operating activities and borrowing capacity is sufficient to meet our liquidity needs for the foreseeable future. We intend, however, to use additional sources of capital to fund property acquisitions and to repay our credit facility.

### **\$300 Million Acquisition Credit Facility**

We have a \$300 million revolving, unsecured credit facility that expires in October 2008. Realty Income's current investment grade credit ratings provide for financing under the credit facility at the London Interbank Offered Rate, commonly referred to as LIBOR, plus 65 basis points with a facility fee of 15 basis points, for all-in drawn pricing of 80 basis points over LIBOR. At October 31, 2006, we had borrowing capacity of \$192.0 million available on our credit facility and an outstanding balance of \$108.0 million at an effective interest rate of 5.97%.

The credit facility is expected to be used to acquire additional retail properties and for other corporate purposes. Any additional borrowings will increase our exposure to interest rate risk. We have the right to request an increase in the borrowing capacity of the credit facility by up to \$100 million, to a total borrowing capacity of \$400 million. Any increase in the borrowing capacity is subject to approval by the lending banks of our credit facility.

### **Mortgage Debt**

We have no mortgage debt on any of our properties.

### **Universal Shelf Registration**

In April 2006, we filed a shelf registration statement with the SEC, which will be effective for a term of three years. In accordance with the SEC rules, the amount of securities to be issued pursuant to this shelf registration statement was not specified when it was filed. The securities covered by this registration statement include common stock, preferred stock, debt securities, or any combination of such securities. Realty Income may periodically offer one or more of these securities in amounts, prices and on terms to be announced when and if the securities are offered. The specifics of any future offerings, along with the use of proceeds of any securities offered, will be described in detail in a prospectus supplement, or other offering materials, at the time of any offering. As such, there is no specific limit to the dollar amount of new securities that can be issued under this new shelf registration before it expires in April 2009.

The Common stock issued in September 2006 and October 2006 and the 2016 Notes issued in September 2006 were issued pursuant to the universal shelf registration statement.

### **Conservative Capital Structure**

We believe that our stockholders are best served by a conservative capital structure. Therefore, we seek to maintain a conservative debt level on our balance sheet and solid interest and fixed charge coverage ratios. At October 31, 2006, our total outstanding credit facility borrowings and outstanding notes were \$920.0 million or approximately 27.1% of our total market capitalization of \$3.79 billion. We define our total market capitalization at October 31, 2006 as the sum of:

- Shares of our common stock outstanding of 99,846,289 multiplied by the last reported sales price of our common stock on the NYSE of \$26.40 per share, or \$2.64 billion;
- Aggregate liquidation value of the Class D preferred stock of \$127.5 million;
- Outstanding borrowings of \$108 million on our credit facility; and
- Outstanding notes of \$920 million.

Historically, we have met our long-term capital needs through the issuance of common stock, preferred stock and long-term unsecured notes and bonds. Over the long term, we believe that the majority of our future securities issuances should be in the form of common stock, however, we may issue additional preferred stock or debt securities from time to time. We may issue common stock when we believe that our share price is at a level that allows for the proceeds of any offering to be accretively invested into additional properties. In addition, we may issue common stock to permanently finance properties that were financed by our credit facility or debt securities. However, we cannot assure you that we will have access to the capital markets at terms that are acceptable to us.



### Credit Agency Ratings

We are currently assigned investment grade corporate credit ratings on our senior unsecured notes from Fitch Ratings, Moody's Investors Service, Inc. and Standard & Poor's Ratings Group. Currently, Fitch Ratings has assigned a rating of BBB+, Moody's has assigned a rating of Baa2 and Standard & Poor's has assigned a rating of BBB to our senior notes. Moody's rating has a positive outlook and the other ratings have a stable outlook.

We have also been assigned investment grade credit ratings from the same rating agencies on our preferred stock. Fitch Ratings has assigned a rating of BBB, Moody's has assigned a rating of Baa3 and Standard & Poor's has assigned a rating of BBB- to our preferred stock. Moody's rating has a positive outlook and the other ratings have a stable outlook.

The credit ratings assigned to us could change based upon, among other things, our results of operations and financial condition.

### Notes Outstanding

In September 2006, we issued \$275 million of 5.95%, 10-year, senior unsecured notes due 2016. Interest on these notes is paid semiannually.

In September 2005, we issued \$175 million of 5-3/8%, 12-year, senior unsecured notes due 2017. Interest on these notes is paid semiannually.

In March 2005, we issued \$100 million of 5-7/8%, 30-year, senior unsecured bonds due 2035. Interest on these bonds is paid semiannually.

In November 2003, we issued \$150 million of 5-1/2%, 12-year, senior unsecured notes due 2015 (the 2015 Notes). Interest on the 2015 Notes is paid semiannually.

In March 2003, we issued \$100 million of 5-3/8%, 10-year, senior unsecured notes due 2013 (the 2013 Notes). Interest on the 2013 Notes is paid semiannually.

In January 1999, we issued \$20 million of 8% senior unsecured notes due 2009 (the 2009 Notes). Interest on the 2009 Notes is payable semiannually.

In October 1998, we issued \$100 million of 8-1/4% Monthly Income Senior Notes due 2008 (the 2008 Notes). Interest on the 2008 Notes is payable monthly. The 2008 Notes are unsecured.

All of these notes contain various covenants, including: (i) a limitation on incurrence of any debt which would cause our debt to total adjusted assets ratio to exceed 60%; (ii) a limitation on incurrence of any secured debt which would cause our secured debt to total adjusted assets ratio to exceed 40%; (iii) a limitation on incurrence of any debt which would cause our debt service coverage ratio to be less than 1.5 times; and (iv) the maintenance at all times of total unencumbered assets not less than 150% of our outstanding unsecured debt. We have been in compliance with these covenants since each of the notes were issued.

The following is a summary of the key financial covenants of our senior unsecured notes. The actual amounts are as of September 30, 2006.

| Note Covenants                           | Required                 | Actual |
|------------------------------------------|--------------------------|--------|
| Limitation on Incurrence of Total Debt   | ≤ 60%                    | 36.7%  |
| Limitation on Incurrence of Secured Debt | ≤ 40%                    | 0.0%   |
| Debt Service Coverage                    | ≥ 1.5 x                  | 3.9 x  |
| Maintenance of Total Unencumbered Assets | ≥ 150% of Unsecured Debt | 273%   |

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All of our outstanding notes and bonds have fixed interest rates. Our credit facility interest rate is variable.

### Table of Obligations

The following table summarizes the maturity of each of our obligations as of September 30, 2006 (dollars in millions):

| Year of Maturity | Credit Facility (1) | Notes    | Interest (2) | Other (3) | Totals     |
|------------------|---------------------|----------|--------------|-----------|------------|
| 2006             | \$                  | \$       | \$ 13.8      | \$ 26.3   | \$ 40.1    |
| 2007             |                     |          | 55.1         |           | 55.1       |
| 2008             |                     | 100.0    | 54.1         |           | 154.1      |
| 2009             |                     | 20.0     | 45.3         |           | 65.3       |
| 2010             |                     |          | 45.3         |           | 45.3       |
| Thereafter       |                     | 800.0    | 350.7        |           | 1,150.7    |
| Totals           | \$                  | \$ 920.0 | \$ 564.3     | \$ 26.3   | \$ 1,510.6 |

(1) The credit facility balance on at October 31, 2006 was \$108 million.

(2) Interest on credit facility and notes has been calculated based on outstanding balances as of September 30, 2006 through their respective maturity dates.

(3) Other consists of a \$25.5 million of estimated unfunded costs on properties under development and \$804,000 of contingent payments for tenant improvements and leasing costs.

Our credit facility and note obligations are unsecured. Accordingly, we have not pledged any assets as collateral for these obligations.

### Preferred Stock Outstanding

In May and October 2004, we issued an aggregate of 5.1 million shares of 7.375% Class D cumulative redeemable preferred stock. Beginning May 27, 2009, shares of Class D preferred stock are redeemable at our option for \$25.00 per share, plus any accrued and unpaid dividends. Dividends on shares of Class D preferred are paid monthly in arrears.

### No Off-Balance Sheet Arrangements or Unconsolidated Investments

Realty Income and its subsidiaries have no unconsolidated or off-balance sheet investments in variable interest entities or off-balance sheet financing, nor do we engage in trading activities involving energy or commodity contracts or other derivative instruments.

As we have no joint ventures, off-balance sheet entities, or mandatory redeemable preferred stock, our financial position or results of operations are currently not affected by Financial Accounting Standard Board Interpretation No. 46R, *Consolidation of Variable Interest Entities* and Statement of Financial Accounting Standard No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*.

### Distributions

Distributions are paid monthly to our common stockholders and Class D preferred stockholders if, and when declared by our Board of Directors.

In order to maintain our tax status as a REIT for federal income tax purposes, we generally are required to distribute dividends to our stockholders aggregating annually at least 90% of our REIT taxable income (determined without regard to the dividends paid deduction and by excluding net capital gains) and we are subject to income tax to the extent we distribute less than 100% of our REIT taxable income (including net capital gains). In 2005, our cash distributions totaled \$118.0 million, or approximately 113.2% of our estimated REIT taxable income of \$104.2 million. Our estimated REIT taxable income reflects non-cash deductions for depreciation and amortization. We intend to continue to make distributions to our stockholders that are sufficient to meet this distribution requirement and that will reduce our exposure to income taxes. Our 2005 cash distributions to common stockholders totaled \$108.6 million, representing



83.8% of our funds from operations available to common stockholders of \$129.6 million.

The Class D preferred stockholders receive cumulative distributions at a rate of 7.375% per annum on the \$25 per share liquidation preference (equivalent to \$1.84375 per annum per share).

Future distributions will be at the discretion of our Board of Directors and will depend on, among other things, our results of operations, FFO, cash flow from operations, financial condition and capital requirements, the annual distribution requirements under the REIT provisions of the Tax Code, our debt service requirements and any other factors the Board of Directors may deem relevant. In addition, our credit facility contains financial covenants that could limit the amount of distributions payable by us in the event of a deterioration in our results of operations or financial condition, and which prohibit the payment of distributions on the common or preferred stock in the event that we fail to pay when due (subject to any applicable grace period) any principal or interest on borrowings under our credit facility.

Distributions of our current and accumulated earnings and profits for federal income tax purposes, generally will be taxable to stockholders as ordinary income, except to the extent that we recognize capital gains and declare a capital gains dividend or that such amounts constitute qualified dividend income subject to a reduced rate of tax. The maximum tax rate of non-corporate taxpayers for qualified dividend income has generally been reduced to 15% (for taxable years beginning after December 31, 2002). In general, dividends payable by REITs are not eligible for the reduced tax rate on corporate dividends, except to the extent the REIT's dividends are attributable to dividends received from taxable corporations (such as our taxable REIT subsidiary, Crest), to income that was subject to tax at the corporate or REIT level (for example, if we distribute taxable income that we retained and paid tax on in the prior taxable year) or, as discussed above, dividends properly designated by us as capital gain dividends. Distributions in excess of earnings and profits generally will be treated as a non-taxable reduction in the stockholders basis in the stock. Distributions above that basis, generally, will be taxable as a capital gain. Approximately 10.1% of the distributions, made or deemed to have been made in 2005, to our common stockholders were classified as a return of capital for federal income tax purposes. We are unable to predict the portion of future distributions that may be classified as a return of capital.

## RESULTS OF OPERATIONS

### Critical Accounting Policies

Our consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ( GAAP ). Our consolidated financial statements are the basis for our discussion and analysis of financial condition and results of operations. Preparing our consolidated financial statements requires us to make a number of estimates and assumptions that affect the reported amounts and disclosures in the consolidated financial statements. We believe that we have made these estimates and assumptions in an appropriate manner in a way that accurately reflects our financial condition. We continually test and evaluate these estimates and assumptions using our historical knowledge of the business, as well as other factors, to ensure that they are reasonable for reporting purposes. However, actual results may differ from these estimates and assumptions.

In order to prepare our consolidated financial statements according to the rules and guidelines set forth by GAAP, many subjective judgments must be made with regard to critical accounting policies. One of these judgments is our estimate for useful lives in determining depreciation expense for our properties. Depreciation of buildings and improvements is computed using the straight line method over an estimated useful life of 25 years. If we use a shorter or longer estimated useful life it could have a material impact on our results of operations. We believe that 25 years is an appropriate estimate of useful life. No depreciation has been recorded on Crest's properties because they are held for sale.

Another significant judgment must be made as to if, and when, impairment losses should be taken on our



properties when events or change in circumstances indicate that the carrying amount of the asset may not be recoverable. Generally, a provision is made for impairment loss if estimated future operating cash flows (undiscounted and without interest charges) plus estimated disposition proceeds (undiscounted) are less than the current book value. Impairment losses are measured as the amount by which the current book value of the asset exceeds the fair value of the asset. If a property is held for sale, it is carried at the lower of carrying cost or estimated fair value, less cost to sell. The carrying value of our real estate is the largest component of our consolidated balance sheet. If events should occur that require us to reduce the carrying value of our real estate by recording provisions for impairment losses, it could have a material impact on our results of operations.

*The following is a comparison of our results of operations for the three and nine months ended September 30, 2006 to the three and nine months ended September 30, 2005.*

#### **Rental Revenue**

Rental revenue was \$59.1 million for the third quarter of 2006 versus \$48.8 million for the third quarter of 2005, an increase of \$10.3 million, or 21.1%. The increase in rental revenue in the third quarter of 2006 is attributable to:

- The 133 retail properties acquired by Realty Income in 2006, which generated \$2.9 million in the third quarter;
- The 135 retail properties acquired by Realty Income in 2005, which generated \$8.3 million in the third quarter of 2006 compared to \$2.6 million in the third quarter of 2005, an increase of \$5.7 million;
- Same store rents generated on 1,430 properties during the third quarters of 2006 and 2005 increased by \$261,000, or 0.6%, to \$44.04 million from \$43.77 million. These properties were leased during all of both quarters;
- An increase in straight-line rent and other non-cash adjustments to rent of \$233,000 in the third quarter of 2006 as compared to the third quarter of 2005; and
- An increase of \$1.2 million relating to the aggregate of (i) development properties acquired before 2005 that started paying rent in 2005, (ii) properties that were vacant during part of 2006 or 2005 and (iii) lease termination settlements. These items totaled \$2.8 million in aggregate in the third quarter of 2006 compared to \$1.6 million in the same quarter of 2005.

Rental revenue was \$169.9 million for the first nine months of 2006 versus \$142.2 million for the first nine months of 2005, an increase of \$27.7 million, or 19.5%. The increase in rental revenue in the first nine months of 2006 is attributable to:

- The 133 retail properties acquired by Realty Income in 2006, which generated \$6.0 million in the first nine months of 2006;
- The 135 retail properties acquired by Realty Income in 2005, which generated \$24.3 million in the first nine months of 2006 compared to \$5.2 million in the first nine months of 2005, an increase of \$19.1 million;
- Same store rents generated on 1,430 properties during the first nine months of 2006 and 2005 increased by \$763,000, or 0.6%, to \$131.54 million from \$130.78 million. These properties were leased during all of both periods;
- A increase in straight-line rent and other non-cash adjustments to rent of \$139,000 in the first nine months of 2006 as compared to the first nine months of 2005; and
- An increase of \$1.8 million relating to the aggregate of (i) development properties acquired before 2005 that started paying rent in 2005, (ii) properties that were vacant during part of 2006 or 2005 and (iii) lease termination settlements. These items totaled \$5.1 million in aggregate in the first nine months of 2006 compared to \$3.3 million in the first nine months of 2005.

Of the 1,766 properties in the portfolio at September 30, 2006, 1,759, or 99.6%, are single-tenant properties and the remaining seven are multi-tenant properties. Of the 1,759 single-tenant properties, 1,739, or 98.9%, were net leased with a weighted average remaining lease term (excluding rights to



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extend a lease at the option of the tenant) of approximately 12.2 years at September 30, 2006. Of our 1,739 leased single-tenant properties, 1,545, or 88.8%, were under leases that provide for increases in rents through:

- Base rent increases tied to a consumer price index with adjustment ceilings;
- Fixed increases;
- To a lesser degree, overage rent based on a percentage of the tenants' gross sales; or
- A combination of two or more of the above rent provisions.

Percentage rent, which is included in rental revenue, was \$233,000 in the third quarter of 2006 and \$256,000 in the third quarter of 2005. Percentage rent was \$458,000 in the first nine months of 2006 and \$455,000 in the first nine months of 2005. Percentage rent in the third quarter and first nine months of 2006 was less than 1% of rental revenue and we anticipate percentage rent to be less than 1% of rental revenue in 2006.

Our portfolio of retail real estate, leased primarily to regional and national chains under net leases, continues to perform well and provides dependable lease revenue supporting the payment of monthly dividends to our stockholders. At September 30, 2006, our portfolio of 1,766 retail properties was 98.8% leased with 21 properties available for lease, one of which is a multi-tenant property.

As of October 31, 2006, transactions to lease or sell five of the 21 properties available for lease at September 30, 2006 were underway or completed. We anticipate these transactions will be completed during the next several months, although we cannot guarantee that all of these properties can be leased or sold within this period. It has been our experience that approximately 1% to 3% of our property portfolio will be unleased at any given time; however, we cannot assure you that the number of properties available for lease will not exceed these levels.

### Interest Expense

Interest expense was \$2.3 million higher in the third quarter of 2006 than in the third quarter of 2005. Interest expense was \$8.6 million higher in the first nine months of 2006 than in the first nine months of 2005. Interest expense increased in 2006 primarily due to higher average outstanding balances, which was partially offset by slightly lower interest rates related to our fixed rate debt. We issued \$100 million of 30-year bonds in March 2005 and \$175 million of 12-year notes in September 2005, which contributed to the increase in average outstanding balances and slightly lower average interest rates on our debt.

The following is a summary of the components of our interest expense (dollars in thousands):

|                                                                                            | <b>Three<br/>months<br/>ended<br/>9/30/06</b> | <b>Three<br/>months<br/>ended<br/>9/30/05</b> | <b>Nine<br/>months<br/>ended<br/>9/30/06</b> | <b>Nine<br/>months<br/>ended<br/>9/30/05</b> |
|--------------------------------------------------------------------------------------------|-----------------------------------------------|-----------------------------------------------|----------------------------------------------|----------------------------------------------|
| Interest on our credit facility and notes                                                  | \$ 13,235                                     | \$ 10,406                                     | \$ 39,367                                    | \$ 28,714                                    |
| Interest included in discontinued operations from real estate acquired for resale by Crest | (711 )                                        | (320 )                                        | (2,175 )                                     | (630 )                                       |
| Amortization of settlements on treasury lock agreement                                     | 121                                           | 189                                           | 499                                          | 567                                          |
| Credit facility commitment fees                                                            | 114                                           | 127                                           | 342                                          | 380                                          |
| Amortization of credit facility origination costs and deferred bond financing costs        | 552                                           | 439                                           | 1,494                                        | 1,286                                        |
| Interest capitalized                                                                       | (781 )                                        | (613 )                                        | (1,870 )                                     | (1,237 )                                     |
| Interest expense                                                                           | \$ 12,530                                     | \$ 10,228                                     | \$ 37,657                                    | \$ 29,080                                    |

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|                                                | Three<br>months<br>ended<br>9/30/06 |   | Three<br>months<br>ended<br>9/30/05 |   | Nine<br>months<br>ended<br>9/30/06 |   | Nine<br>months<br>ended<br>9/30/05 |   |
|------------------------------------------------|-------------------------------------|---|-------------------------------------|---|------------------------------------|---|------------------------------------|---|
| <b>Credit facilities and notes outstanding</b> |                                     |   |                                     |   |                                    |   |                                    |   |
| Average outstanding balances (in thousands)    | \$ 847,580                          |   | \$ 660,487                          |   | \$ 848,377                         |   | \$ 600,053                         |   |
| Average interest rates                         | 6.19                                | % | 6.25                                | % | 6.20                               | % | 6.40                               | % |

At October 31, 2006, the weighted average interest rate on our:

- Credit facility borrowings of \$108 million was 5.97%;
- Notes payable of \$920 million was 5.99%; and
- Combined outstanding credit facility and notes of \$1,028 million was 5.99%.

### Interest Coverage Ratio

Our interest coverage ratio for the third quarter of 2006 was 4.1 times, and was 4.3 times for the third quarter of 2005. Our interest coverage ratio for the first nine months of 2006 was 4.0 times, and was 4.4 times for the first nine months of 2005. Interest coverage ratio is calculated as: the interest coverage amount (as calculated in the following table) divided by interest expense, including interest recorded to discontinued operations. We consider interest coverage ratio to be an appropriate supplemental measure of a company's ability to meet its interest expense obligations. Our calculation of interest coverage ratio may be different from the calculation used by other companies and, therefore, comparability may be limited. This information should not be considered as an alternative to any GAAP liquidity measures.

The following is a reconciliation of net cash provided by operating activities to our interest coverage amount (dollars in thousands):

|                                                            | Three<br>months<br>ended<br>9/30/06 |   | Three<br>months<br>ended<br>9/30/05 |   | Nine<br>months<br>ended<br>9/30/06 |   | Nine<br>months<br>ended<br>9/30/05 |   |
|------------------------------------------------------------|-------------------------------------|---|-------------------------------------|---|------------------------------------|---|------------------------------------|---|
| Net cash provided by operating activities                  | \$ 43,085                           |   | \$ 12,919                           |   | \$ 127,842                         |   | \$ 70,255                          |   |
| Interest expense                                           | 12,530                              |   | 10,228                              |   | 37,657                             |   | 29,080                             |   |
| Interest expense included in discontinued operations (1)   | 711                                 |   | 320                                 |   | 2,175                              |   | 630                                |   |
| Income taxes                                               | 96                                  |   | 202                                 |   | 558                                |   | 603                                |   |
| Income taxes included in discontinued operations (1)       | 18                                  |   | 195                                 |   | 471                                |   | 650                                |   |
| Investment in real estate acquired for resale (1)(2)       | 1,200                               |   | 32,761                              |   | 9,937                              |   | 54,470                             |   |
| Proceeds from sales of real estate acquired for resale (1) | (6,612)                             | ) | (5,758)                             | ) | (16,807)                           | ) | (16,955)                           | ) |
| Collection of a mortgage note receivable by Crest (1)      |                                     |   |                                     |   | (1,333)                            | ) |                                    |   |
| Gain on sales of real estate acquired for resale (1)       | 313                                 |   | 713                                 |   | 1,739                              |   | 2,361                              |   |
| Amortization of deferred stock compensation                | (648)                               | ) | (542)                               | ) | (2,280)                            | ) | (1,627)                            | ) |
| Amortization of stock option costs                         | (6)                                 | ) | (4)                                 | ) | (17)                               | ) | (11)                               | ) |
| Changes in assets and liabilities:                         |                                     |   |                                     |   |                                    |   |                                    |   |
| Accounts receivable and other assets                       | (505)                               | ) | (1,005)                             | ) | (5,033)                            | ) | (617)                              | ) |
| Accounts payable, accrued expenses and other liabilities   | 3,857                               |   | (4,798)                             | ) | 3,636                              |   | (6,752)                            | ) |
| Interest coverage amount                                   | \$ 54,039                           |   | \$ 45,231                           |   | \$ 158,545                         |   | \$ 132,087                         |   |
| Divided by interest expense (3)                            | \$ 13,241                           |   | \$ 10,548                           |   | \$ 39,832                          |   | \$ 29,710                          |   |
| Interest coverage ratio                                    | 4.1                                 |   | 4.3                                 |   | 4.0                                |   | 4.4                                |   |

(1) Crest activities.

(2) The 2005 amount includes intangibles recorded in connection with acquisitions of real estate acquired for resale.

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(3) Includes interest expense recorded to income from discontinued operations, real estate acquired for resale by Crest.

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**Fixed Charge Coverage Ratio**

Our fixed charge coverage ratio for the third quarter of 2006 and 2005 was 3.5 times. For the nine months ended September 30, 2006 our fixed charge coverage ratio was 3.4 times and for the nine months ended September 30, 2005 it was 3.6 times. Fixed charge coverage ratio is calculated in exactly the same manner as interest coverage ratio, except that preferred stock dividends are also added to the denominator. We consider fixed charge coverage ratio to be an appropriate supplemental measure of a company's ability to make its interest and preferred stock dividend payments. Our calculation of the fixed charge coverage ratio may be different from the calculation used by other companies and, therefore, comparability may be limited. This information should not be considered as an alternative to any GAAP liquidity measures.

Interest coverage amount divided by interest expense plus preferred stock dividends (dollars in thousands):

|                                                                | <b>Three<br/>months<br/>ended<br/>9/30/06</b> | <b>Three<br/>months<br/>ended<br/>9/30/05</b> | <b>Nine<br/>months<br/>ended<br/>9/30/06</b> | <b>Nine<br/>months<br/>ended<br/>9/30/05</b> |
|----------------------------------------------------------------|-----------------------------------------------|-----------------------------------------------|----------------------------------------------|----------------------------------------------|
| Interest coverage amount                                       | \$ 54,039                                     | \$ 45,231                                     | \$ 158,545                                   | \$ 132,087                                   |
| Divided by interest expense plus preferred stock dividends (1) | \$ 15,592                                     | \$ 12,899                                     | \$ 46,884                                    | \$ 36,762                                    |
| Fixed charge coverage ratio                                    | 3.5                                           | 3.5                                           | 3.4                                          | 3.6                                          |

(1) Includes interest expense recorded to income from discontinued operations, real estate acquired for resale by Crest.

**Depreciation and Amortization**

For the third quarter of 2006, depreciation and amortization was \$14.6 million as compared to \$11.2 million in the third quarter of 2005. For the first nine months of 2006, depreciation and amortization was \$43.0 million as compared to \$33.1 million in the first nine months of 2005. The increase in depreciation and amortization in 2006 was due to the acquisition of properties in 2006 and 2005, which was partially offset by property sales during these years.

**Loss on Extinguishment of Debt**

In September 2006, we redeemed all of our outstanding \$110 million, 7-¾%, unsecured notes due May 2007. The 2007 Notes were redeemed at a redemption price equal to 100% of the principal amount of the 2007 Notes, plus accrued and unpaid interest of \$3.2 million, as well as a make-whole payment of \$1.6 million. We recorded a loss on extinguishment of debt totaling \$1.6 million related to the make-whole payment associated with the 2007 Notes. The make-whole payment represented approximately \$0.017 per diluted share during the third quarter of 2006.

**General and Administrative Expenses**

General and administrative expenses decreased by \$83,000, to \$4.1 million, in the third quarter of 2006 as compared to \$4.2 million in the third quarter of 2005. In the third quarter of 2006, as a percentage of total revenue, general and administrative expenses decreased to 6.9% as compared to 8.5% in the third quarter of 2005.

General and administrative expenses increased by \$756,000, to \$12.7 million, in the first nine months of 2006 as compared to \$11.9 million in the first nine months of 2005. In the first nine months of 2006, as a percentage of total revenue, general and administrative expenses decreased to 7.4% as compared to 8.4% in the first nine months of 2005.

General and administrative expenses increased during the first nine months of 2006 primarily due to increases in payroll and employee benefit costs.

As our property portfolio has grown and continues to grow, we have increased, and anticipate that we will continue to gradually increase the level of our staffing. We expect general and administrative expenses to continue to increase due to costs attributable to payroll, staffing costs and corporate governance.

In October 2006, we had 71 permanent employees as compared to October 2005 when we had 69 permanent employees and five temporary employees. The temporary employees had been working on a record retention project that was concluded in the third quarter of 2006.

### **Property Expenses**

Property expenses are broken down into costs associated with non-net leased multi-tenant properties, unleased single-tenant properties and general portfolio expenses. Expenses related to the multi-tenant and unleased single-tenant properties include, but are not limited to, property taxes, maintenance, insurance, utilities, property inspections, bad debt expense and legal fees. General portfolio costs include, but are not limited to, insurance, legal, bad debt expense, property inspections and title search fees. At September 30, 2006, 21 properties were available for lease as compared to 25 at December 31, 2005 and 26 at September 30, 2005.

Property expenses were \$787,000 in the third quarter of 2006 and \$1.0 million in the third quarter of 2005. Property expenses were \$2.3 million in the first nine months of 2006 and \$2.9 million in the first nine months of 2005.

### **Income Taxes**

Income taxes were \$96,000 in the third quarter of 2006 as compared to \$202,000 in the third quarter of 2005. Income taxes for the first nine months of 2006 and 2005 were \$558,000 and \$603,000, respectively. These amounts are for city and state income taxes paid by Realty Income.

In addition, Crest incurred state and federal income taxes of \$18,000 in the third quarter of 2006 as compared to \$195,000 in the third quarter of 2005. Crest incurred state and federal income taxes of \$471,000 in the first nine months of 2006 as compared to \$650,000 in the first nine months of 2005. These income taxes are included in income from discontinued operations, real estate acquired for resale by Crest.

### **Discontinued Operations**

Crest acquires properties with the intention of reselling them rather than holding them as investments and operating the properties. Consequently, we classify properties acquired by Crest as held for sale at the date of acquisition and do not depreciate them. The operation of Crest's properties is classified as income from discontinued operations, real estate acquired for resale by Crest.

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

|                                                                                         | <b>Three<br/>months<br/>ended<br/>9/30/06</b> | <b>Three<br/>months<br/>ended<br/>9/30/05</b> | <b>Nine<br/>months<br/>ended<br/>9/30/06</b> | <b>Nine<br/>months<br/>ended<br/>9/30/05</b> |
|-----------------------------------------------------------------------------------------|-----------------------------------------------|-----------------------------------------------|----------------------------------------------|----------------------------------------------|
| <b>Crest's income from discontinued operations,<br/>real estate acquired for resale</b> |                                               |                                               |                                              |                                              |
| Gain on sales of real estate acquired for resale                                        | \$ 313                                        | \$ 713                                        | \$ 1,739                                     | \$ 2,361                                     |
| Rental revenue                                                                          | 913                                           | 514                                           | 3,007                                        | 1,083                                        |
| Interest expense                                                                        | (711 )                                        | (320 )                                        | (2,175 )                                     | (630 )                                       |
| General and administrative expense                                                      | (73 )                                         | (137 )                                        | (227 )                                       | (410 )                                       |
| Property expenses                                                                       | (17 )                                         | (9 )                                          | (50 )                                        | (59 )                                        |
| Provisions for impairment                                                               | (308 )                                        |                                               | (308 )                                       |                                              |
| Income taxes                                                                            | (18 )                                         | (195 )                                        | (471 )                                       | (650 )                                       |
| <b>Income from discontinued operations, real estate acquired for resale by Crest</b>    | <b>\$ 99</b>                                  | <b>\$ 566</b>                                 | <b>\$ 1,515</b>                              | <b>\$ 1,695</b>                              |
| <b>Per common share, basic and diluted</b>                                              | <b>\$ 0.00</b>                                | <b>\$ 0.01</b>                                | <b>\$ 0.02</b>                               | <b>\$ 0.02</b>                               |

Realty Income's properties sold in 2006 and 2005 have been classified as discontinued operations. No Realty Income properties were listed as held for sale at September 30, 2006. The following is a summary of our discontinued operations from real estate held for investment (dollars in thousands):

|                                                                                                 | <b>Three<br/>months<br/>ended<br/>9/30/06</b> | <b>Three<br/>months<br/>ended<br/>9/30/05</b> | <b>Nine<br/>months<br/>ended<br/>9/30/06</b> | <b>Nine<br/>months<br/>ended<br/>9/30/05</b> |
|-------------------------------------------------------------------------------------------------|-----------------------------------------------|-----------------------------------------------|----------------------------------------------|----------------------------------------------|
| <b>Realty Income's income from discontinued<br/>operations, real estate held for investment</b> |                                               |                                               |                                              |                                              |
| Gain on sales of investment properties                                                          | \$ 843                                        | \$ 303                                        | \$ 3,036                                     | \$ 3,767                                     |
| Rental revenue                                                                                  | 68                                            | 358                                           | 453                                          | 1,424                                        |
| Other revenue                                                                                   | 25                                            | 1                                             | 33                                           | 1                                            |
| Depreciation and amortization                                                                   | (20 )                                         | (89 )                                         | (82 )                                        | (330 )                                       |
| Property expenses                                                                               | (72 )                                         | (65 )                                         | (116 )                                       | (203 )                                       |
| Provision for impairment                                                                        |                                               | (15 )                                         |                                              | (35 )                                        |
| <b>Income from discontinued operations, real estate held for investment</b>                     | <b>\$ 844</b>                                 | <b>\$ 493</b>                                 | <b>\$ 3,324</b>                              | <b>\$ 4,624</b>                              |
| <b>Per common share, basic and diluted</b>                                                      | <b>\$ 0.01</b>                                | <b>\$ 0.01</b>                                | <b>\$ 0.04</b>                               | <b>\$ 0.06</b>                               |

The following is a summary of our total discontinued operations (dollars in thousands):

|                                             | <b>Three<br/>months<br/>ended<br/>9/30/06</b> | <b>Three<br/>months<br/>ended<br/>9/30/05</b> | <b>Nine<br/>months<br/>ended<br/>9/30/06</b> | <b>Nine<br/>months<br/>ended<br/>9/30/05</b> |
|---------------------------------------------|-----------------------------------------------|-----------------------------------------------|----------------------------------------------|----------------------------------------------|
| <b>Income from discontinued operations:</b> |                                               |                                               |                                              |                                              |
| Real estate acquired for resale by Crest    | \$ 99                                         | \$ 566                                        | \$ 1,515                                     | \$ 1,695                                     |
| Real estate held for investment             | 844                                           | 493                                           | 3,324                                        | 4,624                                        |
| <b>Income from discontinued operations</b>  | <b>\$ 943</b>                                 | <b>\$ 1,059</b>                               | <b>\$ 4,839</b>                              | <b>\$ 6,319</b>                              |
| <b>Per common share, basic and diluted</b>  | <b>\$ 0.01</b>                                | <b>\$ 0.01</b>                                | <b>\$ 0.06</b>                               | <b>\$ 0.08</b>                               |





#### **Gain on Sales of Real Estate Acquired for Resale by Crest**

During the third quarter of 2006, Crest sold four properties for \$6.6 million, which resulted in a gain of \$313,000. In comparison, during the third quarter of 2005, Crest sold two properties for \$5.8 million, which resulted in a gain of \$713,000. Crest's gains on sales are reported before income taxes and are included in discontinued operations.

During the first nine months of 2006, Crest sold nine properties for \$16.8 million, which resulted in a gain of \$1.7 million. In comparison, during the first nine months of 2005, Crest sold nine properties for \$17.0 million, which resulted in a gain of \$2.4 million.

At September 30, 2006, Crest had \$40.3 million invested in 13 properties, which are held for sale. Our goal is for Crest to carry an average inventory of approximately \$20 to \$25 million in real estate. Crest generates an earnings spread on the difference between the lease payments it receives on the properties held in inventory and the cost of capital used to acquire properties. It is our belief that at this level of inventory, rental revenue will exceed the ongoing operating expenses of Crest without any property sales.

#### **Gain on Sales of Investment Properties by Realty Income**

During the third quarter of 2006, we sold or exchanged three investment properties for \$4.0 million, which resulted in a gain of \$843,000. In comparison, during the third quarter of 2005, we sold four investment properties and a portion of land from one property for \$3.0 million, which resulted in a gain of \$303,000.

During the first nine months of 2006, we sold or exchanged 13 investment properties for \$10.7 million, which resulted in a gain of \$3.0 million. In comparison, during the first nine months of 2005, we sold 15 investment properties and a portion of land from one property for \$17.6 million, which resulted in a gain of \$3.8 million. These gains are included in discontinued operations, except for \$14,000 which is included in other revenue in the first nine months of 2005.

We have an active portfolio management program that incorporates the sale of assets when we believe the reinvestment of the sale proceeds will generate higher returns, enhance the credit quality of our real estate portfolio or extend our average remaining lease term. At September 30, 2006, we classified real estate with a carrying amount of \$40.1 million as held for sale on our balance sheet, which includes properties owned by Crest. Additionally, we anticipate selling investment properties from our portfolio that have not yet been specifically identified, from which we anticipate receiving between \$10 million and \$35 million in proceeds during the next 12 months. We intend to invest these proceeds into new property acquisitions. However, we cannot guarantee that we will sell properties during the next 12 months.

#### **Provision for Impairment on Real Estate Acquired for Resale by Crest**

Provisions for impairment of \$308,000 were recorded by Crest on two properties in the third quarter and first nine months of 2006. No provisions for impairment were recorded by Crest in 2005.

#### **Provision for Impairment on Realty Income Investment Properties**

No provision for impairment was recorded in the third quarter and first nine months of 2006.

In the third quarter of 2005 we recorded provisions for impairment of \$119,000 taken on two properties. These provisions are included in income from discontinued operations, real estate held for investment except for \$104,000 which is included in property expenses.

In the first nine months of 2005 we recorded provisions for impairment of \$186,000 taken on four properties. These provisions are included in income from discontinued operations, real estate held for investment except for \$151,000 which is included in property expenses.

#### **Preferred Stock Dividends**

We paid preferred stock cash dividends of \$2.4 million in both the third quarter of 2006 and 2005. We

paid preferred stock cash dividends of \$7.1 million in each of the first nine months of 2006 and 2005.

### Net Income Available to Common Stockholders

Net income available to common stockholders was \$24.2 million in the third quarter of 2006, an increase of \$3.4 million as compared to \$20.8 million in the third quarter of 2005. Net income available to common stockholders was \$71.0 million in the first nine months of 2006, an increase of \$6.8 million as compared to \$64.2 million in the first nine months of 2005.

The calculation to determine net income available to common stockholders includes gains from the sale of properties. The amount of gains varies from period to period based on the timing of property sales and can significantly impact net income available to common stockholders.

During the third quarter of 2006, the gain recognized from the sales of investment properties was \$843,000 as compared to \$303,000 for the third quarter of 2005. During the first nine months of 2006, the gain recognized from the sales of investment properties was \$3.0 million, as compared to \$3.8 million for the first nine months of 2005.

### FUNDS FROM OPERATIONS AVAILABLE TO COMMON STOCKHOLDERS (FFO)

FFO for the third quarter of 2006 increased by \$6.3 million, or 19.9%, to \$38.0 million as compared to \$31.7 million in the third quarter of 2005. FFO for the first nine months of 2006 increased by \$17.1 million, or 18.2%, to \$110.9 million as compared to \$93.8 million in the third quarter of 2005. The following is a reconciliation of net income available to common stockholders (which we believe is the most comparable GAAP measure) to FFO. Also presented is information regarding distributions paid to common stockholders and the weighted average number of shares outstanding (dollars in thousands, except per share amounts):

|                                                        | Three<br>months<br>ended<br>9/30/06 | Three<br>months<br>ended<br>9/30/05 | Nine<br>months<br>ended<br>9/30/06 | Nine<br>months<br>ended<br>9/30/05 |
|--------------------------------------------------------|-------------------------------------|-------------------------------------|------------------------------------|------------------------------------|
| Net income available to common stockholders            | \$ 24,207                           | \$ 20,771                           | \$ 71,033                          | \$ 64,239                          |
| Depreciation and amortization:                         |                                     |                                     |                                    |                                    |
| Continuing operations                                  | 14,641                              | 11,226                              | 42,961                             | 33,098                             |
| Discontinued operations                                | 20                                  | 89                                  | 82                                 | 330                                |
| Depreciation of furniture, fixtures and equipment      | (49 )                               | (35 )                               | (142 )                             | (102 )                             |
| Gain on sales of investment properties:                |                                     |                                     |                                    |                                    |
| Continuing operations                                  |                                     |                                     |                                    | (14 )                              |
| Discontinued operations                                | (843 )                              | (303 )                              | (3,036 )                           | (3,767 )                           |
| Funds from operations available to common stockholders | \$ 37,976                           | \$ 31,748                           | \$ 110,898                         | \$ 93,784                          |
| FFO per common share:                                  |                                     |                                     |                                    |                                    |
| Basic                                                  | \$ 0.43                             | \$ 0.40                             | \$ 1.28                            | \$ 1.18                            |
| Diluted                                                | \$ 0.43                             | \$ 0.40                             | \$ 1.27                            | \$ 1.18                            |
| Distributions paid to common stockholders              | \$ 32,109                           | \$ 26,867                           | \$ 92,605                          | \$ 79,543                          |
| FFO in excess of distributions to common stockholders  | \$ 5,867                            | \$ 4,881                            | \$ 18,293                          | \$ 14,241                          |
| Weighted average number of common shares:              |                                     |                                     |                                    |                                    |
| Basic                                                  | 89,166,429                          | 79,779,808                          | 86,936,161                         | 79,653,608                         |
| Diluted                                                | 89,267,138                          | 79,843,553                          | 87,084,545                         | 79,727,036                         |

We define FFO, a non-GAAP measure, consistent with the National Association of Real Estate Investment Trusts' definition, as net income available to common stockholders, plus depreciation and amortization of real estate assets, reduced by gains on sales of investment property and extraordinary items.

We consider FFO to be an appropriate supplemental measure of a REIT's operating performance as it is based on a net income analysis of property portfolio performance that excludes non-cash items such as depreciation. The historical accounting convention used for real estate assets requires straight-line depreciation of buildings and improvements, which implies that the value of real estate assets diminishes predictably over time. Since real estate values historically rise and fall with market conditions, presentations of operating results for a REIT, using historical accounting for depreciation, could be less informative. The use of FFO is recommended by the REIT industry as a supplemental performance measure. In addition, FFO is used as a measure of our compliance with the financial covenants of our credit facility.

Presentation of this information is intended to assist the reader in comparing the operating performance of different REITs, although it should be noted that not all REITs calculate FFO the same way, so comparisons with other REITs may not be meaningful. Furthermore, FFO is not necessarily indicative of cash flow available to fund cash needs and should not be considered as an alternative to net income as an indication of Realty Income's performance. In addition, FFO should not be considered as an alternative to reviewing our cash flows from operating, investing and financing activities as a measure of liquidity, of our ability to make cash distributions or of our ability to pay interest payments.

### Other Non-Cash Items and Capitalized Expenditures

The following information includes non-cash items and capitalized expenditures on existing properties in our portfolio. These items are not included in the adjustments to net income available to common stockholders to arrive at FFO. Analysts and investors often request this supplemental information.

| <b>(dollars in thousands)</b>                                      | <b>Three<br/>months<br/>ended<br/>9/30/06</b> | <b>Three<br/>months<br/>ended<br/>9/30/05</b> | <b>Nine<br/>months<br/>ended<br/>9/30/06</b> | <b>Nine<br/>months<br/>ended<br/>9/30/05</b> |
|--------------------------------------------------------------------|-----------------------------------------------|-----------------------------------------------|----------------------------------------------|----------------------------------------------|
| Provision for impairment losses and (reversals)                    | \$                                            | \$ 119                                        | \$ (716 )                                    | \$ 186                                       |
| Crest provision for impairment losses                              | 308                                           |                                               | 308                                          |                                              |
| Amortization of settlements on treasury lock agreements(1)         | 121                                           | 189                                           | 499                                          | 567                                          |
| Amortization of deferred note financing costs(2)                   | 371                                           | 259                                           | 950                                          | 745                                          |
| Amortization of deferred stock compensation and stock option costs | 654                                           | 546                                           | 2,297                                        | 1,638                                        |
| Capitalized leasing costs and commissions                          | (247 )                                        | (114 )                                        | (382 )                                       | (514 )                                       |
| Capitalized building improvements                                  | (76 )                                         | (100 )                                        | (179 )                                       | (964 )                                       |
| Straight line rent(3)                                              | (411 )                                        | (178 )                                        | (1,252 )                                     | (1,113 )                                     |

(1) The settlements on the treasury lock agreements resulted from an interest rate risk prevention strategy that was used by the Company in 1997 and 1998, which correlated to pending issuances of senior note securities. We have not employed this strategy since 1998.

(2) Amortization of deferred note financing costs includes the amortization of costs incurred and capitalized when our notes were issued in May 1997, October 1998, January 1999, March 2003, November 2003, March 2005 and September 2005 and September 2006. These costs are being amortized over the lives of these notes. No costs associated with our credit facility agreements or annual fees paid to credit rating agencies have been included.

(3) A negative amount indicates that our straight-line rent was greater than our actual cash rent collected. A positive amount indicates that our straight-line rent was less than our actual cash rent collected.

**PROPERTY PORTFOLIO INFORMATION**

At September 30, 2006, we owned a diversified portfolio:

- Of 1,766 retail properties;
- With an occupancy rate of 98.8%, or 1,745 properties occupied of the 1,766 properties in the portfolio;
- Leased to 101 different retail chains doing business in 29 separate retail industries;
- Located in 48 states;
- With over 15.0 million square feet of leasable space; and
- With an average leasable retail space of approximately 8,500 square feet.

In addition to our real estate portfolio at September 30, 2006, our subsidiary, Crest had invested \$40.3 million in 13 retail properties located in six states. These properties are classified as held for sale.

At September 30, 2006, 1,739, or 98.5%, of our 1,766 retail properties were leased under net-lease agreements. Net leases typically require the tenant to be responsible for minimum monthly rent and property operating expenses including property taxes, insurance and maintenance. In addition, tenants are typically responsible for future rent increases (generally subject to ceilings) based on increases in the consumer price index, fixed increases or, to a lesser degree, additional rent calculated as a percentage of the tenants' gross sales above a specified level.

Our net-leased retail properties primarily are leased to regional and national retail chain store operators. Most buildings are single-story structures with adequate parking on site to accommodate peak retail traffic periods. The properties tend to be on major thoroughfares with relatively high traffic counts, adequate access and proximity to a sufficient population base to constitute a suitable market or trade area for the retailer's business.

**Industry Diversification**

The following table sets forth certain information regarding Realty Income's property portfolio (excluding properties owned by Crest) classified according to the business of the respective tenants, expressed as a percentage of our total rental revenue:

| Industries                    | Percentage of Rental Revenue (1)                |   |                                        |   |                 |   |                 |   |                 |   |                 |   |                 |   |
|-------------------------------|-------------------------------------------------|---|----------------------------------------|---|-----------------|---|-----------------|---|-----------------|---|-----------------|---|-----------------|---|
|                               | For the<br>Quarter<br>Ended<br>Sept. 30<br>2006 |   | For the Years Ended<br>Dec 31,<br>2005 |   | Dec 31,<br>2004 |   | Dec 31,<br>2003 |   | Dec 31,<br>2002 |   | Dec 31,<br>2001 |   | Dec 31,<br>2000 |   |
| Apparel stores                | 1.4                                             | % | 1.6                                    | % | 1.8             | % | 2.1             | % | 2.3             | % | 2.4             | % | 2.4             | % |
| Automotive collision services | 1.4                                             |   | 1.3                                    |   | 1.0             |   | 0.3             |   |                 |   |                 |   |                 |   |
| Automotive parts              | 2.7                                             |   | 3.4                                    |   | 3.8             |   | 4.5             |   | 4.9             |   | 5.7             |   | 6.0             |   |
| Automotive service            | 9.0                                             |   | 7.6                                    |   | 7.7             |   | 8.3             |   | 7.0             |   | 5.7             |   | 5.8             |   |
| Automotive tire services      | 5.8                                             |   | 7.2                                    |   | 7.8             |   | 3.1             |   | 2.7             |   | 2.6             |   | 2.3             |   |
| Book stores                   | 0.3                                             |   | 0.3                                    |   | 0.3             |   | 0.4             |   | 0.4             |   | 0.4             |   | 0.5             |   |
| Business services             | 0.1                                             |   | 0.1                                    |   | 0.1             |   | 0.1             |   | 0.1             |   | 0.1             |   | 0.1             |   |
| Child care                    | 10.6                                            |   | 12.7                                   |   | 14.4            |   | 17.8            |   | 20.8            |   | 23.9            |   | 24.7            |   |
| Consumer electronics          | 1.1                                             |   | 1.3                                    |   | 2.1             |   | 3.0             |   | 3.3             |   | 4.0             |   | 4.9             |   |
| Convenience stores            | 16.2                                            |   | 18.7                                   |   | 19.2            |   | 13.3            |   | 9.1             |   | 8.4             |   | 8.4             |   |
| Crafts and novelties          | 0.4                                             |   | 0.4                                    |   | 0.5             |   | 0.6             |   | 0.4             |   | 0.4             |   | 0.4             |   |
| Drug stores                   | 3.0                                             |   | 2.8                                    |   | 0.1             |   | 0.2             |   | 0.2             |   | 0.2             |   | 0.2             |   |
| Entertainment                 | 1.6                                             |   | 2.1                                    |   | 2.3             |   | 2.6             |   | 2.3             |   | 1.8             |   | 2.0             |   |
| Equipment rental services     | 0.3                                             |   | 0.4                                    |   | 0.3             |   | 0.2             |   |                 |   |                 |   |                 |   |
| Financial services            | 0.2                                             |   | 0.1                                    |   | 0.1             |   |                 |   |                 |   |                 |   |                 |   |
| General merchandise           | 0.7                                             |   | 0.5                                    |   | 0.4             |   | 0.5             |   | 0.5             |   | 0.6             |   | 0.6             |   |
| Grocery stores                | 0.6                                             |   | 0.7                                    |   | 0.8             |   | 0.4             |   | 0.5             |   | 0.6             |   | 0.6             |   |
| Health and fitness            | 4.5                                             |   | 3.7                                    |   | 4.0             |   | 3.8             |   | 3.8             |   | 3.6             |   | 2.4             |   |
| Home furnishings              | 3.2                                             |   | 3.7                                    |   | 4.1             |   | 4.9             |   | 5.4             |   | 6.0             |   | 5.8             |   |
| Home improvement              | 2.9                                             |   | 1.1                                    |   | 1.0             |   | 1.1             |   | 1.2             |   | 1.3             |   | 2.0             |   |
| Motor vehicle dealerships     | 3.6                                             |   | 2.6                                    |   | 0.6             |   |                 |   |                 |   |                 |   |                 |   |
| Office supplies               | 1.3                                             |   | 1.5                                    |   | 1.6             |   | 1.9             |   | 2.1             |   | 2.2             |   | 2.3             |   |
| Pet supplies and services     | 1.1                                             |   | 1.3                                    |   | 1.4             |   | 1.7             |   | 1.7             |   | 1.6             |   | 1.5             |   |
| Private education             | 1.0                                             |   | 0.8                                    |   | 1.1             |   | 1.2             |   | 1.3             |   | 1.5             |   | 1.4             |   |
| Restaurants                   | 9.7                                             |   | 9.4                                    |   | 9.7             |   | 11.8            |   | 13.5            |   | 12.2            |   | 12.3            |   |
| Shoe stores                   |                                                 |   | 0.3                                    |   | 0.3             |   | 0.9             |   | 0.8             |   | 0.7             |   | 0.8             |   |
| Sporting goods                | 2.9                                             |   | 3.4                                    |   | 3.4             |   | 3.8             |   | 4.1             |   | 0.9             |   |                 |   |
| Theaters                      | 9.4                                             |   | 5.2                                    |   | 3.5             |   | 4.1             |   | 3.9             |   | 4.3             |   | 2.7             |   |
| Travel plazas                 | 0.3                                             |   | 0.3                                    |   | 0.4             |   | 0.3             |   |                 |   |                 |   |                 |   |
| Video rental                  | 2.1                                             |   | 2.5                                    |   | 2.8             |   | 3.3             |   | 3.3             |   | 3.7             |   | 3.9             |   |
| Other                         | 2.6                                             |   | 3.0                                    |   | 3.4             |   | 3.8             |   | 4.4             |   | 5.2             |   | 6.0             |   |
| Totals                        | 100.0                                           | % | 100.0                                  | % | 100.0           | % | 100.0           | % | 100.0           | % | 100.0           | % | 100.0           | % |

(1) Includes rental revenue for all properties owned by Realty Income at the end of each period presented.

**Service Category Diversification**

The following table sets forth certain information regarding the properties owned by Realty Income (excluding properties owned by Crest) at September 30, 2006, classified according to the retail business types and the level of services they provide (dollars in thousands):

| <b>Industry</b>                                  | <b>Number of Properties</b> | <b>Rental Revenue for the Quarter Ended Sept. 30, 2006 (1)</b> | <b>Percentage of Rental Revenue</b> |
|--------------------------------------------------|-----------------------------|----------------------------------------------------------------|-------------------------------------|
| <b><u>Tenants Providing Services</u></b>         |                             |                                                                |                                     |
| Automotive collision services                    | 13                          | \$ 825                                                         | 1.4 %                               |
| Automotive service                               | 219                         | 5,331                                                          | 9.0                                 |
| Child care                                       | 267                         | 6,256                                                          | 10.6                                |
| Entertainment                                    | 8                           | 970                                                            | 1.6                                 |
| Equipment rental services                        | 2                           | 150                                                            | 0.3                                 |
| Financial services                               | 4                           | 89                                                             | 0.2                                 |
| Health and fitness                               | 16                          | 2,648                                                          | 4.5                                 |
| Private education                                | 7                           | 580                                                            | 1.0                                 |
| Theaters                                         | 30                          | 5,574                                                          | 9.4                                 |
| Other                                            | 10                          | 1,560                                                          | 2.6                                 |
|                                                  | 576                         | 23,983                                                         | 40.6                                |
| <b><u>Tenants Selling Goods and Services</u></b> |                             |                                                                |                                     |
| Automotive parts (with installation)             | 30                          | 583                                                            | 1.0                                 |
| Automotive tire services                         | 101                         | 3,424                                                          | 5.8                                 |
| Business services                                | 1                           | 32                                                             | 0.1                                 |
| Convenience stores                               | 393                         | 9,572                                                          | 16.2                                |
| Home improvement                                 | 1                           | 57                                                             | 0.1                                 |
| Motor vehicle dealerships                        | 21                          | 2,112                                                          | 3.6                                 |
| Pet supplies and services                        | 9                           | 595                                                            | 1.0                                 |
| Restaurants                                      | 334                         | 5,756                                                          | 9.7                                 |
| Travel plazas                                    | 1                           | 170                                                            | 0.3                                 |
| Video rental                                     | 34                          | 1,236                                                          | 2.1                                 |
|                                                  | 925                         | 23,537                                                         | 39.9                                |
| <b><u>Tenants Selling Goods</u></b>              |                             |                                                                |                                     |
| Apparel stores                                   | 6                           | 832                                                            | 1.4                                 |
| Automotive parts                                 | 73                          | 1,038                                                          | 1.7                                 |
| Book stores                                      | 2                           | 149                                                            | 0.3                                 |
| Consumer electronics                             | 21                          | 668                                                            | 1.1                                 |
| Crafts and novelties                             | 4                           | 212                                                            | 0.4                                 |
| Drug stores                                      | 34                          | 1,787                                                          | 3.0                                 |
| General merchandise                              | 23                          | 429                                                            | 0.7                                 |
| Grocery stores                                   | 6                           | 347                                                            | 0.6                                 |
| Home furnishings                                 | 40                          | 1,881                                                          | 3.2                                 |
| Home improvement                                 | 31                          | 1,684                                                          | 2.8                                 |
| Office supplies                                  | 10                          | 791                                                            | 1.3                                 |
| Pet supplies                                     | 2                           | 37                                                             | 0.1                                 |
| Sporting goods                                   | 13                          | 1,687                                                          | 2.9                                 |
|                                                  | 265                         | 11,542                                                         | 19.5                                |
| <b>Totals</b>                                    | <b>1,766</b>                | <b>\$ 59,062</b>                                               | <b>100.0%</b>                       |

(1) Includes rental revenue for all properties owned by Realty Income at September 30, 2006.

**Lease Expirations**

The following table sets forth certain information regarding Realty Income's property portfolio (excluding properties owned by Crest) regarding the timing of the lease term expirations (excluding extension options) on our 1,739 net leased, single-tenant and certain other retail properties as of September 30, 2006 (dollars in thousands):

| Year   | Total Portfolio                     |                                                  |                           | Initial Expirations (3)   |                                              |                           | Subsequent Expirations (4) |                                              |                           |
|--------|-------------------------------------|--------------------------------------------------|---------------------------|---------------------------|----------------------------------------------|---------------------------|----------------------------|----------------------------------------------|---------------------------|
|        | Total Number of Leases Expiring (1) | Rental Revenue for the Quarter Ended 9/30/06 (2) | % of Total Rental Revenue | Number of Leases Expiring | Rental Revenue for the Quarter Ended 9/30/06 | % of Total Rental Revenue | Number of Leases Expiring  | Rental Revenue for the Quarter Ended 9/30/06 | % of Total Rental Revenue |
| 2006   | 28                                  | \$ 601                                           | 1.1 %                     | 11                        | \$ 290                                       | 0.5 %                     | 17                         | \$ 311                                       | 0.6 %                     |
| 2007   | 133                                 | 2,435                                            | 4.3                       | 91                        | 1,688                                        | 3.0                       | 42                         | 747                                          | 1.3                       |
| 2008   | 115                                 | 2,515                                            | 4.5                       | 63                        | 1,490                                        | 2.7                       | 52                         | 1,025                                        | 1.8                       |
| 2009   | 103                                 | 2,245                                            | 4.0                       | 33                        | 773                                          | 1.4                       | 70                         | 1,472                                        | 2.6                       |
| 2010   | 74                                  | 1,580                                            | 2.8                       | 36                        | 898                                          | 1.6                       | 38                         | 682                                          | 1.2                       |
| 2011   | 73                                  | 2,137                                            | 3.9                       | 40                        | 1,367                                        | 2.5                       | 33                         | 770                                          | 1.4                       |
| 2012   | 45                                  | 1,405                                            | 2.5                       | 43                        | 1,354                                        | 2.4                       | 2                          | 51                                           | 0.1                       |
| 2013   | 75                                  | 3,333                                            | 6.0                       | 67                        | 3,119                                        | 5.6                       | 8                          | 214                                          | 0.4                       |
| 2014   | 48                                  | 2,040                                            | 3.7                       | 36                        | 1,798                                        | 3.2                       | 12                         | 242                                          | 0.5                       |
| 2015   | 90                                  | 1,787                                            | 3.2                       | 65                        | 1,228                                        | 2.2                       | 25                         | 559                                          | 1.0                       |
| 2016   | 90                                  | 652                                              | 1.2                       | 89                        | 630                                          | 1.2                       | 1                          | 22                                           | *                         |
| 2017   | 22                                  | 1,603                                            | 2.9                       | 18                        | 1,536                                        | 2.8                       | 4                          | 67                                           | 0.1                       |
| 2018   | 23                                  | 1,014                                            | 1.8                       | 23                        | 1,014                                        | 1.8                       |                            |                                              |                           |
| 2019   | 94                                  | 4,649                                            | 8.4                       | 93                        | 4,456                                        | 8.0                       | 1                          | 193                                          | 0.4                       |
| 2020   | 83                                  | 3,184                                            | 5.8                       | 81                        | 3,151                                        | 5.7                       | 2                          | 33                                           | 0.1                       |
| 2021   | 143                                 | 4,856                                            | 8.7                       | 142                       | 4,802                                        | 8.6                       | 1                          | 54                                           | 0.1                       |
| 2022   | 94                                  | 2,529                                            | 4.5                       | 94                        | 2,529                                        | 4.5                       |                            |                                              |                           |
| 2023   | 233                                 | 6,416                                            | 11.5                      | 232                       | 6,389                                        | 11.5                      | 1                          | 27                                           | *                         |
| 2024   | 57                                  | 1,802                                            | 3.2                       | 57                        | 1,802                                        | 3.2                       |                            |                                              |                           |
| 2025   | 66                                  | 5,802                                            | 10.4                      | 62                        | 5,739                                        | 10.3                      | 4                          | 63                                           | 0.1                       |
| 2026   | 38                                  | 1,909                                            | 3.5                       | 37                        | 1,870                                        | 3.4                       | 1                          | 39                                           | 0.1                       |
| 2028   | 2                                   | 54                                               | 0.1                       | 2                         | 54                                           | 0.1                       |                            |                                              |                           |
| 2030   | 2                                   | 213                                              | 0.4                       | 2                         | 213                                          | 0.4                       |                            |                                              |                           |
| 2033   | 3                                   | 357                                              | 0.6                       | 3                         | 357                                          | 0.6                       |                            |                                              |                           |
| 2034   | 2                                   | 230                                              | 0.4                       | 2                         | 230                                          | 0.4                       |                            |                                              |                           |
| 2037   | 2                                   | 325                                              | 0.6                       | 2                         | 325                                          | 0.6                       |                            |                                              |                           |
| 2043   | 1                                   | 13                                               | *                         |                           |                                              |                           | 1                          | 13                                           | *                         |
| Totals | 1,739                               | \$ 55,686                                        | 100.0 %                   | 1,424                     | \$ 49,102                                    | 88.2 %                    | 315                        | \$ 6,584                                     | 11.8 %                    |

\*Less than 0.1%

(1) Excludes six multi-tenant properties and 21 vacant unleased properties, one of which is a multi-tenant property. The lease expirations for properties under construction are based on the estimated date of completion of those properties.

(2) Excludes revenue of \$3,376 from six multi-tenant properties and from 21 vacant and unleased properties at September 30, 2006.

(3) Represents leases to the initial tenant of the property that are expiring for the first time.

(4) Represents lease expirations on properties in the portfolio, which have previously been renewed, extended or re-tenanted.





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**State Diversification**

The following table sets forth certain state-by-state information regarding Realty Income's property portfolio (excluding properties owned by Crest) as of September 30, 2006 (dollars in thousands):

| State          | Number of Properties | Percent Leased | Approximate Leasable Square Feet | Rental Revenue For the Quarter Ended September 30, 2006 (1) | Percentage of Rental Revenue |
|----------------|----------------------|----------------|----------------------------------|-------------------------------------------------------------|------------------------------|
| Alabama        | 34                   | 97 %           | 237,700                          | \$ 455                                                      | 0.8 %                        |
| Alaska         | 2                    | 100            | 128,500                          | 259                                                         | 0.4                          |
| Arizona        | 71                   | 100            | 344,500                          | 1,912                                                       | 3.2                          |
| Arkansas       | 10                   | 100            | 55,900                           | 156                                                         | 0.3                          |
| California     | 61                   | 100            | 1,101,900                        | 5,586                                                       | 9.5                          |
| Colorado       | 46                   | 100            | 385,800                          | 1,789                                                       | 3.0                          |
| Connecticut    | 16                   | 100            | 245,600                          | 977                                                         | 1.7                          |
| Delaware       | 15                   | 100            | 27,700                           | 316                                                         | 0.5                          |
| Florida        | 132                  | 99             | 1,281,000                        | 5,162                                                       | 8.7                          |
| Georgia        | 102                  | 99             | 712,800                          | 2,810                                                       | 4.8                          |
| Idaho          | 14                   | 100            | 91,900                           | 367                                                         | 0.6                          |
| Illinois       | 55                   | 100            | 696,200                          | 3,249                                                       | 5.5                          |
| Indiana        | 41                   | 95             | 417,700                          | 1,698                                                       | 2.9                          |
| Iowa           | 16                   | 94             | 105,400                          | 257                                                         | 0.4                          |
| Kansas         | 27                   | 89             | 539,200                          | 831                                                         | 1.4                          |
| Kentucky       | 17                   | 100            | 58,900                           | 387                                                         | 0.7                          |
| Louisiana      | 23                   | 100            | 90,100                           | 299                                                         | 0.5                          |
| Maryland       | 25                   | 100            | 230,000                          | 1,158                                                       | 2.0                          |
| Massachusetts  | 37                   | 100            | 203,100                          | 997                                                         | 1.7                          |
| Michigan       | 14                   | 100            | 92,800                           | 336                                                         | 0.6                          |
| Minnesota      | 20                   | 100            | 337,100                          | 1,258                                                       | 2.1                          |
| Mississippi    | 61                   | 95             | 278,400                          | 805                                                         | 1.4                          |
| Missouri       | 50                   | 98             | 525,300                          | 1,483                                                       | 2.5                          |
| Montana        | 2                    | 100            | 30,000                           | 74                                                          | 0.1                          |
| Nebraska       | 17                   | 100            | 190,100                          | 600                                                         | 1.0                          |
| Nevada         | 15                   | 100            | 191,000                          | 837                                                         | 1.4                          |
| New Hampshire  | 10                   | 100            | 95,400                           | 377                                                         | 0.6                          |
| New Jersey     | 25                   | 100            | 194,500                          | 992                                                         | 1.7                          |
| New Mexico     | 7                    | 100            | 53,300                           | 137                                                         | 0.2                          |
| New York       | 28                   | 96             | 419,400                          | 2,017                                                       | 3.4                          |
| North Carolina | 52                   | 100            | 348,200                          | 1,601                                                       | 2.7                          |
| North Dakota   | 5                    | 100            | 31,900                           | 54                                                          | 0.1                          |
| Ohio           | 105                  | 100            | 661,500                          | 2,552                                                       | 4.3                          |
| Oklahoma       | 22                   | 100            | 110,600                          | 457                                                         | 0.8                          |
| Oregon         | 19                   | 100            | 294,800                          | 647                                                         | 1.1                          |
| Pennsylvania   | 83                   | 100            | 510,600                          | 2,345                                                       | 4.0                          |
| Rhode Island   | 1                    | 100            | 3,500                            | 29                                                          | 0.1                          |
| South Carolina | 56                   | 100            | 218,700                          | 1,424                                                       | 2.4                          |
| South Dakota   | 7                    | 100            | 18,300                           | 76                                                          | 0.1                          |
| Tennessee      | 105                  | 100            | 476,500                          | 2,206                                                       | 3.7                          |
| Texas          | 193                  | 98             | 2,133,400                        | 6,502                                                       | 11.0                         |
| Utah           | 6                    | 83             | 35,100                           | 95                                                          | 0.2                          |
| Vermont        | 1                    | 100            | 2,500                            | 22                                                          | *                            |
| Virginia       | 62                   | 100            | 431,900                          | 2,313                                                       | 3.9                          |
| Washington     | 37                   | 100            | 243,900                          | 746                                                         | 1.3                          |
| West Virginia  | 1                    | 0              | 12,200                           |                                                             | 0.0                          |
| Wisconsin      | 17                   | 94             | 157,400                          | 394                                                         | 0.7                          |
| Wyoming        | 1                    | 100            | 4,200                            | 18                                                          | *                            |
| Totals/Average | 1,766                | 99 %           | 15,056,400                       | \$ 59,062                                                   | 100.0 %                      |

\* Less than 0.1%

(1) Includes rental revenue for all properties owned by Realty Income at September 30, 2006.

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### IMPACT OF INFLATION

Tenant leases generally provide for limited increases in rent as a result of increases in the tenants' sales volumes, increases in the consumer price index, and/or fixed increases. We expect that inflation will cause these lease provisions to result in rent increases over time. During times when inflation is greater than increases in rent, as provided for in the leases, rent increases may not keep up with the rate of inflation.

Approximately 98.5%, or 1,739, of the 1,766 properties in the portfolio are leased to tenants under net leases where the tenant is responsible for property costs and expenses. Net leases tend to reduce our exposure to rising property expenses due to inflation. Inflation and increased costs may have an adverse impact on our tenants if increases in their operating expenses exceed increases in revenue.

### IMPACT OF RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. Statement No. 157 sets out a framework for measuring fair value, and requires additional disclosures about fair-value measurements. Statement No. 157 becomes effective for us at the beginning of 2008. We are still evaluating what impact, if any, that adopting Statement No. 157 will have on our financial position or results of operations.

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109*. Interpretation 48 applies to all tax positions accounted for under Statement 109, including tax positions acquired in a business combination. Interpretation 48 is effective for us at the beginning of 2007. The impact of adopting Interpretation 48 is not expected to have a material effect on our financial position or results of operations.

In December 2004, the FASB issued Statement No. 123R, *Share-Based Payments*. Statement No. 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees. We adopted Statement No. 123R on January 1, 2006. The impact of adopting Statement No. 123R was not material to our financial position or results of operations.

### OTHER INFORMATION

Realty Income's common stock is listed on the NYSE under the ticker symbol *O*, our central index key, or CIK, number is 726728 and cusip number is 756109-104.

Realty Income's 7.375% Class D cumulative redeemable preferred stock is listed on the NYSE under the ticker symbol *OprD* and its cusip number is 756109-609.

Realty Income's 8-1/4% Monthly Income Senior Notes due 2008, are listed on the NYSE under the ticker symbol *OUI*. The cusip number of these notes is 756109-203.

We maintain an Internet website at [www.realtyincome.com](http://www.realtyincome.com). On our website we make available, free of charge, copies of our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports, as soon as reasonably practicable after we electronically file these reports with the SEC. None of the information on our website is deemed to be a part of this report.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

We are exposed to interest rate changes primarily as a result of our credit facility and long-term notes used to maintain liquidity and expand our real estate investment portfolio and operations. Our interest rate risk management objective is to limit the impact of interest rate changes on earnings and cash flow and to lower our overall borrowing costs. To achieve these objectives we issue long-term notes, primarily at fixed rates, and may selectively enter into derivative financial instruments, such as interest rate lock agreements, interest rate swaps and caps in order to mitigate our interest rate risk on a related financial instrument. We were not a party to any derivative financial instruments at September 30, 2006. We do not enter into any transactions for speculative or trading purposes.

Our interest rate risk is monitored using a variety of techniques. The following table presents by year of expected maturity, the principal amounts, average interest rates, fair values as of September 30, 2006. This information is presented to evaluate the expected cash flows and sensitivity to interest rate changes (dollars in millions):

**Expected Maturity Data as of September 30, 2006**

| Year of maturity | Fixed rate debt | Average interest rate on fixed rate debt | Variable rate debt | Average interest rate on variable rate debt |
|------------------|-----------------|------------------------------------------|--------------------|---------------------------------------------|
| 2006             | \$              |                                          | \$                 |                                             |
| 2007             |                 |                                          |                    |                                             |
| 2008 (1)(2)      | 100.0           | 8.25 %                                   |                    |                                             |
| 2009 (3)         | 20.0            | 8.00 %                                   |                    |                                             |
| 2010             |                 |                                          |                    |                                             |
| Thereafter (4)   | 800.0           | 5.66 %                                   |                    |                                             |
| Totals           | \$ 920.0        | 5.99 %                                   | \$                 | %                                           |
| Fair Value (5)   | \$ 908.3        |                                          | \$                 |                                             |

(1) \$100 million matures in October 2008.

(2) The credit facility expires in October 2008. The credit facility balance as of September 30, 2006 was zero and as of October 31, 2006 was \$108 million.

(3) \$20 million matures in January 2009.

(4) \$100 million matures in March 2013, \$150 million matures in November 2015, \$175 million matures in September 2017, \$275 million matures in September 2016 and \$100 million matures in March 2035.

(5) We base the fair value of the fixed rate debt at September 30, 2006 on the closing market price or indicative price per each note. The fair value of the variable rate debt approximates its carrying value because its terms are similar to those available in the market place at September 30, 2006.

The table incorporates only those exposures that exist as of September 30, 2006; it does not consider those exposures or positions that could arise after that date. As a result, our ultimate realized gain or loss, with respect to interest rate fluctuations, would depend on the exposures that arise during the period, our hedging strategies at the time, and interest rates.

All of our outstanding notes and bonds have fixed interest rates. Our credit facility interest rate is variable. At September 30, 2006, our credit facility balance was zero; however, we intent to borrow funds on our credit facility in the future. Based on hypothetical credit facility borrowing of \$50 million, a 1% change in interest rates would change our interest costs by \$500,000 per year.



**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedure**

We maintain disclosure controls and procedures (as defined in Securities Exchange Act 1934 Rules 13a-14(c) and 15d-14(c)) that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required of and for the quarter ended September 30, 2006, we carried out an evaluation, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective and were operating at a reasonable assurance level.

**Changes in Internal Controls**

There have not been any significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation. There were no material weaknesses, and therefore no corrective actions were taken.

**Limitations on the Effectiveness of Controls**

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

**PART II. OTHER INFORMATION**

**Item 1A. Risk Factors**

There have been no material changes in our risk factors from those disclosed in our 2005 Annual Report on Form 10-K.

**Item 6. Exhibits**

**Exhibit No.**

**Description**

**Articles of Incorporation and By-Laws**

- |     |                                                                                                                                                                                                                                                                      |
|-----|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1 | Articles of Incorporation of the Company, as amended by amendment No. 1 dated May 10, 2005 and amendment No. 2 dated May 10, 2005 (filed as exhibit 3.1 to Realty Income's Form 10-Q for the quarter ended June 30, 2005, and incorporated herein by reference).     |
| 3.2 | Bylaws of the Company, as amended by amendment No. 1 dated March 20, 2000 and amendment No. 2 dated June 15, 2005 (filed as exhibit 3.2 to Realty Income's Form 10-Q for the quarter ended June 30, 2005, and incorporated herein by reference).                     |
| 3.3 | Articles Supplementary to the Articles of Incorporation of the Company classifying and designating the Class D Preferred Stock (filed as exhibit 3.8 to the Company's Form 8-A filed on May 25, 2004 and incorporated herein by reference).                          |
| 3.4 | Articles Supplementary to the Articles of Incorporation of the Company classifying and designating additional shares of the Class D Preferred Stock (filed as exhibit 3.2 to the Company's Form 8-K filed on October 19, 2004 and incorporated herein by reference). |

**Instruments defining the rights of security holders, including indentures**

- |     |                                                                                                                                                                                                                                                                                                                                                     |
|-----|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 4.1 | Pricing Committee Resolutions (filed as an exhibit 4.2 to the Company's Form 8-K, dated October 27, 1998 and incorporated herein by reference).                                                                                                                                                                                                     |
| 4.2 | Form of 8-1/4% Notes due 2008 (filed as exhibit 4.3 to the Company's Form 8-K, dated October 27, 1998 and incorporated herein by reference).                                                                                                                                                                                                        |
| 4.3 | Indenture dated as of October 28, 1998 between the Company and The Bank of New York (filed as exhibit 4.1 to the Company's Form 8-K, dated October 27, 1998 and incorporated herein by reference).                                                                                                                                                  |
| 4.4 | Pricing Committee Resolutions and Form of 8% Notes due 2009 (filed as exhibit 4.2 to the Company's Form 8-K, dated January 21, 1999 and incorporated herein by reference).                                                                                                                                                                          |
| 4.5 | Form of 5-3/8% Senior Notes due 2013 (filed as exhibit 4.2 to the Company's Form 8-K, dated March 5, 2003 and incorporated herein by reference).                                                                                                                                                                                                    |
| 4.6 | Officer's Certificate pursuant to sections 201, 301 and 303 of the Indenture dated October 28, 1998 between the Company and The Bank of New York, as Trustee, establishing a series of securities entitled 5-3/8% Senior Notes due 2013 (filed as exhibit 4.3 to the Company's Form 8-K, dated March 5, 2003 and incorporated herein by reference). |
| 4.7 | Form of 5-1/2% Senior Notes due 2015 (filed as exhibit 4.2 to the Company's Form 8-K, dated November 19, 2003 and incorporated herein by reference).                                                                                                                                                                                                |
| 4.8 | Officer's Certificate pursuant to sections 201, 301 and 303 of the Indenture dated October 28, 1998 between the Company and The Bank of New York, as Trustee, establishing a series of securities entitled 5-1/2% Senior Notes due 2015 (filed as exhibit                                                                                           |





4.3 to the Company's Form 8-K, dated November 19, 2003 and incorporated herein by reference).

4.9 Form of 5-7/8% Senior Notes due 2035 (filed as exhibit 4.2 to the Company's Form 8-K, dated March 8, 2005 and incorporated herein by reference).

4.10 Officer's Certificate pursuant to section 301 of the Indenture dated October 28, 1998 between the Company and The Bank of New York, as Trustee, establishing a series of securities entitled 5-7/8% Senior Debentures due 2035 (filed as exhibit 4.3 to the Company's Form 8-K, dated March 8, 2005 and incorporated herein by reference).

4.11 Form of 5-3/8% Senior Notes due 2017 (filed as exhibit 4.2 to the Company's Form 8-K, dated September 8, 2005 and incorporated herein by reference).

4.12 Officer's Certificate pursuant to section 301 of the Indenture dated October 28, 1998 between the Company and The Bank of New York, as Trustee, establishing a series of securities entitled 5-3/8% Senior Notes due 2017 (filed as exhibit 4.3 to the Company's Form 8-K, dated September 8, 2005 and incorporated herein by reference).

4.13 Form of 5.95% Senior Notes due 2016 (filed as exhibit 4.2 to the Company's Form 8-K, dated September 6, 2006 and incorporated herein by reference).

4.14 Officer's Certificate pursuant to section 301 of the Indenture dated October 28, 1998 between the Company and The Bank of New York, as Trustee, establishing a series of securities entitled 5.950% Senior Notes due 2016 (filed as exhibit 4.3 to the Company's Form 8-K, dated September 6, 2006 and incorporated herein by reference).

#### **Material Contracts**

10.1 First Amendment to Credit Agreement dated October 16, 2006 to the \$300 million Credit Agreement dated June 17, 2005 (filed as exhibit 10.1 to the Company's Form 8-K filed on November 3, 2006 and incorporated herein by reference).

#### **Certifications**

\* 31.1 Section 302 Certifications as filed by the Chief Executive Officer pursuant to SEC release No. 33-8212 and 34-47551.

\* 31.2 Section 302 Certifications as filed by the Chief Financial Officer pursuant to SEC release No. 33-8212 and 34-47551.

\* 32 Section 906 Certifications as furnished by the Chief Executive Officer and the Chief Financial Officer pursuant to SEC release No. 33-8212 and 34-47551.

\* Filed herewith



**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**REALTY INCOME CORPORATION**

/s/ GREGORY J. FAHEY  
Gregory J. Fahey  
Vice President, Controller  
(Principal Accounting Officer)

Date: November 6, 2006