

SPIRIT FINANCE CORP  
Form 10-K  
March 01, 2007

**United States  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

(Mark One)

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

For the fiscal year ended December 31, 2006

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 01-32386

**SPIRIT FINANCE CORPORATION**

(Exact name of registrant as specified in its charter)

**Maryland**  
(State of incorporation)  
**14631 N. Scottsdale Road, Suite 200**  
**Scottsdale, Arizona**  
(Address of Principal Executive Offices)

**20-0175773**  
(I.R.S. Employer Identification No.)  
**85254**  
(Zip Code)

Registrant's telephone number, including area code: (480) 606-0820

Securities Registered Pursuant to Section 12(b) of the Act:

| Title of each class                      | Name of each exchange on which registered |
|--|---|
| Common Stock, par value \$0.01 per share | New York Stock Exchange                   |

Securities Registered Pursuant to Section 12(g) of the Act: None

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the

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past 90 days. Yes  No

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

As of June 30, 2006 the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$1.1 billion based on the closing sale price as reported on the New York Stock Exchange on that date.

The number of shares outstanding of the Registrant's common stock, as of February 23, 2007, was 107,935,085.

### **DOCUMENTS INCORPORATED BY REFERENCE**

Part III, Items 10, 11, 12, 13 and 14 are incorporated by reference to the definitive proxy statement for the Registrant's Annual Meeting of Stockholders to be held on May 18, 2007, to be filed pursuant to Regulation 14A.

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**PART I**

**Item 1. Business**

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

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, which involve certain risks and uncertainties. Forward-looking statements are included with respect to, among other things, Spirit Finance Corporation's (the Company's) current business plan, business strategy and portfolio management. The Company's actual results or outcomes may differ materially from those anticipated. Important factors that the Company believes might cause such differences are discussed in the cautionary statements presented under the caption Risk Factors in Item 1A. of this Form 10-K or otherwise accompany the forward-looking statements contained in this Form 10-K. In assessing all forward-looking statements, readers are urged to read carefully all cautionary statements contained in this Form 10-K.

**Overview**

When used in this report, the terms we, our, us and our company refer to Spirit Finance Corporation, a Maryland corporation, and our subsidiaries, unless the context indicates otherwise. We are a self-managed and self-advised real estate investment trust ( REIT ) for federal income tax purposes. Our common stock is listed on the New York Stock Exchange ( NYSE ) under the ticker symbol SFC.

We were formed in 2003 primarily to acquire single tenant, operationally essential real estate to be leased on a long-term, triple-net basis to retail, distribution and service-oriented companies. Single tenant, operationally essential real estate consists of free-standing real estate facilities that contain our customers' retail, distribution or service activities and are vital to the generation of their sales and profits. We target real estate of established companies in various industries located throughout the United States. Examples of the types of companies that own real estate in our target market include:

- |   |   |
|---|---|
| Automotive dealers                      | Health clubs or gyms                    |
| Automotive parts and service facilities | Interstate travel plazas or truck stops |
| Bank branches                           | Medical offices                         |
| Call centers                            | Movie theaters                          |
| Convenience stores or car washes        | Industrial properties                   |
| Department stores                       | Recreational facilities                 |
| Discount retailers                      | Rental centers                          |
| Distribution facilities                 | Restaurants                             |
| Drugstores                              | Specialty retailer properties           |
| Educational facilities                  | Supermarkets                            |
| Electronics retailers                   | Theme parks                             |
| Furniture stores                        | Wholesale clubs                         |
| Hardware or home improvement stores     |   |

In addition to providing custom and innovative leasing alternatives, we may also selectively originate or acquire long-term commercial mortgage loans that are integral to our strategy of providing a complete product solution to our customers. To a limited extent, we may also acquire properties that could be classified as multi-tenant office space or which could be converted to multi-tenant use where we believe the property to be integral to our customers' businesses. We may also make a limited amount of unsecured corporate loans or provide construction or equipment financing to customers.

## Business Developments

We began business by raising equity through a private offering of our common stock in late 2003 and, in December 2004, we completed our initial public offering of common stock. By the end of 2004, we had built our foundation of diversified real estate investments, expanded our operations and developed strategic outsourcing arrangements to support our growth. During the past two years we developed and implemented our debt financing plans through short- and long-term strategies, including the establishment of our master funding debt structure in 2005. As of December 31, 2006, approximately 56% of our long-term borrowings were in the form of traditional commercial mortgage real estate financing, which is typically amortized over thirty years, with loan maturities in ten years. The weighted average maturity of the \$931 million in commercial mortgage financing was approximately nine years. Our master funding debt structure represented approximately 44% of our long-term borrowings, with a weighted average maturity of approximately 14 years. In December 2006, we reached our second anniversary as a publicly traded company and our third year anniversary since raising our first equity capital and acquiring our first real estate investments. We have continued to capitalize on our core strengths and during 2006 accomplished the following:

- We expanded our real estate investment portfolio by \$1.4 billion in 2006, a gross increase of 62% over our prior year investment activity. At December 31, 2006, our investment portfolio was over \$2.8 billion, nearly doubling the size of our investment portfolio since December 31, 2005. Acquisitions during 2006 included the acquisition of 178 real estate properties from SKO Group Holding Corp. ( SKO ) through a purchase of ShopKo Stores, Inc., where we entered into long-term triple-net master lease arrangements with subsidiaries of SKO for these general merchandise retail locations operating under the ShopKo and Pamida names at the time of acquisition this was the largest single retail sale-leaseback transaction in U.S. history.
- We built a pipeline of targeted potential investment opportunities that has consistently exceeded \$2 billion since the end of 2005, which forms the basis for our strategic initiatives in 2007.
- In March 2006, we issued \$301.8 million aggregate principal amount of net-lease mortgage notes payable. This was the second issuance under our master funding debt program. Under this program, we match-fund our cash flows for fifteen years on a diverse pool of our real estate assets aggregating \$1.1 billion at December 31, 2006. We are able to add collateral to the pool in the future and issue new notes secured by an increasing collateral pool of properties.
- In October, we obtained a \$400 million short-term, variable-rate secured credit facility that replaced other expiring facilities. In conjunction with the acquisition of real estate, we also entered into new long-term, fixed-rate commercial mortgage financing arrangements totaling over \$700 million during 2006. At December 31, 2006, our total fixed-rate debt, including the net-lease mortgage notes, had a weighted average stated interest rate of 6.1%.
- At December 31, 2006, we had match-funded 83% of our long-term, fixed-rate real estate investment portfolio with long-term, fixed-rate debt and had hedged an additional \$199.5 million of long-term debt expected to be issued in early 2007.
- We completed public offerings aggregating approximately 39.5 million shares of common stock, which raised \$428 million in net equity proceeds. Including these common stock offerings, our gross equity proceeds raised since inception totals over \$1.1 billion.
- We generated net income of \$52 million and declared dividends of \$0.85 per common share. As a result, we generated an annual total return to stockholders (distributions plus stock price appreciation) of 18.2%, including the reinvestment of dividends, during 2006.

- At December 31, 2006, substantially all of our properties were occupied and current in their monthly lease and loan payments.

Our core strengths include:

- Experienced management team with a clear vision of how the company should operate for the mutual benefit of our stockholders and customers;
- Demonstrated capacity to originate investments which are accretive to our funds from operations;
- Proven credit and investment evaluation techniques and methods that focus on real estate unit-level cash flows, tenant corporate credit discipline, real estate fundamentals and tenant management depth and experience;
- A highly efficient, scalable operating business model with state-of-the-art servicing and reporting capability; and
- Structured finance expertise and an effective liability strategy that provides greater operational flexibility for both Spirit Finance and our customers.

Our current liquidity position and borrowing capacity from our credit facility provide us with a solid foundation to continue our growth in 2007.

#### **Real Estate Investment Portfolio**

We continually seek to acquire an investment portfolio that is diversified by geography, customer and industry. As of December 31, 2006, our investment portfolio of real estate and loans totaled over \$2.8 billion and represented 1,034 owned or financed properties geographically diversified in 43 states. Only two states, Wisconsin (12%) and Texas (11%), accounted for 10% or more of the total dollar value of our real estate and loan portfolio. Of our total investment portfolio at December 31, 2006, approximately \$2.8 billion, or 97%, represented the gross cost of real estate and related lease intangibles we own; and \$75.2 million, or 3%, represented first priority mortgages secured by single tenant, operationally essential real estate and other loans receivable. Our properties are leased or financed to 145 customers operating in various industries. The three largest industries in which our customers operated at the end of 2006, as a percentage of the total dollar amount of our investment portfolio, were the general and discount retail industry (29%), the restaurant industry (22%) and the specialty retail industry (10%). In addition, we have real estate investments in various other industries, including movie theaters, industrial properties, automotive dealers, parts and service facilities, educational facilities, recreational facilities, distribution facilities and supermarkets.

Our customers are generally established companies. As of December 31, 2006, our ten largest customers as a percentage of our total investment portfolio were: ShopKo Stores Operating Co., LLC; Pamida Stores Operating Co., LLC; Carmike Cinemas, Inc. (NASDAQ: CKEC); National Envelope Corporation; Casual Male Retail Group, Inc. (NASDAQ: CMRG); Dickinson Theatres, Inc.; CarMax, Inc. (NYSE: KMX); United Supermarkets, Ltd.; Main Event Entertainment, LP, the operator of Main Event family entertainment centers; and CBH2O, LP, the operator of Camelback Ski Area and Camelbeach Waterpark in Pennsylvania. Together, these customers accounted for 46% of our total investment portfolio at December 31, 2006. ShopKo Stores Operating Co., LLC and Pamida Stores Operating Co., LLC are the two largest individual tenants representing a total of approximately 29% of our total investment portfolio at December 31, 2006. No other individual tenant represents more than 3% of our total investment portfolio.

Our real estate properties are leased to our customers under long-term operating leases that typically include one or more renewal options. The weighted average remaining noncancelable lease term at December 31, 2006 was approximately 16 years. The leases are generally triple-net, which provides that the

lessee is responsible for the payment of all property operating expenses, including insurance, real estate taxes and repairs and maintenance; therefore, we generally are not responsible for repairs and are not required to make other significant capital expenditures on our properties.

### **Business and Investment Strategy**

*General.* Our business strategy is to build value for our stockholders through growth in our real estate investment portfolio. We seek to enhance our performance and financial position by controlling expenses through economies of scale and by outsourcing selective company operations through strategic business relationships with vendors located in the United States to improve our efficiency. Our investment strategy is designed to take advantage of current market conditions and adjust to changes in market conditions over time by providing our customers with specifically tailored real estate products such as sale-leaseback transactions, mortgage loans, unsecured corporate loans and construction and equipment financing. We continue to diversify our portfolio as we acquire additional properties.

We generally seek to acquire and hold fee simple title to the land, buildings and other assets comprising the real estate. We seek to invest selectively in real estate with strong unit-level economics, meaning profitable retail, distribution or service operations with the least likelihood of default, while increasing rental revenues through scheduled rent escalations or contingent escalations based on a percentage of the lessee's gross sales or increases in the Consumer Price Index (CPI). We do not believe our business is seasonal; however, the timing and amount of our acquisitions will vary from quarter to quarter.

We provide long-term, triple-net leases or loans that offer favorable and attractive terms to us and our customers. We make real estate acquisitions in an effort to achieve our targeted equity returns. If our cost of capital increases due to rising interest rates, we plan to increase tenant lease rates or increase tenant lease escalations on new leases in order to achieve our targeted equity returns. In addition to responding to varying interest rate environments in the origination of new real estate investments, we employ customary derivative strategies designed to hedge the long-term financing costs on our portfolio.

*Transaction Sourcing.* Currently, a majority of our real estate investment transactions are sourced through the efforts of our internal acquisitions staff. Our direct calling efforts are focused on public and private companies in our target market and private equity funds who are active market participants. Transactions are also sourced through banks, real estate brokers and other industry participants. We continually evaluate strategic alternatives and new methods to source transactions in order to remain competitive. Some of the methods we have considered and may pursue include the following:

*Private Equity Funds/Institutional Investors.* We may partner with private equity funds or other large institutional investors to allow us to acquire the real estate of targeted operating companies. These types of investors continually seek out target companies that are operating companies which can be restructured, recapitalized and sold for a profit. Some of these target companies may own substantial amounts of real estate. Because the ownership of real estate by an operating company is often not an efficient use of capital, these companies are often undervalued. By purchasing these undervalued companies and then selling the real estate to us in sale-leaseback transactions, these investors can increase the capital efficiency of the target company which can increase the overall value of the target company in its restructuring, refinancing and sale.

*Spin-Off and Merger Transactions.* We may attempt to acquire the real estate of operating companies through a spin-off and merger transaction. In this type of transaction, we would cause the operating company to form a subsidiary corporation to which it would transfer all of its core business operations except for its real estate assets. The company would then distribute the common stock of the newly created corporation to its shareholders in a spin-off transaction. We would then acquire the ownership of the remaining company holding the real estate in exchange for shares of our common



stock and then lease the real estate of the acquired company to the newly-created corporation. We believe this transaction is attractive to the shareholders of the target corporation because it allows for a non-taxable disposition of the corporation's real estate assets and, following the transaction, the target corporation's shareholders would own shares of the operating business entity and shares of our common stock that represent the value of the real estate we acquired.

*Joint Ventures.* We may enter into joint ventures with other investors that have investment objectives similar to ours. These investors may include pension funds, insurance companies, other REITs, private equity funds or other institutions that invest in real estate. Our objective in these joint ventures would be to diversify our investment risk and obtain an additional source of capital to fund larger transactions.

*UPREIT Transactions.* We may decide to form an operating partnership, or UPREIT, in the future. If we form an UPREIT, we would transfer substantially all of our assets to the newly-formed operating partnership in exchange for UPREIT units. After formation of the UPREIT, some of our property acquisitions could be made by issuing additional UPREIT units in exchange for property owned by third parties. These UPREIT units would be convertible into shares of our common stock at specified ratios set from time to time when the UPREIT units are issued. We believe the formation of an UPREIT could enhance our ability to compete in the market for the acquisition of operationally essential real estate by offering our customers an additional option for the sale of their real estate on a tax-deferred basis. In addition, acquiring real estate in exchange for the issuance of UPREIT units would reduce the amount of cash we need to make property acquisitions.

*DOWNREIT Transactions.* We may decide to form a transaction-specific partnership known as a DOWNREIT. In a DOWNREIT transaction, the real estate assets of a single third-party owner would be transferred to a newly created partnership on terms to be specifically negotiated between us and the owner. Similar to the UPREIT structure, the owner would receive DOWNREIT units which would be convertible into shares of our common stock at a specified ratio determined at the time the DOWNREIT units are issued. The benefits of a DOWNREIT are essentially similar to that of the UPREIT discussed above, except that the performance of the current owner's DOWNREIT unit is tied directly to the real estate the owner sells, not a diversified pool of properties. In addition, until the DOWNREIT unit holder converts the units into shares of our common stock, a substantial majority of the income generated from the properties owned by the DOWNREIT would be paid as distributions on the DOWNREIT units, not to us.

*Select Portfolio Property Resale Transactions.* On a limited and selective basis, we may acquire and re-sell properties that we purchase in connection with the acquisition of a portfolio of properties. If properties are being sold on an all or none basis, we may purchase some properties that do not precisely meet our desired investment criteria in order to acquire a larger portfolio of properties we wish to hold. If we engage in this activity, we intend to conduct it as permitted under the REIT provisions of the Internal Revenue Code. We do not currently believe sales of properties will constitute a major part of our business.

*Additional Income Opportunities.* We may pursue activities that will generate additional income for us. These activities might include property development, property management and the acquisition of properties for the purpose of re-sale for a profit. We anticipate that the activities generating this income will be conducted through one or more taxable REIT subsidiaries. We currently have one taxable REIT subsidiary, Spirit Management Company.

*Financing.* In order to finance the acquisition of our properties, we primarily use equity proceeds from public investors and secured financing through banks and institutional investors. From time to time, we also access various other sources of capital, including banks, financial institutions and institutional investors through additional lines of credit, bridge loans, structured financings and other arrangements. As





of December 31, 2006, we had a maximum aggregate borrowing capacity of \$400 million on a revolving secured credit facility with Citigroup Global Markets Realty Corp. with \$128.5 million outstanding on the facility. The facility is structured as a master loan repurchase agreement and our borrowings under the facility are secured by real estate properties we own and may also be secured by our equity ownership interests in certain of our consolidated special purpose subsidiaries. The facility has a term of approximately one year and has no prepayment penalties.

In March 2006, we issued, through a private offering, \$301.8 million aggregate principal amount of net-lease mortgage notes consisting of amortizing 5.76% notes due in 2021. This was the second issuance under our master funding structure which was created in 2005; the first series of notes totaling \$441.3 million was issued in July 2005. At December 31, 2006, the aggregate principal outstanding on the net-lease mortgage notes totaled \$727.8 million and was secured by a collateral pool in excess of \$1 billion in real estate assets. The notes may be prepaid at any time, subject to a yield maintenance prepayment premium. The notes also permit the substitution of real estate collateral from time to time subject to certain conditions and limits. In addition, as the note structure allows for the contribution of additional properties to the collateral pool and the issuance of additional series of notes secured by the increased collateral pool, we expect that we can continue to diversify the collateral pool which will lead to increasingly efficient borrowings in the future. Our total debt outstanding at December 31, 2006, including our outstanding borrowings on the secured credit facility, was \$1.8 billion.

*Underwriting.* Our real estate investment decisions are made by our investment committee which is comprised of the six members of our senior management. We are authorized by our board of directors to follow broad investment guidelines. We have substantial discretion within our investment guidelines in determining the types of assets we may decide are proper investments for us. Our investment committee has the authority to make real estate investments up to \$100 million in any single credit risk or group of related credit risks. We evaluate potential investments in real estate and attempt to mitigate overall investment risk through adherence to: (1) real estate investment underwriting and documentation criteria that our senior management has developed over the past 20 years, (2) portfolio composition, and (3) portfolio management that emphasizes tenant and borrower covenant compliance and ongoing performance reviews of their business.

#### **Product Lines**

We operate in one industry segment: investment in single tenant, operationally essential real estate. As of December 31, 2006, 97% of our real estate investment portfolio was in real estate we own and lease to our customers and 3% was in mortgage and other loans. Our products are described below.

*Sale-leaseback Transactions.* Our real estate properties are generally acquired in sale-leaseback transactions. We may also purchase properties that have existing lease agreements in place. In a sale-leaseback transaction, we acquire properties and lease the properties back to the seller under a triple-net lease. Under a triple-net lease, the tenant is contractually obligated to pay all property operating expenses, including insurance, real estate taxes and repairs and maintenance. The leases generally have a primary term of 15 to 20 years, with renewal options for one or more additional periods. Our leases generally provide for payments of base rents with scheduled increases, contingent increases based on future changes in the CPI and/or contingent rent based on a percentage of the lessee's gross sales.

*Mortgages and Other Financing Products.* Although we focus on leasing transactions, we may originate a mortgage loan secured by real estate property in situations where a customary sale-leaseback transaction would have an adverse impact on the seller of a property or would otherwise be inappropriate for us. Our lending transactions are loans generally secured by commercial real estate. We may also offer other financing products where we can improve our returns or competitiveness. These financing products may include unsecured corporate loans, construction financing and equipment financing.

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We generated total revenue (including revenues from discontinued operations) of \$192.0 million in 2006, \$86.5 million in 2005, and \$26.2 million in 2004 from our real estate leasing and loan operations. The composition of total revenue was as follows (dollars in thousands):

|                                     | Years Ended December 31, |           |           |
|-------------------------------------|--------------------------|-----------|-----------|
|                                     | 2006                     | 2005      | 2004      |
| Revenues:                           |                          |           |           |
| Rentals                             | \$ 181,523               | \$ 80,076 | \$ 20,511 |
| Interest income on loans receivable | 6,225                    | 4,276     | 3,775     |
| Other interest income               | 4,243                    | 2,138     | 1,942     |
| Total revenues                      | \$ 191,991               | \$ 86,490 | \$ 26,228 |

During 2004, approximately 14% of our total revenues were derived under a single master lease agreement with an operator of interstate travel plazas. As a result of the growth in our investment portfolio, no individual tenant represented more than 5% of total revenues during 2005. On May 31, 2006, we acquired 178 real estate properties from SKO and leased them to two subsidiaries of SKO under long-term, triple-net master lease agreements. Rental revenues under these agreements aggregated \$44.2 million or 23% of our total revenues during 2006. Of the properties purchased, 112 properties are operated as general merchandise retail locations under the ShopKo name in mid-sized to larger cities across the Midwest, Rocky Mountain and Pacific Northwest states, and represented approximately 26% of our total assets at December 31, 2006. The remaining 66 properties are operated under the Pamida name in small, rural communities in the Midwest, North Central and Rocky Mountain states, and represented approximately 3% of our total assets at December 31, 2006. No other individual tenant represented more than 5% of total revenues during 2006.

### Competition

Our property acquisition business faces competition from financial institutions, institutional pension funds, real estate developers, other REITs, other public and private real estate companies and private real estate investors. The commercial lending market is a multi-billion dollar market including numerous competitors with greater economies of scale when compared to us, many of which are larger, have access to more resources and have greater name recognition than we do. The current environment for net lease real estate acquisitions is competitive, with individual and institutional investors exhibiting a strong demand for these investments. This demand may affect the purchase price of real estate we acquire and the rents we are able to obtain on the properties. We may delay or decline opportunities if we feel the rewards do not warrant the capital risk. As a result, the highly competitive triple-net lease environment could limit both the number of properties we acquire and the yield on those acquisitions.

We believe that we have the following competitive advantages:

- *Experienced Management.* Our senior management team has over 100 years of combined experience in the real estate investment and finance business and has a track record in the origination and management of single tenant, commercial real estate assets since 1980. Our strategy for generating attractive returns on our real estate investments combines our ability to originate, underwrite, structure and close accretive transactions, with an efficient servicing function designed to actively monitor our portfolio.
- *Flexibility.* Owners of single tenant, operationally essential real estate require flexibility that permits them to efficiently operate their businesses over a long period of time. We offer our customers lease terms that provide operating flexibility and the potential for lease modifications. This operating flexibility might include the ability to substitute real estate locations in the event a business is sold or a tenant determines that a location is no longer strategic. It might also include the ability to sell, sublease or improve a property at a later date with financing provided by us.

- *Financing Options.* We provide our clients with the convenience of having a one-stop shop for real estate financing needs, by offering sale-leaseback transactions and mortgage loans, and, where appropriate, unsecured corporate loans and construction and equipment financing.
- *Strong Industry Relationships.* Our industry and financial institution relationships provide us with the ability to source and selectively choose real estate investment opportunities. A majority of our investments are sourced by our internal acquisitions staff. We also have sourcing relationships with other real estate industry participants. We believe these arrangements will assist us, from time to time, in originating real estate investment opportunities.
- *Access To and Cost of Capital.* We have elected to be taxed as a REIT. As a REIT, we generally do not have to pay federal corporate income tax on our REIT taxable income to the extent distributed to our stockholders. Therefore, our cost of capital is lower than the targeted rates of return of the companies and private equity firms who comprise our target market for real estate. This lower cost of capital, combined with our leverage strategies, allows us to hold long-term real estate more efficiently than our customers to the mutual benefit of Spirit Finance and our customers.

## **Regulation**

Companies owning real estate are subject to various laws, ordinances, zoning and other regulations. In particular, our real estate investments are subject to compliance with the Americans With Disabilities Act of 1990 (the ADA) and various federal, state and local environmental laws and regulations.

*Compliance With the Americans With Disabilities Act of 1990.* Our properties are required to meet federal requirements related to access and use by disabled persons as a result of the ADA. Noncompliance with these laws or regulations could result in the imposition of fines or an award of damages to private litigants. Although our tenants are responsible for all maintenance and repairs of the property, including compliance with the ADA, we could be held liable as the owner of the property for a failure of one of our tenants to comply with the ADA.

*Environmental Matters.* Under various federal, state and local environmental laws and regulations, a current or previous owner, operator or tenant of real estate may be required to investigate and clean up hazardous or toxic substances, hazardous wastes or petroleum product releases or threats of releases at the property, and may be held liable to a government entity or to third parties for property damage and for investigation, clean-up and monitoring costs incurred by those parties in connection with the actual or threatened contamination. These laws typically impose clean-up responsibility and liability without regard to fault, or whether or not the owner, operator or tenant knew of or caused the presence of the contamination. The costs of investigation, clean-up and monitoring may be substantial, and can exceed the value of the property. The presence of contamination, or the failure to properly remediate contamination, on a property may adversely affect the ability of the owner, operator or tenant to sell or rent that property or to borrow using the property as collateral, and may adversely impact our investment in that property.

Federal regulations require building owners and those exercising control over a building's management to identify and warn, through signs and labels, of potential hazards posed by workplace exposure to installed asbestos-containing materials and potentially asbestos-containing materials in their building. The regulations also have employee training, record keeping and due diligence requirements pertaining to asbestos-containing materials and potentially asbestos-containing materials. Significant fines can be assessed for violation of these regulations. As a result of these regulations, building owners and those exercising control over a building's management may be subject to an increased risk of personal injury lawsuits by workers and others exposed to asbestos-containing materials and potentially asbestos-containing materials. The regulations may affect the value of a building containing asbestos-containing materials and potentially asbestos-containing materials in which we have invested. Federal, state and local laws and regulations also govern the removal, encapsulation, disturbance, handling and/or disposal of

asbestos-containing materials and potentially asbestos-containing materials when those materials are in poor condition or in the event of construction, remodeling, renovation or demolition of a building. These laws may impose liability for improper handling or a release into the environment of asbestos-containing materials and potentially asbestos-containing materials and may provide for fines to, and for third parties to seek recovery from, owners or operators of real properties for personal injury or improper work exposure associated with asbestos-containing materials and potentially asbestos-containing materials.

Before completing any property acquisition, we obtain environmental assessments in a manner we believe prudent in order to attempt to identify potential environmental concerns at the property. These assessments are carried out in accordance with an appropriate level of due diligence and generally include a physical site inspection, a review of relevant federal, state and local environmental database records, one or more interviews with appropriate site-related personnel, review of the property's chain of title and review of historical aerial photographs, if available, and other information on past uses of the property. We may also conduct limited subsurface investigations and test for substances of concern where the results of the first phase of the environmental assessment or other information indicate possible contamination or where our consultants recommend we perform the additional procedures. For some properties, we may rely on previously completed environmental assessments.

Generally, our leases provide that the lessee will indemnify us for any loss or expense we incur as a result of the presence, use or release of hazardous materials on our property. If an environmental occurrence affects one of our properties, our lessee may not have the financial capability to honor its indemnification obligations to us. In limited cases, we may obtain, or cause the lessee to obtain, environmental insurance policies to insure against these losses. We determine whether to obtain, or require, environmental insurance on a case-by-case basis depending on the type of property, the availability and cost of the insurance and various other factors we deem relevant. Our ultimate liability for environmental conditions may exceed the policy limits on any environmental insurance policies we obtain, if any. If we are unable to enforce the indemnification obligations of our lessees or if the amount of environmental insurance is inadequate, our financial condition and results of operations could be adversely affected.

#### **Employees**

In order to efficiently manage our operations, we outsource certain due diligence, legal and portfolio servicing functions to businesses located in the United States. As a result, we expect our operations to require a lower number of full-time employees than a company that performs all of its operating functions internally. As of February 23, 2007, we had 41 full-time employees.

#### **Facilities**

Our principal offices are located at 14631 N. Scottsdale Road, Suite 200, Scottsdale, Arizona 85254. We currently occupy approximately 18,700 square feet of space leased from an unaffiliated third party. We believe that our facilities are adequate for our present operations and that adequate additional space will be available as needed in the future.

#### **Website Access to Reports and Other Documents**

We maintain a website at [www.spiritfinance.com](http://www.spiritfinance.com). We make available, free of charge, our Annual Proxy Statements, Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to those reports filed or furnished in accordance with Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we electronically file that material with, or furnish it to, the Securities and Exchange Commission. Our corporate governance guidelines, code of business conduct and ethics and the charters of our audit committee, compensation committee and nominating and governance committee are also available on our website.

**Item 1A. Risk Factors**

In addition to factors discussed elsewhere in this report, the following are important factors which could cause our actual results or events to differ materially from those contained in any forward-looking statements made by or on behalf of the Company.

***Risks Related to Our Business***

***We rely on key personnel with long-standing business relationships, the loss of whom could materially impair our ability to operate successfully.*** Our future success depends, to a significant extent, on the continued services of Morton H. Fleischer, our Chairman of the Board, and Christopher H. Volk, our President and Chief Executive Officer. In particular, the extent and nature of the relationships that these individuals have developed with financial institutions and existing and prospective customers is critically important to the success of our business. Although we have employment agreements with Mr. Fleischer and Mr. Volk, these agreements cannot guarantee that Mr. Fleischer and Mr. Volk will remain employed by us. The loss of services of one or more members of our corporate management team could harm our business and our prospects.

***A substantial amount of our investment portfolio consists of properties operated by two customers under common control, which may result in increased risk due to tenant and industry concentrations.*** As of December 31, 2006, our investment portfolio totaled over \$2.8 billion. Approximately 29% of this portfolio represented real estate assets operated by ShopKo Stores Operating Co., LLC and Pamida Stores Operating Co., LLC, two general retailers operating under the ShopKo and Pamida names that are owned by SKO. These properties include 112 ShopKo properties and 66 Pamida properties leased under master leases to ShopKo and Pamida, respectively. A default by either of these tenants will significantly and adversely affect our results of operations and the amounts we have available to pay distributions. Due to the concentration of these two tenants, our performance will be closely tied to the performance of these tenants operating the ShopKo and Pamida stores and the retail industry in which they operate until we reduce our investment concentration through the acquisition of a substantial amount of additional properties.

ShopKo operates as a multi-department store retailer under the ShopKo name primarily in mid-size and larger communities in the Midwest, Pacific Northwest and Western Mountain states. Pamida operates as a general merchandise retailer under the Pamida name in smaller and more rural communities in the Midwest, North Central and Rocky Mountain states. ShopKo and Pamida stores are subject to the following risks, as well as other risks that we currently do not know, that could adversely affect their ability to pay rent to us:

- The retail industry in which ShopKo and Pamida operate is highly competitive, which could limit growth opportunities and reduce profitability for ShopKo and Pamida. ShopKo and Pamida compete with other discount retail merchants as well as mass merchants, catalog merchants, internet retailers and other general merchandise, apparel and household merchandise retailers. ShopKo and Pamida face strong competition from large national discount retailers, such as Wal-Mart, Kmart and Target;
- ShopKo and Pamida stores are geographically located in a limited region, particularly the Midwest, Western Mountain and Pacific Northwest regions. Adverse economic conditions in these regions may materially and adversely affect ShopKo's and Pamida's results of operations and retail sales;
- Fluctuations in quarterly performance and seasonality in retail operations may cause ShopKo's and Pamida's results of operations to vary considerably from quarter to quarter and could adversely affect cash flows;

- The failure to maintain the existing ShopKo and Pamida stores or to carry out any remodeling plans in a cost-effective manner could have a material adverse affect on ShopKo's and Pamida's results of operations, financial condition, anticipated sales and profitability;
- ShopKo and Pamida stores are dependent on the efficient functioning of their distribution networks. Problems that cause delays or interruptions in the distribution networks could have a material adverse impact on the results of their operations; and
- ShopKo and Pamida stores depend on attracting and retaining quality employees. Many employees are entry level or part-time employees with historically high rates of turnover.

*Our investments are currently concentrated in a relatively small number of customers and we may be unable to adequately continue to diversify our real estate portfolio, which may result in increased risk due to industry, borrower or tenant concentration.* As of December 31, 2006, our investment portfolio totaled over \$2.8 billion, representing 1,034 properties operated by 145 customers in various industries. Due to our current level of diversity, our performance may be closely tied to the performance of each of our customers and the industries in which they operate. This increases the chance that a default by any single customer will significantly and adversely affect our results of operations and the amounts available to pay distributions.

If we are unable to diversify our portfolio, we may also be affected by changing conditions in the industries in which our customers operate. As of December 31, 2006, approximately 29% of our total real estate investments were concentrated in the general and discount retail industry, 22% in the restaurant industry and 10% in the specialty retail industry. There are several factors that affect the retail industry, including the level of competition, the seasonality of retail sales, the availability of consumer credit and the levels of household incomes. Some of the factors that affect the restaurant industry include the demand for convenience, the levels of household incomes and the costs of restaurant labor. Changes in these factors could adversely affect the financial performance of our tenants operating in these industries and their ability to make payments to us. This lack of industry diversification increases the chance that a downturn in a particular industry or part of a particular industry will materially and adversely affect us.

In addition, we may be unable to continue to diversify our portfolio geographically. As of December 31, 2006, approximately 12% of our properties were located in Wisconsin and approximately 11% were located in Texas. The inability to geographically diversify our portfolio increases the chance that a decline or adverse economic or other event in one region or in a particular real estate market will adversely affect the results of our operations.

*Our use of debt to finance acquisitions could restrict our operations, inhibit our ability to grow our business and our revenues, and adversely affect our cash flow.* Some of our property acquisitions were made, and may be made in the future, by borrowing a portion of the purchase price of our properties and securing the loan with a mortgage on the property. In addition, we obtain debt financing by placing secured mortgage loans on properties that we initially acquire for cash. As of December 31, 2006, a substantial portion of our properties were subject to debt or pledged as collateral under our secured debt facility. We may acquire properties for the purpose of securitization or use similar structured finance alternatives. If we are unable to make our debt payments as required, a lender could foreclose on the property or properties securing its debt. This could cause us to lose part or all of our investment, which in turn could cause the value of our shares and distributions to our stockholders to be reduced. We have a target overall leverage ratio of 65%, but there is no limitation on the amount we can borrow on a single property or the aggregate amount of our borrowings and we can exceed this ratio or change this policy at any time without stockholder approval.

We may not be able to obtain debt financing at favorable rates. In addition, if interest rates increase, any variable rate borrowings we have would result in our expenses increasing. Some of our borrowings

require the payment of the principal amount in a balloon payment at maturity. We may not have sufficient funds available to make all of our balloon payments at maturity, which would require us to refinance that debt at maturity. If we have to refinance our debt as it matures in a rising interest rate environment, our expenses will increase. An increase in our expenses would reduce the funds we have available to pay distributions.

To the extent the agreements governing our borrowings require us to comply with financial and other covenants, our operating flexibility may be limited. Borrowings under our secured debt facility are subject to various covenants, including a maximum leverage ratio, minimum liquidity amount, minimum tangible net worth and other financial ratio calculations. These covenants, as well as any additional covenants we may be subject to in the future on additional borrowings, could cause us to have to forego investment opportunities, or may cause us to have to finance investments in a less efficient manner than if we were not subject to the covenants. In addition, the agreements governing some of our borrowings have cross default provisions such that a default on one of our borrowings would lead to a default on some of our other borrowings.

***Our ability to realize future rent increases will vary depending on changes in the Consumer Price Index.*** Most of our leases contain rent escalators, or provisions that periodically increase the base rent payable by the tenant under the lease. Although some of our rent escalators increase rent at a fixed amount or percentage on each adjustment date, most of our rent escalators increase rent at the lesser of (1) 1 to 1.25 times the increase in the CPI or (2) a fixed amount or percentage. If the increase in the CPI multiplied by the applicable factor is less than the fixed amount or percentage, the increased rent we are entitled to receive will be less than what we otherwise would have been entitled to receive if the rent escalator was based solely on a fixed amount or percentage. Therefore, during periods of low inflation or deflation, the low or negative change in the CPI will subject us to the risk of receiving lower rental revenue than we otherwise would have been entitled to receive if our rent escalators were based solely on fixed percentages or amounts.

***Failure to hedge effectively against interest rate changes may adversely affect our results of operations.*** We attempt to mitigate our exposure to interest rate volatility by using interest rate hedging arrangements that involve risk; however, these arrangements may not be effective in reducing our exposure to interest rate changes. In addition, the counterparties to our hedging arrangements may not honor their obligations. Failure to hedge effectively against changes in interest rates relating to the interest expense of our future borrowings may have a material adverse effect on our operating results and financial condition.

***We compete for customers and the acquisition or refinancing of properties which could reduce the yields we are able to negotiate on our investments.*** We compete for the acquisition or financing of properties with financial institutions, real estate funds and investment companies, pension funds, private individuals and other REITs. We also face competition from institutions that provide or arrange for other types of commercial financing through private or public offerings of equity or debt or traditional bank financings. Many of our competitors have greater name recognition, resources and access to capital than we have. In particular, larger REITs may enjoy significant competitive advantages that result from a lower cost of capital and enhanced operating efficiencies. Because the real estate financing market is highly competitive, competitors are quick to adopt new financing products. To the extent we offer unique financing terms in the future, our competitors could also begin offering similar terms, which would decrease our ability to develop a competitive advantage. We continue to experience increased competitive conditions caused by larger amounts of investor capital seeking quality income-producing investments, which has caused us to lose bids or turn down various transactions where competition has reduced yields to the point that we concluded the transaction did not provide us a sufficient return. We may have to increase our purchase price of properties, reduce the rent we require a tenant to pay or reduce the interest rates on loans we make in order to secure customers or remain competitive. If this happens, our returns to stockholders may be adversely affected.



*We may not have adequate access to funding to successfully execute our growth strategy.* Our business strategy principally depends on our continued ability to grow the size of our real estate portfolio. Our business plan requires significant funds for property acquisition, loan origination, working capital, minimum REIT distributions and other needs. This strategy depends, in part, on our ability to access the debt and equity capital markets to finance our cash requirements. We will need to continue to access long-term debt financing facilities or other permanent debt strategies and also to raise additional equity capital in order to continue to successfully execute our business plan. We will need access to significant additional funding to adequately diversify our portfolio and continue to execute our business strategy. An inability to effectively access these markets would have an adverse effect on our ability to make new investments and could adversely affect our ability to pay distributions.

*The loss of a tenant or the failure of a tenant to pay rent, or our inability to re-lease a property, will reduce our revenues, which could lead to losses on our investments and reduced returns to our stockholders.* Generally, each of our properties is operated and occupied by a single tenant; therefore, the success of our investments is materially dependent on the financial stability of each tenant. Leasing activity represented approximately 95% of our total revenues for the fiscal year ended December 31, 2006. The success of our tenants is dependent on each of their individual businesses and their industries, which could be adversely affected by economic conditions in general, changes in consumer trends and preferences and other factors over which neither they nor we have control. We generally acquire properties from single tenants that typically operate multiple locations, which means we may own numerous properties operated by the same tenant. To the extent we own numerous properties operated by one company, the general failure of that single tenant or a loss or significant decline in its business would have an adverse affect on us.

A default of a tenant on its lease payments to us that would cause us to lose the revenue from the property would have an adverse effect on our operating results and financial condition and/or could cause us to reduce the amount of distributions we pay to stockholders. In the event of a default, we may incur substantial costs in protecting our investment and re-leasing our property. In addition, if a lease is terminated or not renewed, we may not be able to re-lease the property on favorable terms or sell the property without incurring a loss.

Loss of a tenant may further reduce our revenues because the net leases we may enter into or acquire may be for properties that are specially suited to the particular business of our tenants. With these types of properties, if the current lease is terminated or not renewed, we may be required to renovate the property at substantial costs, decrease the rent we charge or provide other concessions in order to lease the property to another tenant. In addition, in the event we are required to sell the property, we may have difficulty selling it to a party other than the tenant due to the special purpose for which the property may have been designed. This potential illiquidity may limit our ability to quickly modify our portfolio in response to changes in economic or other conditions. These and other limitations may negatively affect our cash flow from operations or the proceeds from disposition of any such properties and adversely affect returns to our stockholders.

*The loss of a borrower or the failure of a borrower to make loan payments on a timely basis will reduce our revenues, which could lead to losses on our investments and reduced returns to our stockholders.* Currently, our total mortgage loan portfolio represents four different borrowers; therefore, the success of our mortgage loan investments is materially dependent on the financial stability of each of these borrowers. The success of our borrowers is dependent on each of their individual businesses and their industries, which could be affected by economic conditions in general, changes in consumer trends and preferences and other factors over which neither they nor we have control. A default of a borrower on its loan payments to us that would prevent us from earning interest or receiving a return of the principal of our loan would have an adverse effect on our operating results and financial condition and could cause us to reduce the amount of dividends we pay to our stockholders. In the event of a default, we may also experience delays in enforcing

our rights as lender and may incur substantial costs in collecting the amounts owed to us and in liquidating any real estate collateral.

Foreclosure and other similar proceedings used to enforce payment of real estate loans are generally subject to principles of equity, which are designed to relieve the indebted party from the legal effect of that party's default. Foreclosure and other similar laws may limit our right to obtain a deficiency judgment against the defaulting party after a foreclosure or sale. The application of any of these principles may lead to a loss or delay in the payment on loans we hold, which in turn could reduce the amounts we have available to pay distributions. Further, in the event we have to foreclose on a property, the amount we receive from the foreclosure sale of the property may be inadequate to fully pay the amounts owed to us by the borrower and our costs incurred to foreclose, repossess and sell the property which could adversely impact our results of operations.

***The risk of default on our real estate investment portfolio may be higher because, as of December 31, 2006, most of our properties were operated by non-investment grade companies.*** As of December 31, 2006, most of our properties were operated by customers that do not have an investment grade rating from at least one of the nationally recognized rating agencies. Investment grade means companies which have unsecured corporate debt ratings equal to or greater than BBB- by Standard & Poor's (a division of The McGraw Hill Companies, Inc.), Baa3 by Moody's Investment Services, Inc. (a subsidiary of Moody's Corporation) and NAIC-2 by the National Association of Insurance Commissioners. We also may have customers who are highly leveraged. Customers who are highly leveraged or do not have recognized credit ratings may be more likely to default or file for bankruptcy.

Any bankruptcy filings by or relating to one of our customers could prevent us from collecting pre-bankruptcy debts from that customer or their property, unless we receive an order permitting us to do so from the bankruptcy court. A customer bankruptcy could delay our efforts to collect past due balances under the subject leases or loans, and could ultimately prevent full collection of these sums. If a lease were rejected by a tenant in bankruptcy, we would have only a general unsecured claim for damages. Any unsecured claim we hold against a bankrupt entity may be paid only to the extent that funds are available and only in the same percentage as is paid to all other holders of unsecured claims. Additionally, we may not be able to terminate the subject lease and seek new tenants. We may recover substantially less than the full value of any unsecured claims, if anything, which would harm our financial condition.

***We invest in real estate in industries in which we have limited investment and underwriting experience, which could adversely affect our results of operations.*** Our current strategy is to acquire real estate assets across a variety of industries in a variety of geographic locations. We have limited experience investing in real estate operated by some of the industries we are targeting. Accordingly, we will be required to develop expertise, relationships and market knowledge across a broad range of industries and will be subject to the market conditions affecting each industry operating our properties, including such factors as the economic climate, the level of competition, business layoffs, industry slowdowns, changing demographics, and supply and demand issues. This multi-industry approach could require more management time, support staff and expense than a company whose focus is dedicated to a greater extent on a single property type. If we are not able to efficiently and effectively manage a diverse multi-industry portfolio of real estate properties and loans, our results of operations and returns to our stockholders would be adversely impacted.

***Insurance on our real estate collateral may not adequately cover all losses which could reduce stockholder returns if a material uninsured loss occurs.*** Our customers are required to maintain insurance coverage for the properties they operate. There are various types of losses, generally of a catastrophic nature, such as earthquakes, floods, hurricanes, terrorism or acts of war that may be uninsurable or not economically insurable. Should an uninsured loss occur, we could lose our capital investment and/or anticipated profits and cash flow from one or more properties. Inflation, changes in building codes and ordinances, environmental considerations, and other factors, including terrorism or acts of war, also might make the

insurance proceeds insufficient to repair or replace a property if it is damaged or destroyed. In that case, the insurance proceeds received might not be adequate to restore our economic position with respect to the affected real property. If this happens, it could reduce the amounts we have available to pay dividends to our stockholders.

*The costs of compliance with or liabilities under environmental laws may harm our operating results.* The properties we acquire may be subject to known and unknown environmental liabilities. This risk is further increased because as of December 31, 2006, approximately 2% of our total assets were invested in interstate travel plazas or convenience stores/car washes that sell petroleum products. An owner of real property can face liability for environmental contamination created by the presence or discharge of hazardous substances on the property. We may face liability regardless of:

- our knowledge of the contamination;
- the timing of the contamination;
- the cause of the contamination; or
- the party responsible for the contamination of the property.

There may be environmental problems associated with our properties of which we are unaware. We generally obtain or update Phase I environmental surveys on the properties we finance or acquire. The environmental surveys may not reveal all environmental conditions affecting a property; therefore, there could be undiscovered environmental liabilities on the properties we own. Some of our properties use, or may have used in the past, underground tanks for the storage of petroleum-based products or waste products that could create a potential for release of hazardous substances. Some properties may contain asbestos-containing materials. If environmental contamination exists on our properties, we could be subject to strict, joint and/or several liability for the contamination by virtue of our ownership interest.

The presence of hazardous substances on a property may adversely affect our ability to sell the property and we may incur substantial remediation costs. In addition, although our leases generally require our tenants to operate in compliance with all applicable laws and to indemnify us against any environmental liabilities arising from a tenant's activities on the property, we could be subject to strict liability by virtue of our ownership interest, and we cannot be sure that our tenants will, or will be able to, satisfy their indemnification obligations under our lease, if any. The discovery of environmental liabilities attached to our properties could adversely affect a customer's ability to make payments to us or otherwise affect our results of operations and financial condition and our ability to pay distributions to stockholders.

Our environmental liability may include property damage, personal injury, investigation, remediation and clean-up costs. These costs could be substantial. Generally, properties we own at which petroleum products are sold are covered by different types of environmental insurance, which can vary extensively from property to property in the scope, amount and terms of coverage. Although these properties generally are covered by environmental insurance for a period of time, that insurance may be insufficient to address a particular environmental situation that arises, and may be subsequently unavailable, at a reasonable cost or at all, in the future. If the existing environmental insurance coverage were inadequate relative to the exposure, we could become subject to material losses for environmental liabilities. Our ability to receive the benefits of any environmental insurance policy will depend on the financial ability of the insurance companies that have issued the policies and the positions they take with respect to those policies. If we become subject to significant environmental liabilities, our business, financial condition, liquidity and results of operations would be materially and adversely affected.

Most of the environmental risks discussed above refer to properties that we own or may acquire in the future; however, each of the risks identified also applies to the owners (and potentially, the lessees) of the properties that secure each of our mortgage loans and any mortgage loans we may acquire or make in the

future. Therefore, the existence of environmental conditions could diminish the value of each of the mortgage loans and the abilities of the borrowers to repay the mortgage loans, as well as adversely affect our results of operations and financial condition and our ability to pay distributions to stockholders.

***Our properties may contain or develop harmful mold, which could lead to liability for adverse health effects and costs of remediation of the problem.*** When excessive moisture accumulates in buildings or on building materials, mold growth may occur, particularly if the moisture problem remains undiscovered or is not addressed over a period of time. Some molds may produce airborne toxins or irritants. Concern about indoor exposure to mold has been increasing along with awareness that exposure to mold may cause a variety of adverse health effects and symptoms, including allergic or other reactions. As a result, the presence of significant mold at any of our properties could require us to undertake a costly remediation program to contain or remove the mold from the affected properties. In addition, the presence of significant mold could expose us to liability from our tenants, employees of our tenants and others if property damage or health concerns arise. If we ever become subject to significant mold-related liabilities, our business, financial condition, liquidity, results of operations and ability to pay dividends could be materially and adversely affected.

***Compliance with the Americans with Disabilities Act and fire, safety and other regulations may require us to make unintended expenditures that adversely impact our ability to pay dividends.*** All of our properties are required to comply with the ADA. The ADA has separate compliance requirements for public accommodations and commercial facilities, but generally requires that the buildings be made accessible to people with disabilities. Compliance with the ADA requirements could require removal of access barriers and non-compliance could result in imposition of fines by the U.S. government or an award of damages to private litigants, or both. While our tenants are obligated by law to comply with the ADA provisions, and typically under our leases and financing agreements are obligated to cover costs associated with compliance, if required changes involve greater expenditures than anticipated, or if the changes must be made on a more accelerated basis than anticipated, the ability of these tenants to cover costs could be adversely affected and we could be required to expend our own funds to comply with the provisions of the ADA, which could adversely affect our results of operations and financial condition and our ability to pay dividends to our stockholders.

In addition, we are required to operate our properties in compliance with fire and safety regulations, building codes and other land use regulations, as they may be adopted by governmental agencies and bodies and become applicable to our properties. We may be required to make substantial capital expenditures to comply with those requirements and these expenditures could have an adverse effect on our ability to pay distributions. Additionally, failure to comply with any of these requirements could result in the imposition of fines by governmental authorities or awards of damages to private litigants. While we intend to only acquire properties that we believe are currently in substantial compliance with all regulatory requirements, these requirements could be changed or new requirements could be imposed which would require significant unanticipated expenditures by us and could have an adverse affect on our cash flow and distributions paid.

***Construction loans are riskier than loans on developed properties because the underlying property may not generate income and could encounter problems associated with construction.*** From time to time, we make loans to finance the development of new properties. These loans are generally made to fund the construction of one or more buildings on real property. These loans are riskier than loans secured by income producing properties because of increased risks during construction, and the fact that the property does not generate income until construction is completed, which reduces the funds the borrower has available to make payments on the loan. We may also be required to expend funds to complete construction of the property if the borrower defaults and does not complete construction.

*We may make loans that are not secured by any assets, which could lead to losses if borrowers default on those loans.* In connection with a real estate financing, we may make general business loans that are not secured by real estate or any other assets. In these cases, we will not have a security interest in a specific asset, but will rely instead on a promise to pay from the borrower. If the borrower does not keep its promise to pay and defaults, we will not have the benefit of a lien on any specific asset on which to foreclose to collect the loan. If we do not have any collateral to repossess through foreclosure and sell, we may lose our entire investment on that loan.

*We may not be able to effectively manage a rapidly growing portfolio which could lead to losses.* The successful implementation of our growth strategy depends, in part, on our ability to effectively manage rapid growth in our portfolio. Our ability to effectively manage rapid growth in our portfolio depends on our ability to successfully attract and retain additional qualified personnel. An inability to attract the necessary qualified personnel to properly manage and grow our portfolio could have an adverse affect on our business.

#### ***Risks Related to Ownership of Our Common Stock***

*The market price and trading volume of our common stock may fluctuate.* The market price of our common stock may be volatile, may be subject to wide fluctuations and could decline significantly in the future. In addition, the trading volume in our common stock may fluctuate and cause significant price variations to occur. If the market price of our common stock declines significantly, our stockholders may be unable to resell their shares at or above their purchase price. Some of the factors that could negatively affect our share price or result in fluctuations in the price or trading volume of our common stock include:

- actual or anticipated variations in our quarterly operating results or dividends;
- changes in our funds from operations or earnings estimates or publication of research reports about us or the real estate industry;
- increases in market interest rates that lead purchasers of our shares to demand a higher yield;
- changes in market valuations of similar companies;
- adverse market reaction to any real estate acquisitions we make or any increased indebtedness we incur in the future;
- additions or departures of key management personnel;
- actions by institutional stockholders;
- speculation in the press or investment community;
- changes in regulatory policies or tax guidelines with respect to REITs;
- loss of a major funding source; and
- general market and economic conditions.

*We may not be able to maintain our current level of distributions and we may not have the ability to pay distributions in the future.* We intend to pay quarterly distributions to our stockholders in amounts such that all or substantially all of our taxable income in each year, subject to adjustments, is distributed. Our ability to continue to pay distributions in the future may be adversely affected by the risk factors described in this report. All distributions are made at the discretion of

our board of directors and depend on our earnings, our financial condition, maintaining our REIT status and other factors our board of directors deems relevant from time to time. We cannot predict our ability to continue to pay distributions in the future or the amount of those distributions, if any.

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*Future sales of shares of our common stock, including sales of our common stock by our senior management, may depress the price of our shares.* As of December 31, 2006, there were 107,515,866 shares of our common stock outstanding and 267,484,134 shares remained available for issuance under our charter. We have reserved 4,100,000 shares of common stock for issuance to our officers, non-employee directors, employees and consultants under our 2003 Stock Option and Incentive Plan, or stock option plan. Under the stock option plan, as of December 31, 2006, we had outstanding options to purchase 1,260,000 shares of common stock and 646,256 shares of unvested restricted common stock, with awards related to 2,051,746 shares remaining available for issuance. Our senior management's ability to resell their shares of our common stock or actual sales by our senior management in the future could create the impression that the interests of our senior management are not aligned with those of our stockholders. In addition, if members of our senior management sell their shares, they may have less incentive to remain employed by us, which could lead to discontinuity in our management team. An impression that our senior management's interests are not aligned with those of our stockholders or any discontinuity in our management team could adversely affect our operations and the price of our common stock. Further, future sales of substantial amounts of our common stock, or the perception that sales could occur, could also have a material adverse effect on the price of our common stock.

*Our board of directors may authorize the issuance of additional shares of stock that may cause dilution.* Our charter authorizes the issuance of up to 500,000,000 shares of stock and further authorizes our board of directors, without stockholder approval, to:

- amend our charter to increase or decrease the aggregate number of shares of stock, or the number of shares of stock of any class or series, that we have the authority to issue;
- authorize the issuance of additional shares of common or preferred stock in connection with future equity offerings, acquisitions of properties or other assets of companies; and
- classify or reclassify any unissued preferred stock and to set the preferences, rights and other terms of the classified or reclassified stock, including the issuance of preferred shares of stock that have preference rights over our common stock with respect to dividends, liquidation, voting and other matters or shares of our common stock that have preference rights with respect to voting.

The issuance of additional stock could be substantially dilutive to our existing stockholders.

*Future offerings of debt, preferred securities or other equity, which could be senior to our common stock in liquidation or for the purposes of dividend distributions, may harm the value of our common stock.* In the future, it is likely we will attempt to continue to increase our capital resources by making additional offerings of common stock. We likely will also issue additional debt, including senior or subordinated notes, commercial paper, or medium-term notes and may also issue preferred stock or additional classes of common stock. If we were to liquidate, holders of our debt securities and shares of preferred stock and lenders with respect to other borrowings will receive a distribution of our available assets before the holders of our common stock. We could also issue securities of our subsidiaries either for cash or in exchange for the acquisition of additional properties, which securities would effectively rank senior to our common stock as to any assets held by that subsidiary. Since July 2005, our subsidiaries have issued \$743.1 million of Net-Lease Mortgage Notes, of which \$727.8 million remained outstanding at December 31, 2006. As of December 31, 2006, we had total outstanding debt obligations of approximately \$1.8 billion that would rank senior to our common stock in liquidation.

Additional equity offerings by us may dilute our stockholders' interest in our company or reduce the value of their shares, or both. Our preferred stock, if issued, could have a preference on dividend payments that could limit our ability to make a dividend distribution to our stockholders. Because our decision to issue securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings. Thus, our





stockholders will bear the risk of our future offerings reducing the value of their shares and diluting their interest in us.

*An investment in our common stock may not be suitable for pension or profit sharing trusts, Keoghs or IRAs.* If our stockholders are investing the assets of a pension, profit sharing, 401(k), Keogh or other retirement plan, IRA or benefit plan in our shares, they should consider:

- whether their investment is consistent with the applicable provisions of ERISA or the Internal Revenue Code;
- whether their investment will produce unrelated business taxable income, referred to as UBTI, to the benefit plan; and
- their need to value the assets of the benefit plan annually.

*An increase in market interest rates may have an adverse effect on the price of our common stock.* One of the factors that investors may consider in deciding whether to buy or sell our common stock is our dividend rate as a percentage of our share price relative to market interest rates. If market interest rates increase, prospective investors may desire a higher dividend yield on our common stock or seek securities paying higher dividends or interest. The price of our common stock likely will be based, in part, on the earnings that we derive from rental income with respect to our properties, interest earned on our mortgage loans and our related distributions to stockholders, and not entirely from the underlying appraised value of the properties themselves. As a result, interest rate fluctuations and capital market conditions are likely to affect the price of our common stock, and such effects could be significant. For instance, if interest rates rise without an increase in our dividend rate, the price of our common stock could decrease because potential investors may require a higher dividend yield on our common stock as market rates on interest-bearing securities, such as bonds, rise.

#### *Risks Related to Our Organization and Structure*

*Our organizational documents and Maryland law contain provisions that may inhibit potential acquisition bids that may be in our stockholders' best interests.* Our organizational documents contain provisions that may have an anti-takeover effect and inhibit a change in our board of directors. These provisions include the following:

- *There are ownership limits and restrictions on transferability in our charter.* In order to qualify as a REIT, not more than 50% of the value of our outstanding shares of stock (in some cases, after taking into account options to acquire shares of stock) may be owned, beneficially or constructively, by five or fewer individuals and our shares of stock must be beneficially owned by 100 or more persons during at least 335 days of a taxable year of 12 months or during a proportionate part of a shorter taxable year. To assist us in satisfying these tests, subject to some exceptions, our charter generally prohibits any stockholder from beneficially or constructively owning more than 9.8%, in value or voting power, whichever is more restrictive, of our outstanding shares of stock or owning more than 9.8%, in value or number, whichever is more restrictive, of our outstanding shares of common stock and also prohibits any transfer which would result in a violation of these ownership limits. This restriction may:
  - discourage a tender offer or other transactions or a change in the composition of our board of directors or control that might involve a premium price for our shares of stock or otherwise be in the best interests of our stockholders; or
  - compel the transfer of shares of stock held by a stockholder who had acquired more than 9.8% of our shares of stock to a charitable trust and, as a result, forfeit the benefits of owning the shares over 9.8%.



- *Our charter permits our board of directors to issue preferred stock with terms that may discourage a third party from acquiring us.* Our charter permits our board of directors to authorize the issuance of up to 125,000,000 shares of preferred stock, having preferences, conversion or other rights, voting powers, restrictions, limitations as to distributions, qualifications, or terms or conditions of redemption as determined by our board. Thus, our board could authorize the issuance of preferred stock with terms and conditions that could have the effect of discouraging a takeover or other transaction in which holders of some or a majority of our common stock might receive a premium for their shares over the then-prevailing market price of our common stock.
- *Our charter and bylaws contain other possible anti-takeover provisions.* Our charter and bylaws contain other provisions that may have the effect of delaying, deferring or preventing a change in control of us or the removal of existing directors and, as a result, could prevent our stockholders from being paid a premium for their common stock over the then-prevailing market price. These provisions include advance notice requirements for stockholder proposals. Although we do not have a poison pill or similar rights at this time, we have reserved the right to adopt those measures in the future as we deem necessary for stockholder protection.

In addition, Maryland law provides protection for Maryland corporations against unsolicited takeovers by providing, among other things, that the duties of the directors in unsolicited takeover situations do not require them to:

- accept, recommend or respond to any proposal by a person seeking to acquire control of the corporation;
- authorize the corporation to redeem any rights under, or modify or render inapplicable, any stockholders rights plan;
- take any action under the Maryland Business Combination Act or the Maryland Control Share Acquisition Act; or
- respond because of the effect the response or lack of a response may have on an acquisition or potential acquisition of control of the corporation or the amount or type of consideration that may be offered or paid to the stockholders in an acquisition.

Under Maryland law, the act of the directors of a Maryland corporation relating to or affecting an acquisition or potential acquisition of control is not subject to any higher duty or greater scrutiny than is applied to any other act of a director. Maryland law also contains a statutory presumption that an act of a director of a Maryland corporation satisfies the applicable standards of conduct for directors under Maryland law.

*Our rights and the rights of our stockholders to take action against our directors and officers are limited.* Maryland law provides that a director or officer has no liability in that capacity if the director performs the director's duties in good faith, in a manner the director reasonably believes to be in the best interests of our stockholders and with the care that an ordinarily prudent person in a like position would use under similar circumstances. Our charter, in the case of directors and officers, requires us to indemnify our directors and officers for actions taken by them in those capacities to the fullest extent permitted by Maryland law.

*Our executive officers have agreements that provide them with benefits in the event their employment is terminated following a change of control of our company which could discourage a takeover that could be in the best interests of our stockholders.* We have entered into employment agreements with the senior members of our management team that provide them with severance benefits if their employment ends under specified circumstances, including events involving a change in control of our company. In addition, in the event of a change in control, we would provide to other officers certain termination benefits. These



benefits could increase the cost to a potential acquirer of our company and thereby prevent or discourage a change of control of our company that might involve a premium price for shares of our common stock or could otherwise be viewed as in our stockholders' best interest.

***Risks Related to Our REIT Status***

***Failure to qualify as a REIT would adversely affect our operations and ability to make distributions.*** If we fail to qualify as a REIT in any taxable year, we would be subject to federal income tax on our taxable income at regular corporate rates. In addition, we would generally be disqualified from treatment as a REIT for the four taxable years following the year we lost our REIT status. Losing our REIT status would reduce our net earnings available for investment or distribution to stockholders because of the additional tax liability, and we would no longer be required to make distributions. We might be required to borrow funds or liquidate some investments in order to pay the applicable tax.

Qualification as a REIT is subject to the satisfaction of tax requirements and various factual matters and circumstances which are not entirely within our control and which will be evaluated in light of our future operations. New legislation, regulations, administrative interpretations or court decisions could change the tax laws with respect to qualification as a REIT or the federal income tax consequences of being a REIT. In addition, future tax laws related to other types of entities could reduce our tax-advantaged status relative to those entities, which could cause a reduction in the market price of our shares. Further, our future operations may, contrary to expectation, prohibit us from satisfying one or more conditions to qualifying as a REIT.

***Complying with REIT requirements may cause us to forego otherwise attractive opportunities.*** In order to remain a REIT for U.S. federal income tax purposes, we must continually satisfy tests concerning our sources of income, the nature and diversification of our assets, the amounts we distribute to our stockholders and the ownership of our stock. We may also be required to make distributions to our stockholders at disadvantageous times or when we do not have funds readily available for distribution. Thus, compliance with REIT requirements may hinder our ability to operate solely with the goal of maximizing profits.

In addition, the REIT provisions of the Internal Revenue Code impose a 100% tax on income from prohibited transactions. Prohibited transactions generally include sales of assets that constitute inventory or other property primarily held for sale to customers in the ordinary course of a business, other than foreclosure property. This 100% tax could impact our desire to sell properties at otherwise opportune times if we believe those sales could result in us being treated as engaging in a prohibited transaction.

***Complying with REIT requirements may force us to borrow funds or sell properties on disadvantageous terms in order to make distributions to our stockholders and those distributions may represent a return of capital to investors.*** As a REIT, we must distribute 90% of our REIT taxable income to our stockholders each year. REIT taxable income is determined without regard to the deduction for dividends paid and by excluding net capital gains. We are also required to pay tax at regular corporate rates to the extent that we distribute less than 100% of our taxable income (including net capital gains) each year. In addition, we are required to pay a 4% nondeductible excise tax on the amount, if any, by which specified distributions we pay, or are deemed to pay, with respect to any calendar year are less than the sum of 85% of our ordinary income for that calendar year, 95% of our capital gain net income for the calendar year and any amount of our income that was not distributed in prior years. From time to time, we may generate taxable income greater than our cash flow available for distribution to our stockholders. If we do not have other funds available in these situations, we may be unable to distribute 90% of our taxable income as required by the REIT rules or an amount sufficient to minimize our exposure to federal income tax and the nondeductible excise tax. Thus, we could be required to borrow funds, sell a portion of our properties at disadvantageous times or prices or find another alternative source of funds. These distributions could also represent a

return of capital to investors. These alternatives could increase our costs or reduce our equity and reduce amounts we have available to invest.

*The IRS may treat sale-leaseback transactions as loans, which could jeopardize our REIT status.* The Internal Revenue Service may take the position that specific sale-leaseback transactions we treat as true leases are not true leases for federal income tax purposes but are, instead, financing arrangements or loans. If a sale-leaseback transaction were so re-characterized, we might fail to satisfy the REIT asset tests, the income tests or distribution requirements and consequently lose our REIT status effective with the year of re-characterization. The primary risk relates to our loss of previously incurred depreciation expenses, which could affect the calculation of our REIT taxable income and could cause us to fail the REIT distribution test that requires a REIT to distribute at least 90% of our REIT taxable income.

#### **Forward-Looking Statements**

Some of the statements in this report constitute –forward-looking statements. Forward-looking statements relate to expectations, beliefs, projections, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts. In some cases, forward-looking statements can be identified by terms such as anticipate, believe, could, estimate, expect, intend, may, potential, should, will and would or the negative of these terms or other similar terminology.

The forward-looking statements are based on our beliefs, assumptions and expectations of our future performance, taking into account all information currently available to us. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to us or are within our control. If a change occurs, our business, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. The following are some of the factors that could cause actual results to vary from our forward-looking statements:

- changes in our industry, interest rates or general economic conditions;
- general volatility of the capital markets and the market price of our common stock;
- changes in our business strategy or development plans;
- availability and terms of additional capital;
- failure to maintain our status as a REIT;
- availability of suitable properties to acquire at favorable prices and our ability to rent those properties at favorable rates;
- timing of acquisitions;
- defaults by tenants on our leases;
- our ability to renew leases with tenants at the expiration of their lease term or otherwise re-lease those properties to suitable new tenants;
- availability of qualified personnel and our ability to retain our key management personnel;
- changes in, or the failure or inability to comply with, government regulation;
- the extent and nature of our competition; and
- other factors referenced in this report, including those set forth under the captions Risk Factors above and Management's Discussion and Analysis of Financial Condition and Results of Operations.



These forward-looking statements speak only as of the date of this report. We expressly disclaim any obligation or undertaking to disseminate any updates or revisions to any forward-looking statements contained in this report to reflect any change in our expectations with regard to the statements or any change in events, conditions or circumstances on which any such statements are based.

**Item 1B. Unresolved Staff Comments**

None.

**Item 2. Properties**

**Our Current Real Estate Investment Portfolio**

As of December 31, 2006, our real estate investment portfolio represented 1,034 properties geographically diversified across 43 states. Of our portfolio of real estate investments, \$2.8 billion (including related lease intangibles of \$27.7 million), or 97%, represented 931 real estate properties we own, and \$75.2 million, or 3%, represented mortgage, equipment and other loans receivable we hold. For the properties we own, we generally own fee simple title to the real estate. The properties are generally leased to a single tenant under a long-term, triple-net lease where the tenant is responsible for paying all property operating expenses, including insurance, real estate taxes and repairs and maintenance. Our mortgage loans receivable are generally secured by a first priority lien on the underlying real estate properties. We believe that, through our customers' obligations to carry insurance, all of our properties are adequately covered by insurance. A substantial portion of our owned properties and mortgage loans were pledged as collateral under our secured debt obligations as of December 31, 2006.

**Investment Diversification**

*Customer diversification.* Our properties are leased or financed to 145 customers operating in various industries. Our customers are generally established companies. As of December 31, 2006, our ten largest customers as a percentage of the total investment portfolio were: ShopKo Stores Operating Co., LLC; Pamida Stores Operating Co., LLC; Carmike Cinemas, Inc. (NASDAQ: CKEC); National Envelope Corporation; Casual Male Retail Group, Inc. (NASDAQ: CMRG); Dickinson Theatres, Inc.; CarMax, Inc. (NYSE: KMX); United Supermarkets, Ltd.; Main Event Entertainment, LP, the operator of Main Event family entertainment centers; and CBH2O, LP, the operator of Camelback Ski Area and Camelbeach Waterpark in Pennsylvania. Together, these customers accounted for 46% of our total investment portfolio at December 31, 2006. ShopKo Stores Operating Co., LLC and Pamida Stores Operating Co., LLC are the two largest individual tenants representing a total of approximately 29% of our total investment portfolio at December 31, 2006. No other individual tenant represents more than 3% of our total investment portfolio.



*Property Diversification.* Our properties are free-standing, commercial real estate properties consisting of land and buildings used by our customers in the operations of their businesses. Our customers operate retail, distribution and service businesses in various industries. The following table shows information regarding the diversification of our investment portfolio among the different industries in which our customers operate:

**Total Investments as of December 31, 2006**

| Property Diversification                         | Number of Properties | Total Dollar Amount of Investments(a) |                  | Percent of Total Dollar Amount of Investments |          |
|--|----------------------|---------------------------------------|------------------|---|----------|
|  |                      | (Dollars in thousands)                |                  |   |          |
| General and discount retailer properties         | 178                  | \$                                    | 827,040          | 29  | %        |
| Restaurants                                      | 569                  |                                       | 630,709          | 22  |          |
| Specialty retailer properties                    | 36                   |                                       | 271,205          | 10  |          |
| Movie theaters                                   | 24                   |                                       | 218,799          | 8   |          |
| Industrial properties                            | 26                   |                                       | 181,776          | 6   |          |
| Automotive dealers, parts and service facilities | 76                   |                                       | 163,839          | 6   |          |
| Educational facilities                           | 20                   |                                       | 157,055          | 6   |          |
| Recreational facilities                          | 7                    |                                       | 100,316          | 4   |          |
| Distribution facilities                          | 46                   |                                       | 67,206           | 2   |          |
| Supermarkets                                     | 19                   |                                       | 62,785           | 2   |          |
| Interstate travel plazas                         | 4                    |                                       | 37,535           | 1   |          |
| Call centers                                     | 2                    |                                       | 33,988           | 1   |          |
| Health clubs/gyms                                | 5                    |                                       | 23,022           | *   |          |
| Medical office                                   | 1                    |                                       | 21,020           | *   |          |
| Convenience stores/car washes                    | 12                   |                                       | 19,273           | *   |          |
| Drugstores                                       | 9                    |                                       | 18,310           | *   |          |
| <b>Total Investments</b>                         | <b>1,034</b>         | <b>\$</b>                             | <b>2,833,878</b> | <b>100</b>                                    | <b>%</b> |

\* Less than 1%.

(a) The dollar amount of investments includes the gross cost of land, buildings and lease intangibles related to properties owned and the carrying amount of loans receivable.

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*Geographic Diversification.* The following table shows the geographic distribution of our investment portfolio across the United States. We do not own or finance any real estate properties outside of the United States.

**Investments by State as of December 31, 2006**

| <b>Location</b>          | <b>Number of Properties</b> | <b>Total Dollar Amount of Investments(a)<br/>(Dollars in thousands)</b> | <b>Percent of Total Dollar Amount of Investments</b> |
|--------------------------|-----------------------------|---|--|
| Wisconsin                | 59                          | \$ 341,851  | 12 %   |
| Texas                    | 108                         | 303,524   | 11   |
| Illinois                 | 74                          | 151,768   | 5  |
| Minnesota                | 52                          | 141,086   | 5  |
| Arizona                  | 16                          | 126,960   | 4  |
| Michigan                 | 40                          | 125,544   | 4  |
| California               | 13                          | 108,184   | 4  |
| Florida                  | 59                          | 106,934   | 4  |
| Georgia                  | 60                          | 102,186   | 4  |
| Pennsylvania             | 21                          | 98,483  | 3  |
| Massachusetts            | 6                           | 95,185  | 3  |
| Nebraska                 | 11                          | 77,960  | 3  |
| Indiana                  | 31                          | 70,445  | 2  |
| Ohio                     | 40                          | 63,419  | 2  |
| Utah                     | 14                          | 61,942  | 2  |
| North Carolina           | 24                          | 61,355  | 2  |
| Idaho                    | 10                          | 55,630  | 2  |
| Alabama                  | 36                          | 52,852  | 2  |
| Tennessee                | 58                          | 50,659  | 2  |
| Iowa                     | 32                          | 47,177  | 2  |
| Washington               | 9                           | 44,791  | 2  |
| South Carolina           | 13                          | 41,800  | 1  |
| Missouri                 | 26                          | 41,242  | 1  |
| Montana                  | 9                           | 41,195  | 1  |
| South Dakota             | 9                           | 40,224  | 1  |
| Oklahoma                 | 25                          | 38,805  | 1  |
| Virginia                 | 20                          | 35,770  | 1  |
| Kentucky                 | 22                          | 34,223  | 1  |
| Kansas                   | 6                           | 34,094  | 1  |
| New York                 | 16                          | 32,637  | 1  |
| Oregon                   | 8                           | 29,999  | 1  |
| Colorado                 | 10                          | 28,939  | 1  |
| Wyoming                  | 18                          | 25,029  | *  |
| Nevada                   | 12                          | 19,273  | *  |
| Mississippi              | 15                          | 14,577  | *  |
| Louisiana                | 16                          | 14,067  | *  |
| Maryland                 | 14                          | 13,566  | *  |
| North Dakota             | 3                           | 12,471  | *  |
| New Jersey               | 2                           | 12,280  | *  |
| Arkansas                 | 6                           | 11,080  | *  |
| West Virginia            | 5                           | 9,002   | *  |
| New Mexico               | 4                           | 8,581   | *  |
| Vermont                  | 2                           | 7,089   | *  |
| <b>Total Investments</b> | <b>1,034</b>                | <b>\$ 2,833,878</b>   | <b>100 %</b>   |

\* Less than 1%.

(a) The dollar amount of investments includes the gross cost of land, buildings and lease intangibles related to properties owned and the carrying amount of loans receivable.

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**Lease Expirations**

Substantially all of our owned properties are occupied and subject to leases. The weighted average remaining noncancelable lease term of our properties at December 31, 2006 was approximately 16 years. The following table shows a summary of the lease expirations. Our leases generally provide for one or more renewal options ranging from five to 20 years. The table assumes that the tenants do not exercise any renewal options.

**Lease Expirations as of December 31, 2006**

|              | <b>Number of<br/>Properties<br/>(Dollars in thousands)</b> | <b>Total Dollar<br/>Amount of<br/>Real Estate<br/>Investments(a)</b> | <b>Percent of<br/>Total Dollar<br/>Amount of<br/>Real Estate<br/>Investments</b> |
|--------------|--|--|--|
| 2007         | 1  | \$ 621   | * %  |
| 2008         | 3  | 2,035  | *  |
| 2009         | 2  | 1,240  | *  |
| 2010         | 14   | 28,138   | 1  |
| 2011         | 20   | 14,151   | *  |
| 2012         | 10   | 19,391   | *  |
| 2013         | 14   | 16,218   | *  |
| 2014         | 74   | 138,151  | 5  |
| 2015         | 18   | 27,672   | 1  |
| 2016         | 21   | 32,515   | 1  |
| 2017         | 59   | 99,393   | 4  |
| 2018         | 40   | 142,234  | 5  |
| 2019         | 78   | 223,347  | 8  |
| 2020         | 68   | 257,713  | 9  |
| 2021         | 174  | 321,570  | 12   |
| 2022-2028    | 335  | 1,434,316  | 52   |
| <b>Total</b> | <b>931</b>   | <b>\$ 2,758,705</b>  | <b>100 %</b>   |

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\* Less than 1%.

(a) The dollar amount of real estate investments includes the gross cost of land, buildings and lease intangibles related to properties owned.

**Loan Maturities**

The following table shows a summary of the scheduled principal maturities of our mortgage and other loans receivable as of December 31, 2006. The loans may be prepaid with penalties.

**Loan Maturities as of December 31, 2006**

|                                      | Principal Amount<br>Maturing<br>(Dollars in thousands) | Percent of Total<br>Principal Amount<br>Maturing |
|--------------------------------------|--|--|
| 2007                                 | \$ 3,192   | 4 %  |
| 2008                                 | 2,665  | 4  |
| 2009                                 | 1,670  | 2  |
| 2010                                 | 1,850  | 3  |
| 2011                                 | 2,191  | 3  |
| 2012-2016                            | 21,276   | 29   |
| 2017-2021                            | 29,588   | 40   |
| 2022-2026                            | 6,365  | 8  |
| 2027-2030                            | 5,339  | 7  |
|                                      | 74,136   | 100 %  |
| Premium on mortgage loans receivable | 1,037  |  |
|                                      | \$ 75,173  |  |

**Item 3. Legal Proceedings**

We are not a party to any material litigation or legal proceedings, or to the best of our knowledge, any threatened litigation or legal proceedings which, in the opinion of management, individually or in the aggregate, are expected to have a material adverse effect on our results of operations or financial condition.

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

No matters were submitted to a vote of the Company's stockholders during the fourth quarter of the year ended December 31, 2006.

**PART II****Item 5. Market For Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities****Market Information**

Our common stock is traded on the NYSE under the symbol SFC. The following table sets forth, for the periods indicated, the high and low sale prices in dollars on the NYSE for our common stock. The closing stock price on December 31, 2006 was \$12.47.

| 2006           | High |       | Low |       |
|----------------|------|-------|-----|-------|
| Fourth Quarter | \$   | 12.67 | \$  | 11.22 |
| Third Quarter  | \$   | 11.73 | \$  | 10.23 |
| Second Quarter | \$   | 12.15 | \$  | 10.61 |
| First Quarter  | \$   | 12.60 | \$  | 11.11 |

**2005**

|                |    |       |    |       |
|----------------|----|-------|----|-------|
| Fourth Quarter | \$ | 11.70 | \$ | 10.20 |
| Third Quarter  | \$ | 12.05 | \$ | 10.07 |
| Second Quarter | \$ | 11.75 | \$ | 10.03 |

First Quarter

\$ 12.76 \$ 10.60

**Stockholder Information**

As of February 23, 2007, there were 44 record holders of our common stock. This figure does not reflect the beneficial ownership of shares held in nominee name.

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**PERFORMANCE GRAPH**

On December 16, 2004, Spirit Finance began trading on the NYSE under the symbol "SFC. Prior to December 16, 2004, there was no public market for our securities. The initial offering price for the Company's common stock was \$11.00 per common share. The graph below compares the cumulative total shareholder return (assuming reinvestment of dividends) of the Company's common shares with that of the S&P 500 Index, the Morgan Stanley REIT Index and a peer group of companies (the Peer Group ) from December 16, 2004 through December 31, 2006. The chart assumes the investment of \$100 at the Company's closing stock price of \$12.40 per share on December 16, 2004 and the investment of \$100 in the S&P 500 Index, the Morgan Stanley REIT Index and the Peer Group at the respective closing index prices on November 30, 2004, the closest month end prior to our initial public offering, and as required by the SEC, all values shown assume the reinvestment of all distributions, if any, and, in the case of the Peer Group, are weighted to reflect the market capitalization of the component companies. The Peer Group consists of eight real estate investment trusts that invest in net lease real estate and includes American Financial Realty Trust, Capital Lease Funding, Inc., Entertainment Properties Trust, Getty Realty Corp., Gladstone Commercial Corporation, Lexington Realty Trust, National Retail Properties, Inc. and Realty Income Corp. The performance reflected in this graph is not necessarily indicative of future performance of our common shares.

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|                       | Company/Index              |           |                     |            |
|-----------------------|----------------------------|-----------|---------------------|------------|
|                       | Spirit Finance Corporation | S & P 500 | Morgan Stanley REIT | Peer Group |
| Dec. 16/Nov. 30, 2004 | 100.00                     | 100.00    | 100.00              | 100.00     |
| December 31, 2004     | 102.02                     | 103.40    | 104.89              | 102.33     |
| January 31, 2005      | 95.97                      | 100.88    | 95.87               | 96.06      |
| February 28, 2005     | 89.35                      | 103.01    | 98.67               | 95.88      |
| March 31, 2005        | 87.58                      | 101.18    | 97.09               | 95.09      |
| April 30, 2005        | 85.00                      | 99.26     | 102.86              | 99.34      |
| May 31, 2005          | 90.34                      | 102.42    | 106.22              | 101.31     |
| June 30, 2005         | 96.49                      | 102.57    | 111.55              | 104.63     |
| July 31, 2005         | 98.16                      | 106.38    | 119.54              | 104.43     |
| August 31, 2005       | 88.98                      | 105.41    | 114.95              | 101.41     |
| September 30, 2005    | 93.90                      | 106.26    | 115.61              | 102.50     |
| October 31, 2005      | 95.33                      | 104.49    | 112.85              | 94.83      |
| November 30, 2005     | 97.71                      | 108.44    | 117.74              | 96.65      |
| December 31, 2005     | 96.44                      | 108.48    | 117.62              | 95.25      |
| January 31, 2006      | 104.18                     | 111.36    | 126.65              | 102.29     |
| February 28, 2006     | 104.26                     | 111.66    | 129.03              | 99.91      |
| March 31, 2006        | 105.56                     | 113.05    | 135.44              | 102.14     |
| April 30, 2006        | 102.22                     | 114.57    | 130.41              | 99.06      |
| May 31, 2006          | 102.66                     | 111.27    | 126.65              | 93.66      |
| June 30, 2006         | 99.22                      | 111.42    | 133.47              | 97.00      |
| July 31, 2006         | 99.63                      | 112.11    | 138.25              | 101.03     |
| August 31, 2006       | 101.87                     | 114.77    | 143.51              | 107.71     |
| September 30, 2006    | 104.21                     | 117.73    | 146.31              | 107.55     |
| October 31, 2006      | 108.89                     | 121.57    | 155.47              | 114.56     |
| November 30, 2006     | 111.63                     | 123.88    | 162.83              | 119.13     |
| December 31, 2006     | 114.01                     | 125.62    | 159.87              | 118.84     |

*The foregoing graph and chart shall not be deemed incorporated by reference by any general statement incorporating by reference this Annual Report on Form 10-K into any filing under the Securities Act or under the Exchange Act, except to the extent we specifically incorporate this information by reference, and shall not otherwise be deemed filed under those acts.*



**Distribution Information**

Distributions declared during 2006 and 2005 are summarized as follows:

| Declaration Date   | Payment Date     | Dividends Declared<br>Per Common Share |                         | Total   |
|--------------------|------------------|--|-------------------------|---------|
|                    |                  | Taxable<br>Dividend(a)                 | Return of<br>Capital(b) |         |
| <b>2006</b>        |                  |  |                         |         |
| December 19, 2006  | January 25, 2007 | (c)                                    | (c)                     | \$ 0.22 |
| September 25, 2006 | October 25, 2006 | \$ 0.21                                | \$                      | 0.21    |
| June 26, 2006      | July 25, 2006    | 0.21                                   |                         | 0.21    |
| March 27, 2006     | April 25, 2006   | 0.21                                   |                         | 0.21    |
|                    |                  |  |                         | \$ 0.85 |
| <b>2005</b>        |                  |  |                         |         |
| December 27, 2005  | January 25, 2006 | \$ 0.21                                | \$                      | \$ 0.21 |
| September 26, 2005 | October 25, 2005 | 0.11                                   | 0.08                    | 0.19    |
| June 27, 2005      | July 25, 2005    | 0.11                                   | 0.08                    | 0.19    |
| March 25, 2005     | April 25, 2005   | 0.11                                   | 0.08                    | 0.19    |
|                    |                  |  |                         | \$ 0.78 |

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- (a) Dividends are taxable in the year paid by the Company.
- (b) To the extent that the Company makes distributions in excess of current and accumulated earnings and profits, these distributions are treated as a tax free return of capital.
- (c) Treatment as taxable dividend or return of capital will be determined in connection with 2007 activity.

We intend to continue to make regular quarterly distributions to our stockholders so that we distribute each year all or substantially all of our REIT taxable income so as to minimize our exposure to corporate level income tax and excise tax on our earnings and to qualify for the tax benefits accorded to REITs under the Internal Revenue Code. Dividends are expected to be paid from cash flow from operations, although we may also borrow funds to make distributions. The distributions, if any, will be authorized and paid as determined at the discretion of our board of directors and will be subject to our financial condition and our actual results of operations, which are dependent on our receipt of payments from our leases and loans with respect to our properties. If our operations are not successful, we may not be able to make distributions in the future.

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**Item 6. Selected Financial Data**

The following table presents selected consolidated financial and operating data for Spirit Finance Corporation for the years ended December 31, 2006, 2005, 2004 and for the period from inception (August 14, 2003) to December 31, 2003 and should be read in conjunction with the consolidated financial statements, the notes to the consolidated financial statements and Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations.

|   | Years Ended December 31,                      |              |            | Date of Inception                               |
|---|---|--------------|------------|---|
|   | 2006(a)                                       | 2005(a)      | 2004(a)    | (August 14, 2003)<br>to December 31,<br>2003(b) |
|   | (Dollars in thousands, except per share data) |              |            |   |
| <b>Operations Data:</b>                               |   |              |            |   |
| Total revenues  | \$ 188,556                                    | \$ 82,629    | \$ 24,813  | \$ 286  |
| Expenses:   |   |              |            |   |
| General and administrative                            | 17,115  | 12,727       | 7,122      | 1,405   |
| Depreciation and amortization                         | 43,624  | 19,619       | 4,393      | 4   |
| Interest  | 84,883  | 25,767       | 4,916      | 35  |
| Total expenses  | 145,622                                       | 58,113       | 16,431     | 1,444   |
| Income (loss) from continuing operations              | 42,934  | 24,516       | 8,382      | (1,158 )  |
| Discontinued operations:                              |   |              |            |   |
| Income from discontinued operations                   | 2,916   | 2,531        | 602        |   |
| Net gains (losses) on sales of real estate            | 6,510   | 772          | (12 )      |   |
| Total discontinued operations                         | 9,426   | 3,303        | 590        |   |
| Net income (loss)                                     | \$ 52,360                                     | \$ 27,819    | \$ 8,972   | \$ (1,158 )                                     |
| Income (loss) per common share:                       |   |              |            |   |
| Basic:  |   |              |            |   |
| Continuing operations                                 | \$ 0.48                                       | \$ 0.36      | \$ 0.22    | \$ (0.22 )                                      |
| Discontinued operations                               | 0.11  | 0.05         | 0.02       |   |
| Net income  | \$ 0.59                                       | \$ 0.41      | \$ 0.24    | \$ (0.22 )                                      |
| Diluted:  |   |              |            |   |
| Continuing operations                                 | \$ 0.48                                       | \$ 0.36      | \$ 0.22    | \$ (0.22 )                                      |
| Discontinued operations                               | 0.10  | 0.05         | 0.02       |   |
| Net income  | \$ 0.58                                       | \$ 0.41      | \$ 0.24    | \$ (0.22 )                                      |
| Weighted average outstanding common shares:           |   |              |            |   |
| Basic   | 89,336,654                                    | 67,240,350   | 37,522,747 | 5,160,524                                       |
| Diluted   | 89,634,236                                    | 67,462,750   | 37,688,074 | 5,160,524                                       |
| Cash dividends declared per common share(c)           | \$ 0.85                                       | \$ 0.78      | \$ 0.44    | \$  |
| <b>Balance Sheet Data:</b>                            |   |              |            |   |
| Gross investments including related lease intangibles | \$ 2,833,878                                  | \$ 1,487,460 | \$ 667,927 | \$ 78,297                                       |
| Total assets  | 2,856,590                                     | 1,513,425    | 782,227    | 277,875   |
| Total debt obligations                                | 1,799,374                                     | 894,784      | 178,854    |   |
| Stockholders' equity                                  | 994,025                                       | 592,793      | 587,703    | 276,902   |
| <b>Other Data:</b>                                    |   |              |            |   |
| Number of real estate investments owned or financed   | 1,034   | 684          | 374        | 71  |
| Cash flows from operating activities                  | \$ 99,018                                     | \$ 54,292    | \$ 17,442  | \$ (169 )                                       |
| Funds from operations(d)                              | 90,254  | 47,394       | 13,574     | (1,158 )  |
| Total debt to total assets ratio                      | 63  | % 59         | % 23       | %   |

(a) Periodically, Spirit Finance may sell real estate properties. Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, requires that gains and losses from any such dispositions of properties and all operations from these properties be reclassified as discontinued operations in the consolidated statements of operations. As a result of this reporting requirement, each time a property is sold, the operations of such property previously reported as part of income from continuing operations are reclassified into discontinued operations. This presentation has no impact on net income or cash flows.

(b) Operations for this period related primarily to organization and start-up activities prior to the closing of our December 2003 private offering.

(c) All dividend record dates in 2004 were prior to our initial public offering.

(d) Funds from operations ( FFO ) is a non-GAAP financial measure. For a definition of FFO and a reconciliation from net income prepared in accordance with U.S. generally accepted accounting principles, see Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, under the section entitled Reconciliation of Non-GAAP Financial Measures.



**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis is more clearly understood when read in conjunction with the accompanying consolidated financial statements and related notes thereto included in Item 8. Undue reliance should not be placed upon historical financial statements since they are not indicative of expected results of operations or financial conditions for any future periods.

**Overview**

Spirit Finance Corporation is a self-managed and self-advised real estate investment trust ( REIT ) formed as a Maryland corporation in 2003. Our objective is to acquire single tenant, operationally essential real estate throughout the United States to be leased on a long-term, triple-net basis to retail, distribution and service-oriented companies. Single tenant, operationally essential real estate consists of properties that are free-standing, commercial real estate facilities that are vital to the generation of our customers' sales and profits. A triple-net lease generally requires the tenant to pay all operating and maintenance costs, insurance premiums and real estate taxes on the property. We may also selectively originate or acquire long-term, commercial mortgage loans that are integral to our strategy of providing a complete product solution to our customers. Since we began purchasing real estate assets in December 2003, we have completed nearly \$3.0 billion in real estate acquisitions and mortgage loan investments. Our common stock is listed on the New York Stock Exchange under the ticker symbol SFC.

As of December 31, 2006, our investment portfolio of real estate properties and loans totaled over \$2.8 billion and represented 1,034 owned or financed properties geographically diversified across 43 states. Only two states, Wisconsin (12%) and Texas (11%), accounted for 10% or more of the total dollar value of our real estate and loan portfolio. Of our total investment portfolio as of December 31, 2006, \$2.8 billion, or 97%, represented the gross cost of real estate and related lease intangibles that we own and \$75.2 million, or 3%, represented mortgage and other loans receivable. Our properties are leased or financed to 145 customers operating in various industries. The three largest industries in which our customers operated at December 31, 2006, as a percentage of our total investment portfolio, were the general and discount retail industry (29%), the restaurant industry (22%) and the specialty retail industry (10%). As of December 31, 2006, our 10 largest customers as a percentage of the total investment portfolio were: ShopKo Stores Operating Co., LLC; Pamida Stores Operating Co., LLC; Carmike Cinemas, Inc. (NASDAQ: CKEC); National Envelope Corporation; Casual Male Retail Group, Inc. (NASDAQ: CMRG); Dickinson Theatres, Inc.; CarMax, Inc. (NYSE: KMX); United Supermarkets, Ltd.; Main Event Entertainment, LP, the operator of Main Event family entertainment centers; and CBH2O, LP, the operator of Camelback Ski Area and Camelbeach Waterpark in Pennsylvania. Together, these customers accounted for 46% of our total investment portfolio at December 31, 2006. ShopKo Stores Operating Co., LLC is the largest individual tenant at 26% of the portfolio. No other individual tenant represents more than 4% of the total investment portfolio.

We generate our revenue and cash flow primarily by leasing our real estate properties to our customers and from interest income on our portfolio of loans receivable. Our ability to generate positive cash flow will depend heavily on the difference between the income earned on our assets and the interest expense incurred on our borrowings. The cash we generate from our long-term leases is expected to increase over the term of the leases because they generally contain rent escalation provisions; however, the amount of any future rent increases is variable and unpredictable since the majority of our escalation provisions are indexed to future changes in the Consumer Price Index ( CPI ). We finance our real estate properties with long-term, fixed-rate debt which provide for a fixed monthly debt payment. As of December 31, 2006, 83% of our investment portfolio was match-funded with long-term, fixed-rate debt. As a result, we expect to realize a growing stream of net cash flows over the term of the leases.

We expect to grow through continuing our business strategy of acquiring single tenant, operationally essential real estate principally through sale-leaseback transactions. Our ability to realize our plan of continued growth is dependent on achieving a substantial volume of acquisitions at attractive yields without compromising our underwriting criteria and our ability to effectively finance those acquisitions to meet our targeted yields. The current environment for net lease real estate acquisitions continues to be highly competitive, with substantial amounts of capital competing for the same real estate investments, which has led to an increase in the valuation of real estate investments. This competitive environment could limit both the dollar volume of properties we acquire and the yield on those acquisitions. We continue to maintain our strict underwriting and review of the underlying property fundamentals and we may delay or decline opportunities if we feel the financial returns do not warrant the capital risk. In addition, the timing of completing property acquisitions, which is dependent on the completion of due diligence and other factors that may not be under our control, may vary significantly from quarter to quarter. In response to these challenges, we are committed to seeking numerous potential investment opportunities through our full-time acquisitions staff and through our other sourcing relationships. We continue to seek opportunities to combine our cost of capital and operational structure with efficient leverage strategies to deliver competitively priced lease products to our customers.

### **Liquidity and Capital Resources**

Our real estate investments have been generally acquired using a combination of cash and borrowings under our secured credit facilities or mortgage notes payable. As of December 31, 2006, we had a maximum aggregate borrowing capacity of \$400 million under our secured credit facility. We intend to fund future real estate investments initially with borrowings on our secured credit facility and then implement our long-term financing strategies by raising funds through the issuance of debt and additional equity securities.

During 2006, we acquired or financed 398 single tenant commercial real estate properties through various transactions totaling over \$1.4 billion using a combination of proceeds from new borrowings and additional issuances of equity securities. Our acquisitions for 2006 included 178 real estate properties acquired from SKO Group Holding Corp. ( SKO ) through the purchase of ShopKo Stores, Inc. for \$815.3 million, excluding transaction expenses. This acquisition was partially funded with \$611.5 million in long-term mortgage notes and the remainder of the purchase price was funded with existing cash and borrowings available under our secured credit facilities. During 2006, we also used net cash proceeds totaling \$73.3 million from the sales of 46 real estate properties to acquire new properties. At December 31, 2006, we had commitments totaling \$55.8 million related to future property purchases and future improvements on properties we currently own. In addition, since the end of 2005, we have consistently maintained a pipeline of potential investments under review of greater than \$2 billion. We consider investments as under review when we have signed a confidentiality agreement, we have exchanged financial information, or we or our advisors are in current and active negotiations. Investments under review are generally subject to significant change, and the timing of completing any such transactions may vary significantly from quarter to quarter. After further due diligence, we may decide not to pursue any or all of these transactions, we may not be the successful bidder on all of the transactions we pursue, and there is no assurance that we will ultimately complete any of the real estate acquisitions. We continue to maintain disciplined underwriting criteria for new investments while also closely monitoring the ongoing credit quality of our existing investment portfolio.

We generate our revenue and cash flow primarily by leasing our real estate properties to our customers. We generally offer long-term leases that provide for payments of base rent with scheduled increases, contingent increases based on future changes in the CPI and/or contingent rent based on a percentage of the lessee's gross sales. At December 31, 2006, our weighted average noncancelable remaining initial lease term was approximately 16 years, and our leases generally provide for one or more

renewal options. Less than 2% of the leases in our real estate investment portfolio at December 31, 2006 will expire prior to 2012. Our leases are generally triple-net, which provides that the lessee is responsible for the payment of all property operating expenses, such as insurance, real estate taxes and repairs and maintenance. Since our tenants generally pay the property operating and maintenance costs, we do not believe we will incur significant capital or operating expenditures on our properties.

Although we do not expect to make significant investments in mortgages and other loans, we may selectively originate or acquire such loans as opportunities arise in the market. Our real estate mortgage and other loans receivable, totaling \$75.2 million at December 31, 2006, generally require that our customers make monthly payments of principal and interest with balloon payments totaling \$13.5 million due in 2021. The mortgage loans receivable are secured by single tenant, operationally essential real estate. Our other loans receivable are primarily secured by equipment used in the operation of certain real estate properties we own. We may also offer other financing products where we can improve our investment returns or competitiveness.

Our operating expenses include interest expense on our debt and the general and administrative costs of acquiring and managing our real estate investment portfolio, such as the compensation and benefit costs of our employees, professional fees such as legal and portfolio servicing costs and office expenses such as rent and other office operating expenses. Noncash items include straight-line rental revenue, depreciation expense on the buildings and improvements in our real estate portfolio, stock-based compensation (included in general and administrative expenses), deferred financing costs and the amortization of the net losses on our settled interest rate swaps (included in interest expense). After payment of expenses, our cash flow from operating activities totaled \$99.0 million for 2006 as compared to \$54.3 million in 2005 and \$17.4 million for 2004. Cash flows from operating activities have increased primarily due to the increases in net income and the non-cash adjustment for depreciation and amortization expense, which are reflective of the growth in our investment portfolio.

We intend to make regular quarterly distributions to our stockholders so that we distribute each year all or substantially all of our REIT taxable income to minimize our exposure to corporate level federal income tax and excise tax on our earnings. The distributions we pay may include a return of capital. During 2006, we declared dividends of \$0.85 per share or \$82.5 million as compared to \$0.78 per share or \$52.8 million during 2005 and \$0.44 per share or \$16.5 million during 2004. Dividends paid during 2006 (including those dividends declared in 2005 and paid in 2006) totaled \$73.1 million. Cash for future distributions is expected to be generated from operations, although we may also borrow funds to make distributions. Our ability to pay distributions will depend on, among other things, our actual results of operations, which depend primarily on our receipt of payments from our leases and loans with respect to our real estate investments.

In order to continue to achieve significant growth in revenues and net income, we will need to make substantial real estate acquisitions, which will in turn require that we obtain significant additional debt and equity funding beyond our currently committed external sources of liquidity. During 2006, we completed three public offerings under our existing shelf registration statement on file with the Securities and Exchange Commission ( SEC ) aggregating approximately 39.5 million shares of common stock which raised aggregate proceeds of approximately \$427.7 million, after deducting the underwriters' discounts and offering expenses. We used a portion of the proceeds to pay down outstanding balances under our secured credit facilities. The remaining proceeds were used to provide funds for real estate acquisitions.

We generally use our revolving secured credit facilities to partially fund the initial purchase of real estate pending the issuance of long-term, fixed-rate debt. As described further in the Notes to Consolidated Financial Statements and Quantitative and Qualitative Disclosures About Market Risk, we use interest rate swaps to manage our exposure to changes in interest rates until we can put into place our long-term debt arrangements. As of December 31, 2006, Spirit Finance had three outstanding

forward-starting interest rate swap agreements with an aggregate notional amount of \$190.0 million. These derivative instruments were designated to hedge the variability of cash flows related to forecasted interest payments over a term of 15 years on long-term debt with an initial principal balance totaling at least \$199.5 million expected to be issued in early 2007.

In November 2006, we allowed our \$200 million revolving secured credit facility to expire in accordance with its terms. When our other \$300 million revolving secured credit facility expired in October 2006, it was replaced with a new \$400 million revolving secured credit facility with the same bank. As of December 31, 2006, \$128.5 million was outstanding under this facility. The facility is structured as a master loan repurchase agreement and our borrowings under the facility are secured by the underlying real estate properties we pledge (we can borrow up to 60% of the value of the properties) and may also be secured by our equity ownership interests in certain of our consolidated special purpose subsidiaries. Borrowings under the facility require monthly payments of interest indexed to the one-month London Interbank Offered Rate (LIBOR) plus an additional amount ranging from 1.25% to 3.25%, depending on the amount of outstanding borrowings. At December 31, 2006, the one-month LIBOR was 5.32%.

In March 2006, we issued, through a private placement, \$301.8 million aggregate principal amount of 5.76% amortizing net-lease mortgage notes with a balloon payment due at maturity in 2021. We used a portion of the proceeds to repay balances outstanding under our secured credit facilities. The remaining proceeds were used to provide funds for real estate acquisitions. This was the second issuance under our master funding debt structure which was created in 2005; the first series of notes totaling \$441.3 million was issued in July 2005. At December 31, 2006, the aggregate balance of the net-lease mortgage notes totaled \$727.8 million and was secured by a collateral pool in excess of \$1 billion in real estate assets. The notes may be prepaid at any time, subject to a yield maintenance prepayment premium. The notes also permit the substitution of real estate collateral from time to time subject to certain conditions and limits. In addition, the note structure allows for the contribution of additional properties to the collateral pool and the issuance of additional series of notes secured by the increased collateral pool.

In conjunction with the March 2006 issuance of the net-lease mortgage notes, we settled three forward-starting interest rate swap agreements for an aggregate cash receipt from the swap counterparties of \$5.8 million because long-term rates had risen since the inception of the hedges. Accordingly, this amount is being amortized to earnings, using the effective interest method, as a decrease in interest expense over a period of 15 years.

During 2006, we entered into new long-term financing arrangements totaling over \$700 million in conjunction with four real estate acquisition transactions. At December 31, 2006, the total carrying amount of our fixed-rate debt, including the net-lease mortgage notes described above, was \$1.7 billion. Real estate investments with an aggregate investment value of \$2.4 billion were pledged as collateral for our fixed-rate debt.

Over the long term, we expect lease rates on new leases to fluctuate commensurate with changes in long-term interest rates. However, we may experience periods where long-term interest rates on future borrowings rise faster than lease rates on our existing portfolio of real estate investments, which may reduce our cash flow. Therefore, in order to limit the effects of changes in interest rates on our operations, we seek to match-fund our long-term, fixed-rate assets with long-term, fixed-rate liabilities. At December 31, 2006, 83% of our investment portfolio was match-funded with long-term debt as compared to 66% and 36% at December 31, 2005 and 2004, respectively.

We are subject to various customary operating and financial covenants under our mortgage notes payable and our secured credit facility. The mortgage notes payable and our secured credit facility include a limitation on our ability to incur additional indebtedness on the underlying secured real estate. Our secured credit facility also includes, among other requirements, a minimum liquidity requirement of \$15 million, a maximum total debt to tangible net worth ratio of 4:1, a maximum ratio of total debt to total

assets of 75% and a minimum tangible net worth requirement of \$573.6 million. As of December 31, 2006, we were in compliance with all of our debt covenants and requirements.

In the short-term, we believe that cash provided by our operating activities and the liquidity available on our secured credit facility will be sufficient to meet our liquidity needs for the operating and financing obligations and commitments of our existing real estate investment portfolio. On a long-term basis, we intend to use a combination of debt and equity financing methods to accomplish our goal of acquiring real estate while maintaining our borrowings at a targeted leverage ratio, defined as the ratio of our total debt to total assets, of approximately 65%. However, we may exceed this target from time to time. At December 31, 2006, our leverage ratio was 63%. We intend to obtain additional unsecured and/or secured financing through various sources including banks, institutional investors and other lenders. We may also obtain lines of credit, bridge loans, warehouse facilities and other debt arrangements or may incur debt in the form of publicly or privately placed debt instruments. We intend to use substantially all of our properties to secure our borrowings under our various debt financings. Our ability to achieve continuous real estate investment growth will also depend on our ability to raise additional equity capital.

#### Off-Balance Sheet Arrangements and Contractual Obligations

The following table outlines the timing of payment requirements related to our off-balance sheet and contractual obligations as of December 31, 2006. The contractual obligations relating to mortgages and notes payable listed in the table below are included in the Consolidated Balance Sheet at December 31, 2006.

|                             | Total<br>(Dollars in thousands) | 2007      | 2008 - 2009 | 2010 - 2011 | 2012 and<br>Thereafter |
|-----------------------------|---------------------------------|-----------|-------------|-------------|------------------------|
| Mortgages and notes payable | \$ 1,668,657                    | \$ 34,110 | \$ 54,140   | \$ 105,549  | \$ 1,474,858           |
| Operating lease obligations | 30,751                          | 1,446     | 3,036       | 2,934       | 23,335                 |
| Total                       | \$ 1,699,408                    | \$ 35,556 | \$ 57,176   | \$ 108,483  | \$ 1,498,193           |

At December 31, 2006, we had commitments totaling \$55.8 million related to future property purchases and future improvements on properties we currently own. The commitment amount does not include \$14.4 million related to improvements on properties we own which had been completed but not yet paid as of December 31, 2006; these amounts are included in accounts payable, accrued expenses and other liabilities in the accompanying Consolidated Balance Sheets. The agreements related to property purchases are subject to our normal due diligence process and are expected to be completed in early 2007. These acquisitions, once completed, are expected to result in an increase in our rental revenues. The future improvements include costs to be incurred on facilities during which the tenant's business continues to operate without interruption and advances for the construction of new facilities for which operations have not commenced. In accordance with the underlying lease agreements, these improvements, the majority of which are anticipated to be completed during 2007, will result in increases in related contractual rent. These commitments are not included in the table above because they are not contracts to purchase goods or services. We are also contingently liable for \$5.7 million of debt of one of our tenants for which we have been indemnified by that tenant for any payments we may be required to make on the debt.

#### Results of Operations

We commenced operations on August 14, 2003 and have realized significant growth in revenues and net income per share due to the substantial growth in our real estate investment portfolio. Since we began purchasing real estate assets in December 2003, we have completed nearly \$3.0 billion in real estate acquisitions and mortgage loan investments, of which over \$1.4 billion was completed during 2006. The



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increase in net income, as summarized in the following table, is reflective of the growth in our rental revenues as a result of the increase in the size of our investment portfolio and increased gains on the sales of real estate as discussed below.

|  | Years Ended December 31, |         |         |
|--|--------------------------|---------|---------|
|  | 2006                     | 2005    | 2004    |
| Net income (in millions)   | \$ 52.4                  | \$ 27.8 | \$ 9.0  |
| Net income per diluted common share                              | \$ 0.58                  | \$ 0.41 | \$ 0.24 |
| Weighted average outstanding common shares diluted (in millions) | 89.6                     | 67.5    | 37.7    |

The increase in the number of weighted average shares outstanding between 2006 and 2005 is primarily the result of common stock offerings during 2006 of approximately 39.5 million common shares. The increase in the number of weighted average shares outstanding between 2005 and 2004 is primarily the result of our December 2004 initial public offering of 30 million common shares.

Periodically, we may sell real estate properties we own. We consider these occasional sales of real estate properties to be an integral part of our long-term business strategy in acquiring a diversified real estate investment portfolio; consequently, proceeds from the sales of real estate properties are expected to be reinvested in additional properties such that cash flows from ongoing operations are not negatively affected by sales of individual properties. In addition, we consider the combined effect of income from continuing operations and discontinued operations in our evaluation of our ability to pay dividends. Each time properties are sold, current accounting principles require that gains and losses from any such dispositions and all operations from the properties previously reported as part of income from continuing operations be reclassified to discontinued operations. This reclassification has no impact on net income or cash flows.

We sold 46 properties during 2006, 43 properties during 2005 and four properties during 2004. Income from continuing operations and discontinued operations and the related per share amounts associated with all properties sold are presented in the table below (dollars in thousands, except per share data):

|  | Years Ended December 31, |           |          |
|--|--------------------------|-----------|----------|
|  | 2006                     | 2005      | 2004     |
| Income from continuing operations          | \$ 42,934                | \$ 24,516 | \$ 8,382 |
| Discontinued operations:                   |                          |           |          |
| Income from discontinued operations        | 2,916                    | 2,531     | 602      |
| Net gains (losses) on sales of real estate | 6,510                    | 772       | (12 )    |
| Total discontinued operations              | 9,426                    | 3,303     | 590      |
| Net income                                 | \$ 52,360                | \$ 27,819 | \$ 8,972 |
| Income per diluted common share:           |                          |           |          |
| Continuing operations                      | \$ 0.48                  | \$ 0.36   | \$ 0.22  |
| Discontinued operations                    | 0.10                     | 0.05      | 0.02     |
| Net income                                 | \$ 0.58                  | \$ 0.41   | \$ 0.24  |

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The following discussion for the years ended December 31, 2006, 2005 and 2004 includes the results of both continuing and discontinued operations as summarized in the following table (dollars in thousands):

|                                     | Continuing Operations |           |           | Discontinued Operations |          |          | Total Operations |           |           |
|-------------------------------------|-----------------------|-----------|-----------|-------------------------|----------|----------|------------------|-----------|-----------|
|                                     | 2006                  | 2005      | 2004      | 2006                    | 2005     | 2004     | 2006             | 2005      | 2004      |
| Revenues                            | \$ 188,556            | \$ 82,629 | \$ 24,813 | \$ 3,435                | \$ 3,861 | \$ 1,415 | \$ 191,991       | \$ 86,490 | \$ 26,228 |
| General and administrative expenses | 17,115                | 12,727    | 7,122     | 69                      | 97       | 11       | 17,184           | 12,824    | 7,133     |
| Depreciation and amortization       | 43,624                | 19,619    | 4,393     | 449                     | 858      | 260      | 44,073           | 20,477    | 4,653     |
| Interest                            | 84,883                | 25,767    | 4,916     | 1                       | 375      | 542      | 84,884           | 26,142    | 5,458     |

### Revenues

Total revenues increased to \$192.0 million in 2006 from \$86.5 million in 2005 which was up from \$26.2 million in 2004. The increase in revenues during 2006 and 2005 is the result of the growth in our investment portfolio primarily due to property acquisitions made over the past few years.

Approximately 95% of the revenues we generated in 2006 were rental revenues from real estate properties we own and lease to our customers. At December 31, 2006, substantially all of our properties were occupied and current in their monthly lease and loan payments. On May 31, 2006, we acquired 178 real estate properties from SKO and leased them to two subsidiaries of SKO under long-term, triple-net master lease agreements. Rental revenues under these agreements totaled 23% of our total revenues during 2006. Of the properties purchased, 112 properties are operated as general merchandise retail locations under the ShopKo name in mid-sized to larger cities across the Midwest, Rocky Mountain and Pacific Northwest states, and represented approximately 26% of our total assets at December 31, 2006. The remaining 66 properties are operated under the Pamida name in small, rural communities in Midwest, North Central and Rocky Mountain states, and represented approximately 3% of our total assets. No other individual tenant represented more than 5% of total revenues during 2006. In comparison, during 2005, no single tenant represented more than 6% of total revenues. During 2004, approximately 14% of total revenues were derived under a single master lease agreement with one customer.

Rental revenues have increased in relation to the growth in our investment portfolio. Rental revenues, including rental revenues reclassified as discontinued operations, and the related weighted average real estate investments are presented in the following table (dollars in thousands):

|  | Years Ended December 31, |            |            |
|--|--------------------------|------------|------------|
|  | 2006                     | 2005       | 2004       |
| Rental revenues, excluding the adjustment for straight-line rent | \$ 179,979               | \$ 78,921  | \$ 20,216  |
| Straight-line rent, net  | 1,544                    | 1,155      | 295        |
| Total rental revenues  | \$ 181,523               | \$ 80,076  | \$ 20,511  |
| Weighted average real estate investments                         | \$ 2,065,834             | \$ 918,004 | \$ 225,195 |

During 2006, interest income on mortgage and other loans receivable totaled \$6.2 million as compared to \$4.3 million and \$3.8 million for 2005 and 2004, respectively. The increase in interest income in 2006 over 2005 was primarily the result of the origination of approximately \$25 million of new loans in 2006. Interest and other income is primarily generated from temporary investments pending investment in real estate or pending the payment of dividends.

**Expenses**

General and administrative expenses include employee-related expenses, professional fees, portfolio servicing costs, and office and other expenses. As our investment portfolio grows, our general and administrative expenses are expected to increase; however, general and administrative expenses calculated as a percent of average gross investments are expected to continue to decline as we continue to manage our expense base and benefit from our scalable, cost-effective operation. The ratio of general and administrative expenses to average gross investments was 0.8% in 2006, 1.2% in 2005 and 1.9% in 2004. Employee-related expenses increased over the past two years primarily as a result of our real estate investment activity as we increased our work force from 25 employees at December 31, 2004 to 37 at December 31, 2005 and 42 at December 31, 2006 to support our larger real estate investment portfolio. The large increase in the number of properties in our portfolio has also resulted in increased portfolio servicing costs and higher general insurance costs, which costs will continue to grow proportionately with the growth in our investment portfolio.

Depreciation and amortization expense relates primarily to real estate buildings and improvements and related lease intangibles. Depreciation and amortization expense was \$44.1 million in 2006 as compared to \$20.5 million in 2005 and \$4.7 million in 2004. The increases between years were the result of the addition of properties to our real estate investment portfolio. Depreciation and amortization expense are expected to increase in future periods as we continue to make investments in real estate.

The increase in interest expense during 2006 and 2005 is primarily attributable to higher weighted average outstanding debt resulting from new borrowings used to grow our investment portfolio. The following table summarizes our interest expense and related borrowings (dollars in thousands):

|   | <b>Years Ended December 31,</b> |             |             |
|---|---------------------------------|-------------|-------------|
|   | <b>2006</b>                     | <b>2005</b> | <b>2004</b> |
| Interest expense  | \$ 79,289                       | \$ 22,587   | \$ 4,665    |
| Amortization of deferred financing costs and net losses on settled interest rate swaps and debt insurer premium expense | 5,595                           | 3,555       | 793         |
| Total interest expense  | \$ 84,884                       | \$ 26,142   | \$ 5,458    |
| Weighted average debt outstanding   | \$ 1,349,317                    | \$ 414,100  | \$ 93,507   |

**Reconciliation of Non-GAAP Financial Measures**

We use certain measures of historical or future financial performance that are different from measures calculated and presented in accordance with U.S. generally accepted accounting principles ( GAAP ). One such non-GAAP financial measure is funds from operations ( FFO ). We use FFO as a measure of our performance as a REIT because we believe this measure provides investors with an understanding of our operating performance, cash flows and profitability.

We calculate FFO consistent with the definition used by the National Association of Real Estate Investment Trusts ( NAREIT ), adopted to promote an industry-wide standard measure of REIT operating performance. We use FFO as a measure of performance to adjust for certain non-cash expenses such as depreciation and amortization because accounting for real estate assets under GAAP implicitly assumes that the value of real estate assets diminishes predictably over time. We disclose FFO to facilitate comparisons between Spirit Finance and other REITs, although other REITs may not calculate FFO in accordance with the NAREIT definition and, accordingly, our FFO may not be directly comparable to FFO reported by other REITs.

FFO should not be considered an alternative to net income determined in accordance with GAAP as a measure of profitability, nor should it be considered an equivalent to cash flows provided by operating

activities determined in accordance with GAAP as a measure of liquidity. Spirit Finance's statements of operations and cash flows include disclosures of interest expense, capital expenditures and items excluded from the calculation of FFO, all of which should be considered when evaluating our performance.

A reconciliation of net income calculated in accordance with GAAP to FFO is presented in the following table (dollars in thousands):

|  | Years Ended December 31, |           |           |
|--|--------------------------|-----------|-----------|
|  | 2006                     | 2005      | 2004      |
| Net income                                       | \$ 52,360                | \$ 27,819 | \$ 8,972  |
| Portfolio depreciation and amortization expense: |                          |           |           |
| Continuing operations                            | 43,453                   | 19,489    | 4,330     |
| Discontinued operations                          | 449                      | 858       | 260       |
| Net (gains) losses on sales of real estate(a)    | (6,008 )                 | (772 )    | 12        |
| FFO(b)   | \$ 90,254                | \$ 47,394 | \$ 13,574 |

(a) Excludes the gain on sale related to development properties during 2006 totaling \$502,000, net of tax.

(b) FFO includes the adjustment between scheduled rents and rental revenue recognized on a straight-line basis totaling \$1.5 million, \$1.2 million and \$0.3 million for the years ended December 31, 2006, 2005 and 2004, respectively.

#### Significant Accounting Estimates and Critical Accounting Policies

Our accounting policies are determined in accordance with U.S. generally accepted accounting principles. The preparation of our consolidated financial statements requires us to make estimates and assumptions that are subjective in nature and consequently our actual results could differ materially from our estimates. Estimates and assumptions include, among other things, subjective judgment with regard to the fair values and useful lives of our properties for depreciation purposes and for classification of leases as either operating or capital leases, judgment regarding the collectibility of receivables and asset impairment analysis, assumptions used in estimating the fair value of our financial instruments and judgment required to estimate the fair value and hedge effectiveness of our derivative financial instruments. Listed below are the more critical accounting policies that require management judgment and estimates in the preparation of our consolidated financial statements.

*Revenue recognition* We lease real estate to our customers under long-term net leases that are classified as operating leases. Our leases generally provide for rent escalation provisions throughout the lease term. Some leases provide for scheduled, contractual rent escalations. For these leases, rental revenue is recognized on a straight-line basis so as to produce a constant periodic rent over the term of the lease. Accordingly, accrued rental revenue, calculated as the aggregate difference between the scheduled rents and rental revenue recognized on a straight-line basis, represents unbilled rent receivables that we will receive only if the tenant makes all rent payments required through the expiration of the initial term of the lease.

Our leases may also provide for contingent rent based on a percentage of the lessee's gross sales or contingent rent indexed to future increases in the CPI. For contingent rentals that are based on a percentage of the lessee's gross sales, we recognize contingent rental revenue when the change in the factor on which the contingent lease payment is based actually occurs. Leases that have contingent rent escalations indexed to future increases in the CPI may adjust over a one-year period or over multiple-year periods. Generally, these lease escalators increase rent at the lesser of (a) a multiplier of 1 to 1.25 times the increase in the CPI or (b) a fixed amount or percentage. Because of the volatility and uncertainty with respect to future changes in the CPI, our inability to determine the extent to which any specific future change in the CPI is probable at each lease adjustment date during the entire term of our leases and our

view that the multiplier does not represent a significant leverage factor, rental revenues for lease escalations are recognized only after the changes in the index have occurred.

We will suspend revenue recognition if the collectibility of amounts due on a lease are not reasonably assured or in the event a lessee's monthly lease payments become more than 60 days past due, whichever is earlier.

We recognize interest income on mortgage loans receivable using the effective-interest method applied on a loan-by-loan basis. Direct costs associated with originating loans are offset against any related fees received and the balance, along with any premium or discount, is deferred and amortized as an adjustment to interest income over the terms of the related mortgage loans receivable using the effective-interest method. A loan is placed on non-accrual status when the loan has become 60 days past due, or earlier, if in our opinion, full recovery of the contractual principal and interest becomes doubtful. While on non-accrual status, interest income is recognized only when received.

*Real estate investments* Investments in real estate are recorded at cost, including acquisition and closing costs. For real estate acquired subject to existing lease agreements, we must allocate a portion of the purchase price of our real estate investments between the tangible and intangible assets and liabilities acquired, which requires us to make subjective assessments regarding their estimated fair values. We primarily use independent appraisals to support our estimates of the fair value of our real estate. We also make subjective assessments regarding the useful lives of our investments in real estate for purposes of determining the amount of depreciation to record on an annual basis. Depreciation is generally computed using the straight-line method over an estimated useful life of 40 years for buildings and improvements and 20 years for land improvements.

*Impairment of real estate investments* We make subjective assessments in our periodic review of our real estate investments for impairment whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable. Management considers factors such as expected future operating income, estimated residual value, market trends such as the effects of leasing demand and competition and other factors in making this assessment. In general, if the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized in the amount by which the carrying amount of the asset exceeds the fair value of the asset. The carrying amount of our real estate investments is the largest component of our consolidated balance sheets. If events should occur that require us to reduce the carrying amount of our real estate by recording provisions for impairment losses, it could have a material impact on our results of operations and our financial condition.

*Loan impairment* We periodically evaluate our mortgage loans receivable, including accrued interest, for collectibility by analyzing the underlying property-level economics and trends, collateral value and quality and other relevant factors in determining the adequacy of our allowance for loan losses. A loan is determined to be impaired when, in our judgment based on current information and events, it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. Specific allowances for losses are provided for impaired loans on an individual loan basis in the amount by which the carrying amount exceeds the estimated fair value of the underlying collateral less disposition costs.

#### **Accounting Developments**

See the *New Accounting Pronouncements* section of Note 1 to the Consolidated Financial Statements.

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk**

Spirit Finance is exposed to various financial market risks, especially interest rate risk. Interest rates and credit risk influence our performance more so than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. We generally offer leases that provide for payments of base rent with scheduled increases, increases based on changes in the Consumer Price Index and/or contingent rent based on a percentage of the lessee's gross sales to help mitigate the effect of inflation. Because the properties in our portfolio are generally leased to tenants under triple-net leases where the tenant is responsible for property costs and expenses, this tends to reduce our exposure to rising property expenses due to inflation.

Interest rates are highly sensitive to many factors, including governmental monetary policies, domestic and global economic and political conditions, and other factors which are beyond our control. Our operating results will depend heavily on the difference between the income earned on our assets and the interest expense incurred on our borrowings. Decreases in interest rates may lead to additional competition for the acquisition of real estate due to a reduction in desirable alternate income-producing investments. Increased competition for the acquisition of real estate may lead to a decrease in the yields on real estate we have targeted for acquisition. In such circumstances, if we are not able to offset the decrease in yields by obtaining lower interest costs on our borrowings, our results of operations will be adversely affected. Significant increases in interest rates may also have an adverse impact on our earnings if we are unable to acquire real estate with rental rates high enough to offset the increase in interest rates on our borrowings.

In a rising interest rate environment and/or economic downturn, defaults may increase and result in credit losses which may adversely affect our liquidity and operating results; through December 31, 2006, we have not experienced any significant credit losses. In a decreasing interest rate environment, borrowers are generally more likely to prepay their loans in order to obtain financing at lower interest rates; however, our investments in mortgage loans receivable are subject to significant restrictions on prepayment in the form of yield maintenance provisions or other prepayment penalties which provide us with a certain level of yield protection in a decreasing interest rate environment.

Our interest rate risk management policy seeks to limit the effects of changes in interest rates on our operations. One objective of our interest rate risk management policy is to match fund fixed-rate assets with fixed-rate liabilities and variable-rate assets with variable-rate liabilities. As part of this strategy, we have used and may continue to use derivative contracts, such as forward-starting interest rate swaps, to manage our interest rate risk. We do not enter into derivative contracts for speculative or trading purposes. We generally intend to utilize derivative instruments to hedge interest rate risk on our liabilities and not use derivatives for other purposes, such as hedging asset-related risks, as such hedging transactions may generate income which is not qualified income for purposes of maintaining our REIT status. Our hedging strategy is monitored by the audit committee of our board of directors.

At December 31, 2006, our fixed-rate debt totaled \$1.7 billion as compared to \$664.9 million at December 31, 2005. Using a discounted cash flow analysis based on estimates of the amount and timing of future cash flows, market rates and credit spreads, the estimated fair value of the fixed-rate debt exceeded its carrying amount at December 31, 2006 by approximately \$4.6 million. Our mortgage loans receivable are also fixed-rate instruments. At December 31, 2006, our mortgage loans receivable (excluding equipment and other loans) totaled \$58.0 million as compared to \$55.6 million at December 31, 2005. Using a discounted cash flow analysis, the estimated fair value of our fixed-rate mortgage loans receivable exceeded the carrying amount by approximately \$900,000 at December 31, 2006. It is our intent to hold our fixed-rate mortgage loans receivable and our fixed-rate mortgages and notes payable to maturity; accordingly, changes in market interest rates impact the fair value of these financial instruments but have no impact on interest recognized or cash flows.

We use variable-rate debt to fund acquisitions on a short-term basis until our long-term debt strategies can be implemented. During 2006, the weighted average outstanding balance of our variable-rate debt, which was based on spreads over one-month LIBOR, was \$50.9 million. Excluding amortization of deferred financing costs, this variable rate indebtedness had a weighted average interest rate of 6.8%. During 2006, one-month LIBOR increased approximately 93 basis points. Had the weighted average interest rate been 100 basis points higher (lower) during 2006, our 2006 net income would have been reduced (increased) by approximately \$516,000. This amount was determined by considering the impact of a hypothetical interest rate change on our average variable-rate borrowings outstanding during 2006 and assumes no other changes in our capital structure.

At December 31, 2005, Spirit Finance had three outstanding forward-starting interest rate swap agreements with an aggregate notional amount of \$225 million. In March 2006, the anticipated long-term debt was issued, and the interest rate swaps were settled for an aggregate cash receipt from the swap counterparties because long-term rates had risen since the inception of the swaps. The fair value of the interest rate swaps at the time of settlement, totaling \$5.8 million, was recorded in accumulated other comprehensive income and is being amortized to earnings as a decrease in interest expense over a period of 15 years.

As of December 31, 2006, Spirit Finance was a party to three outstanding forward-starting interest rate swaps with an aggregate notional amount of \$190.0 million. These instruments were designed to hedge the variability of cash outflows related to forecasted interest payments over a term of 15 years on long-term debt with an initial principal balance totaling at least \$199.5 million expected to be issued in early 2007. The counterparty for each swap is a major financial institution that has a credit rating of at least A- from a nationally recognized rating agency. As the hedging relationships are expected to be highly effective at achieving offsetting changes in future cash outflows, these interest rate swaps are accounted for as cash flow hedges. The fair value of these interest rate swaps was a net unrealized loss of \$4.4 million at December 31, 2006. Had market interest rates been 100 basis points lower at December 31, 2006, the net unrealized loss would have been approximately \$22.1 million; had market interest rates been 100 basis points higher at December 31, 2006, the fair value of the interest rate swap would have resulted in a net unrealized gain of approximately \$11.3 million. For interest rate swaps entered into prior to August 1, 2006, hedge effectiveness is assessed and measured using the hypothetical derivative method. For interest rate swaps entered into after August 1, 2006, hedge effectiveness is assessed using a regression analysis and measured using the hypothetical derivative method.

Even with hedging strategies in place, there can be no assurance that our results of operations will remain unaffected as a result of changes in interest rates. In addition, hedging transactions using derivative instruments involve additional risks such as counterparty credit risk and basis risk. Basis risk in a hedging contract occurs when the index upon which the contract is based is more or less variable than the index upon which the hedged item is based, thereby making the hedge less effective. We address basis risk by matching, to a reasonable extent, the contract index to the index upon which the hedged item is based. To manage the risk of nonperformance by counterparties, our interest rate risk management policy requires that we deal only with major financial institutions that have credit ratings no lower than A- from a nationally recognized rating agency.

**Item 8.** Financial Statements and Supplementary Data

**Spirit Finance Corporation**  
**Consolidated Financial Statements**  
**December 31, 2006 and 2005**

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**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders  
Spirit Finance Corporation

We have audited the accompanying consolidated balance sheets of Spirit Finance Corporation as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. Our audits also included the financial statement schedule included at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Spirit Finance Corporation at December 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Spirit Finance Corporation's internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 26, 2007 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Phoenix, Arizona  
February 26, 2007

**Spirit Finance Corporation**

## Consolidated Balance Sheets

(dollars in thousands, except per share data)

|   | December 31,<br>2006 | December 31,<br>2005 |
|---|----------------------|----------------------|
| <b>Assets</b>   |                      |                      |
| Investments, at cost:   |                      |                      |
| Real estate investments:  |                      |                      |
| Land and improvements   | \$ 1,042,368         | \$ 524,196           |
| Buildings and improvements  | 1,688,630            | 881,386              |
| Total real estate investments   | 2,730,998            | 1,405,582            |
| Less: Accumulated depreciation  | (63,871 )            | (22,729 )            |
|   | 2,667,127            | 1,382,853            |
| Loans receivable  | 75,173               | 59,008               |
| Net investments   | 2,742,300            | 1,441,861            |
| Cash and cash equivalents   | 52,317               | 30,536               |
| Lease intangibles, net  | 24,313               | 21,395               |
| Deferred costs and other assets, net  | 37,660               | 19,633               |
| Total assets  | \$ 2,856,590         | \$ 1,513,425         |
| <b>Liabilities and stockholders equity</b>  |                      |                      |
| Liabilities:  |                      |                      |
| Secured credit facilities   | \$ 128,535           | \$ 229,855           |
| Mortgages and notes payable   | 1,670,839            | 664,929              |
| Accounts payable, accrued expenses and other liabilities  | 39,538               | 11,639               |
| Dividends payable   | 23,653               | 14,209               |
| Total liabilities   | 1,862,565            | 920,632              |
| Commitments and contingencies (Note 7)  |                      |                      |
| Stockholders equity:  |                      |                      |
| Preferred stock, \$0.01 par value per share, 125,000,000 shares authorized, no shares issued and outstanding                                    |                      |                      |
| Common stock, \$0.01 par value per share, 375,000,000 shares authorized, 107,515,866 (2006) and 67,663,071 (2005) shares issued and outstanding | 1,075                | 677                  |
| Capital in excess of par value  | 1,069,217            | 640,289              |
| Accumulated distributions in excess of net income   | (63,787 )            | (33,607 )            |
| Accumulated other comprehensive loss  | (12,480 )            | (14,566 )            |
| Total stockholders equity   | 994,025              | 592,793              |
| Total liabilities and stockholders equity   | \$ 2,856,590         | \$ 1,513,425         |

See accompanying notes.

**Spirit Finance Corporation**  
**Consolidated Statements of Operations**  
(dollars in thousands, except per share data)

|  | Years Ended December 31, |            |            |
|--|--------------------------|------------|------------|
|  | 2006                     | 2005       | 2004       |
| <b>Revenues:</b>                                   |                          |            |            |
| Rentals  | \$ 178,088               | \$ 76,215  | \$ 19,096  |
| Interest income on loans receivable                | 6,225                    | 4,276      | 3,775      |
| Interest and other income                          | 4,243                    | 2,138      | 1,942      |
| Total revenues                                     | 188,556                  | 82,629     | 24,813     |
| <b>Expenses:</b>                                   |                          |            |            |
| General and administrative                         | 17,115                   | 12,727     | 7,122      |
| Depreciation and amortization                      | 43,624                   | 19,619     | 4,393      |
| Interest   | 84,883                   | 25,767     | 4,916      |
| Total expenses                                     | 145,622                  | 58,113     | 16,431     |
| Income from continuing operations                  | 42,934                   | 24,516     | 8,382      |
| <b>Discontinued operations:</b>                    |                          |            |            |
| Income from discontinued operations                | 2,916                    | 2,531      | 602        |
| Net gains (losses) on sales of real estate         | 6,510                    | 772        | (12 )      |
| Total discontinued operations                      | 9,426                    | 3,303      | 590        |
| Net income   | \$ 52,360                | \$ 27,819  | \$ 8,972   |
| <b>Income per common share:</b>                    |                          |            |            |
| <b>Basic:</b>                                      |                          |            |            |
| Continuing operations                              | \$ 0.48                  | \$ 0.36    | \$ 0.22    |
| Discontinued operations                            | 0.11                     | 0.05       | 0.02       |
| Net income   | \$ 0.59                  | \$ 0.41    | \$ 0.24    |
| <b>Diluted:</b>                                    |                          |            |            |
| Continuing operations                              | \$ 0.48                  | \$ 0.36    | \$ 0.22    |
| Discontinued operations                            | 0.10                     | 0.05       | 0.02       |
| Net income   | \$ 0.58                  | \$ 0.41    | \$ 0.24    |
| <b>Weighted average outstanding common shares:</b> |                          |            |            |
| Basic  | 89,336,654               | 67,240,350 | 37,522,747 |
| Diluted  | 89,634,236               | 67,462,750 | 37,688,074 |

See accompanying notes.

**Spirit Finance Corporation**  
**Consolidated Statements of Stockholders Equity**  
(dollars in thousands, except per share data)

|  | Common<br>Shares | Common<br>Stock<br>Par Value | Capital in<br>Excess of<br>Par Value | Accumulated<br>Distributions<br>in Excess of<br>Net Income | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Stockholders<br>Equity |
|--|------------------|------------------------------|--------------------------------------|--|--|---------------------------------|
| <b>Balances at December 31, 2003</b>   | 31,327,612       | \$ 313                       | \$ 277,746                           | \$ (1,158 )  | \$ 1   | \$ 276,902                      |
| Comprehensive income:  |                  |                              |                                      |  |  |                                 |
| Net income   |                  |                              |                                      | 8,972  |  | 8,972                           |
| Unrealized loss on cash flow hedge   |                  |                              |                                      |  | (3,582 )   | (3,582 )                        |
| Reclassification of realized gain on investment available for sale to earnings |                  |                              |                                      |  | (1 )   | (1 )                            |
| Total comprehensive income   |                  |                              |                                      |  |  | 5,389                           |
| Issuances of common stock, net   | 32,086,957       | 321                          | 320,487                              |  |  | 320,808                         |
| Dividends declared on common stock (\$0.44 per share)                          |                  |                              |                                      | (16,464 )  |  | (16,464 )                       |
| Restricted stock activity, net   | 92,250           | 1                            | 1,067                                |  |  | 1,068                           |
| <b>Balances at December 31, 2004</b>   | 63,506,819       | 635                          | 599,300                              | (8,650 )   | (3,582 )   | 587,703                         |
| Comprehensive income:  |                  |                              |                                      |  |  |                                 |
| Net income   |                  |                              |                                      | 27,819   |  | 27,819                          |
| Change in net unrealized losses on cash flow hedges                            |                  |                              |                                      |  | (11,454 )  | (11,454 )                       |
| Cash flow hedge losses reclassified to earnings                                |                  |                              |                                      |  | 470  | 470                             |
| Total comprehensive income   |                  |                              |                                      |  |  | 16,835                          |
| Issuances of common stock, net   | 3,913,043        | 39                           | 40,028                               |  |  | 40,067                          |
| Dividends declared on common stock (\$0.78 per share)                          |                  |                              |                                      | (52,776 )  |  | (52,776 )                       |
| Exercise of stock options  | 5,000            |                              | 50                                   |  |  | 50                              |
| Restricted stock activity, net   | 238,209          | 3                            | 911                                  |  |  | 914                             |
| <b>Balances at December 31, 2005</b>   | 67,663,071       | 677                          | 640,289                              | (33,607 )  | (14,566 )  | 592,793                         |
| Comprehensive income:  |                  |                              |                                      |  |  |                                 |
| Net income   |                  |                              |                                      | 52,360   |  | 52,360                          |
| Change in net unrealized losses on cash flow hedges                            |                  |                              |                                      |  | 1,493  | 1,493                           |
| Net cash flow hedge losses reclassified to earnings                            |                  |                              |                                      |  | 593  | 593                             |
| Total comprehensive income   |                  |                              |                                      |  |  | 54,446                          |
| Issuances of common stock, net   | 39,475,000       | 395                          | 427,292                              |  |  | 427,687                         |
| Dividends declared on common stock (\$0.85 per share)                          |                  |                              |                                      | (82,540 )  |  | (82,540 )                       |
| Exercise of stock options  | 6,000            |                              | 60                                   |  |  | 60                              |
| Restricted stock activity, net   | 371,795          | 3                            | 1,576                                |  |  | 1,579                           |
| <b>Balances at December 31, 2006</b>   | 107,515,866      | \$ 1,075                     | \$ 1,069,217                         | \$ (63,787 )   | \$ (12,480 )   | \$ 994,025                      |

See accompanying notes.

**Spirit Finance Corporation**  
**Consolidated Statements of Cash Flows**  
(dollars in thousands)

|  | Years Ended December 31, |           |            |
|--|--------------------------|-----------|------------|
|  | 2006                     | 2005      | 2004       |
| <b>Cash flows from operating activities</b>              |                          |           |            |
| Net income   | \$ 52,360                | \$ 27,819 | \$ 8,972   |
| Adjustments to net income:                               |                          |           |            |
| Depreciation and amortization                            | 44,073                   | 20,477    | 4,653      |
| Stock-based compensation                                 | 1,576                    | 911       | 1,067      |
| Amortization of deferred financing costs                 | 2,820                    | 2,350     | 765        |
| Amortization of net interest rate swap hedge losses      | 593                      | 470       |            |
| Net (gains) losses on sales of real estate               | (6,510)                  | (772)     | 12         |
| Other noncash items                                      | 569                      | 285       | 19         |
| Changes in operating assets and liabilities:             |                          |           |            |
| Deferred costs and other assets                          | (3,434)                  | (2,856)   | (2,061)    |
| Accounts payable, accrued expenses and other liabilities | 6,971                    | 5,608     | 4,015      |
| Net cash provided by operating activities                | 99,018                   | 54,292    | 17,442     |
| <b>Cash flows from investing activities</b>              |                          |           |            |
| Acquisitions of real estate                              | (1,374,771)              | (802,580) | (412,135)  |
| Investment in loans receivable                           | (21,782)                 | (18,645)  | (450)      |
| Proceeds from sales of real estate                       | 73,339                   | 57,365    | 6,031      |
| Collections of principal on loans receivable             | 8,654                    | 429       | 301        |
| Net cash used in investing activities                    | (1,314,560)              | (763,431) | (406,253)  |
| <b>Cash flows from financing activities</b>              |                          |           |            |
| Borrowings under secured credit facilities               | 341,181                  | 579,761   | 229,171    |
| Repayments under secured credit facilities               | (442,501)                | (349,906) | (229,171)  |
| Borrowings under mortgages and notes payable             | 1,015,441                | 575,300   |            |
| Repayments under mortgages and notes payable             | (18,615)                 | (144,767) | (4,339)    |
| Deferred financing costs paid                            | (6,921)                  | (12,782)  | (3,253)    |
| Payments received (made) on interest rate swaps          | 5,825                    | (14,984)  |            |
| Proceeds from issuances of common stock, net             | 427,687                  | 40,067    | 320,808    |
| Proceeds from exercise of stock options                  | 60                       | 50        |            |
| Dividends paid on common stock                           | (73,096)                 | (45,677)  | (9,354)    |
| Transfers to restricted cash and escrow deposits         | (11,738)                 | (612)     | (915)      |
| Net cash provided by financing activities                | 1,237,323                | 626,450   | 302,947    |
| Net increase (decrease) in cash and cash equivalents     | 21,781                   | (82,689)  | (85,864)   |
| Cash and cash equivalents, beginning of year             | 30,536                   | 113,225   | 199,089    |
| Cash and cash equivalents, end of year                   | \$ 52,317                | \$ 30,536 | \$ 113,225 |

See accompanying notes.

**Spirit Finance Corporation**  
**Notes to Consolidated Financial Statements**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**The Company**

Spirit Finance Corporation ( Spirit Finance or the Company ) is a Maryland corporation formed on August 14, 2003 as a self-managed and self-advised real estate investment trust ( REIT ) under the Internal Revenue Code. The common stock of Spirit Finance is listed on the New York Stock Exchange under the symbol SFC.

Spirit Finance was formed primarily to acquire single tenant, operationally essential real estate leased on a long-term, triple-net basis to retail, distribution and service-oriented companies. Operationally essential real estate includes land and buildings that are vital to the generation of a company's sales and profits. Spirit Finance may also selectively originate and acquire long-term commercial mortgage loans or equipment loans that are integral to its strategy of providing a complete solution of products to its customers, and the Company may also make a limited amount of corporate loans to its customers. Spirit Finance's objective is to acquire or finance the real estate of companies that provide goods and services to consumers through retail, distribution and service locations throughout the United States, such as general and discount retailer properties, restaurants, specialty retailer properties, movie theaters, industrial properties, automotive dealers, parts and service facilities, educational facilities, recreational facilities, distribution facilities, supermarkets, interstate travel plazas and other similar businesses.

**Principles of Consolidation**

The accompanying consolidated financial statements are prepared on the accrual basis of accounting in accordance with U.S. generally accepted accounting principles.

The consolidated financial statements of Spirit Finance include the accounts of the Company and its wholly owned subsidiaries, Spirit Management Company ( Spirit Management ), Spirit Finance Acquisitions, LLC ( Spirit Acquisitions ) and numerous wholly-owned special purpose entities as described below. Spirit Acquisitions was formed primarily to hold real estate assets. Spirit Management was formed as a taxable REIT subsidiary in order to have the operational flexibility to engage in non-REIT activities that may include short-term gains from opportunistic real estate sales of development properties, advisory and management fee income, and other sources of revenue not suitable for a REIT. Because Spirit Management is a taxable REIT subsidiary, Spirit Management's net income, if any, is taxed at regular corporate rates.

Spirit Finance formed numerous special purpose entities to acquire and hold real estate subject to mortgage notes payable and to facilitate borrowings under the Company's secured credit facilities (see Note 4). As a result, substantially all of the Company's consolidated assets are held in these wholly-owned special purpose entities and are subject to debt. Each special purpose entity is a separate legal entity and is the sole owner of its assets and liabilities. The assets of the special purpose entities are not available to pay, or otherwise satisfy obligations to, the creditors of any owner or affiliate of the special purpose entity. At December 31, 2006 and 2005, assets totaling over \$2.7 billion and \$1.4 billion, respectively, were held and liabilities totaling \$1.7 billion and \$668.6 million, respectively, were owed by these special purpose entities and are included in the accompanying Consolidated Balance Sheets.

All intercompany account balances and transactions have been eliminated in consolidation.

**Spirit Finance Corporation**  
**Notes to Consolidated Financial Statements (Continued)**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**Use of Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although management believes its estimates are reasonable, actual results could differ from those estimates.

**Reclassifications**

Certain reclassifications have been made to prior period balances in order to conform to the current period presentation.

**Real Estate Investments**

*Cost of Acquisitions* Spirit Finance allocates the purchase price of real estate properties, including acquisition and closing costs, to the tangible and intangible assets and liabilities acquired based on their estimated fair values. In making estimates of fair values for this purpose, management utilizes a number of sources, including independent appraisals and information obtained about each property as a result of its pre-acquisition due diligence and its marketing and leasing activities.

Depreciation is generally computed using the straight-line method over an estimated useful life of 40 years for buildings and improvements and 20 years for land improvements.

Lease intangibles, if any, acquired in conjunction with the purchase of real estate generally represent the value of in-place leases or above- or below-market leases. For real estate acquired subject to existing lease agreements, in-place lease intangibles are valued based on management's estimates of carrying costs during the time it would take to locate a tenant if the property were vacant, considering current market conditions and costs to execute similar leases, and are amortized on a straight-line basis over the remaining initial term of the related lease. Above- and below-market lease intangibles are recorded based on the present value of the difference between (a) the contractual amounts to be paid pursuant to the leases at the time of acquisition of the real estate and (b) management's estimate of current market lease rates for the property, measured over a period equal to the remaining initial term of the lease. Capitalized above- and below-market lease intangibles are amortized over the remaining initial terms of the respective leases as an adjustment to rental revenue.

*Impairment* Spirit Finance reviews its real estate investments and related lease intangibles periodically for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Management considers factors such as expected future operating income, estimated residual value, market trends such as the effects of leasing demand and competition and other factors in making this assessment. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized in the amount by which the carrying amount of the asset exceeds the fair value of the asset.

*Revenue Recognition* Spirit Finance leases real estate to its customers under long-term net leases that are classified as operating leases. Lease origination fees and internal direct lease origination costs,

**Spirit Finance Corporation**  
**Notes to Consolidated Financial Statements (Continued)**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

including employee compensation directly related to time spent performing successful lease origination activities, are deferred and amortized over the related lease term as an adjustment to rental revenue.

The leases generally provide for rent escalation provisions throughout the lease term. Some leases provide for scheduled, contractual rent escalations. For these leases, rental revenue is recognized on a straight-line basis so as to produce a constant periodic rent over the term of the lease. Accordingly, accrued rental revenue, calculated as the aggregate difference between the scheduled rents and rental revenue recognized on a straight-line basis, represents unbilled rent receivables that the Company will receive only if the tenant makes all rent payments required through the expiration of the initial term of the lease. The rental revenue representing this straight-line adjustment is subject to an evaluation of collectibility and a provision for losses is made as noted below.

The leases may also provide for contingent rent based on a percentage of the lessee's gross sales or contingent rent indexed to future increases in the Consumer Price Index (CPI). For contingent rentals that are based on a percentage of the lessee's gross sales, the Company recognizes contingent rental revenue when the change in the factor on which the contingent lease payment is based actually occurs. Leases that have contingent rent escalations indexed to future increases in the CPI may adjust over a one-year period or over multiple-year periods. Generally, these lease escalators increase rent at the lesser of (a) a multiplier of 1 to 1.25 times the increase in the CPI or (b) a fixed amount or percentage. Because of the volatility and uncertainty with respect to future changes in the CPI, the inability of the Company to determine the extent to which any specific future change in the CPI is probable at each lease adjustment date during the entire term of the Company's leases and the Company's view that the multiplier does not represent a significant leverage factor, rental revenues for lease escalations are recognized only after the changes in the index have occurred.

Spirit Finance will suspend revenue recognition if the collectibility of amounts due on a lease are not reasonably assured or in the event a lessee's monthly lease payments become more than 60 days past due, whichever is earlier.

*Provision for Doubtful Accounts* The Company reviews its rent receivables for collectibility on a regular basis, taking into consideration changes in factors such as the lessee's payment history, the financial condition of the lessee, business conditions in the industry in which the lessee operates, and economic conditions in the area in which the property is located. In the event that the collectibility of a receivable with respect to any lessee is in doubt, a provision for uncollectible accounts will be established or a direct write-off of the specific rent receivable will be made. For accrued rental revenues related to the straight-line method of reporting rental revenue, the Company provides a valuation allowance (\$2 million and \$1 million at December 31, 2006 and 2005, respectively) based on the risks and estimates of uncollectible receivables that management believes are inherent in the portfolio, giving consideration to industry default rates for long-term receivables.

**Loans Receivable**

Spirit Finance holds its commercial mortgage loans receivable for long-term investment. The mortgage loans are secured by single tenant, operationally essential real estate. Equipment loans are secured by equipment used in the operation of properties owned or financed by the Company. The loans are carried at cost, net of related unamortized premiums or discounts.



**Spirit Finance Corporation**  
**Notes to Consolidated Financial Statements (Continued)**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

*Revenue Recognition* Interest income on mortgage loans receivable is recognized using the effective-interest method applied on a loan-by-loan basis. Direct costs associated with originating loans are offset against any related fees received and the balance, along with any premium or discount, is deferred and amortized as an adjustment to interest income over the terms of the related mortgage loans receivable using the effective-interest method. A loan is placed on non-accrual status when the loan has become 60 days past due, or earlier, if in the opinion of management, full recovery of the contractual collection of principal and interest becomes doubtful. While on non-accrual status, interest income is recognized only when received.

*Impairment and Provision for Loan Losses* The Company periodically evaluates the collectibility of its mortgage loans receivable, including accrued interest, by analyzing the underlying property-level economics and trends, collateral value and quality and other relevant factors in determining the adequacy of its allowance for loan losses. A loan is determined to be impaired when, in management's judgment based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Specific allowances for loan losses are provided for impaired loans on an individual loan basis in the amount by which the carrying value exceeds the estimated fair value of the underlying collateral less disposition costs.

**Cash and Cash Equivalents**

Cash and cash equivalents include cash and highly liquid investment securities with maturities at acquisition of three months or less. Pending further investment in real estate, the Company invests cash primarily in money-market funds of a major financial institution consisting of highly rated money market instruments and other short-term instruments.

**Restricted Cash and Escrow Deposits**

The Company classified restricted cash and escrow deposits totaling \$13.3 million and \$1.5 million at December 31, 2006 and 2005, respectively, in Deferred costs and other assets, net in the accompanying Consolidated Balance Sheets. The restricted cash balances primarily represented amounts required to be maintained under certain of the Company's debt agreements. In January 2007, \$9.7 million of the restricted cash and escrow deposits was used to repay a maturing note payable.

**Accounting for Derivative Financial Instruments and Hedging Activities**

The Company's interest rate derivative contracts are designated to mitigate the risk of changes in forecasted interest payments and are considered to be cash flow hedges. At inception of a hedge transaction, the Company enters into a contractual arrangement with the hedge counterparty and formally documents the relationship between the hedging instrument and the forecasted transaction, as well as its risk management objective and strategy for undertaking the hedge transaction. At inception and at least quarterly thereafter, a formal assessment is performed to determine whether the interest rate derivative contract has been highly effective in offsetting changes in cash flows of the forecasted financing transaction and whether it is expected to be highly effective in the future.

For derivatives designated as cash flow hedges, the fair value of the derivative instrument is recorded on the balance sheet as either an asset or liability. In determining the fair values of the derivative financial instruments, the Company uses either market quotes or valuation models that are based upon the net

**Spirit Finance Corporation**  
**Notes to Consolidated Financial Statements (Continued)**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

present value of estimated future cash flows and incorporate certain market data inputs. The effective portions of the corresponding gain or loss on the derivatives are recorded in accumulated other comprehensive income within stockholders' equity. When the anticipated debt is issued, the fair value of the hedge contract at that time will be recorded in accumulated other comprehensive income and amortized into earnings as a yield adjustment over the term of the new debt instrument. Any ineffective portions of the corresponding gain or loss are recognized immediately in the income statement.

**Stock-Based Compensation**

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share Based Payment (SFAS No. 123(R)), using the modified prospective application. SFAS No. 123(R) requires entities to measure and recognize the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award and applies to (i) new awards, (ii) awards modified, repurchased or cancelled after the adoption date, and (iii) any outstanding awards accounted for under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25), for which all requisite service has not yet been rendered. The adoption of SFAS No. 123(R) did not have a material impact on the Company's financial statements since the Company elected to adopt, effective January 1, 2005, the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, for all unvested stock-based awards outstanding at January 1, 2005 and for all new grants made in 2005. Prior to January 1, 2005, the Company used the intrinsic-value method prescribed by APB No. 25 and related interpretations in accounting for its stock-based compensation. Under this method, no compensation expense was recorded with respect to stock options as the options were granted at an exercise price equal to the estimated fair value of the underlying common shares on the date of grant. The fair value of the options was estimated on the grant dates using the minimum-value method, which omits the assumption of any volatility, because the Company was not a publicly traded entity on the respective grant dates. Using the minimum-value method, the fair value of the stock options was zero on the date of grant. Compensation expense for the unvested stock options granted prior to the Company becoming a publicly traded entity continues to be recognized using the minimum-value method.

**Income Taxes**

Spirit Finance has elected to be taxed as a REIT under the Internal Revenue Code. As a REIT, Spirit Finance generally will not be subject to federal income tax provided it continues to satisfy certain tests concerning the Company's sources of income, the nature of its assets, the amounts distributed to its stockholders and the ownership of Company stock. If Spirit Finance fails to qualify as a REIT in any taxable year, it may be subject to federal income tax (including any applicable alternative minimum tax). Even if Spirit Finance qualifies for taxation as a REIT, it may be subject to state and local income and franchise taxes and to federal income tax and excise tax on its undistributed income. Management believes that the Company has qualified and will continue to qualify as a REIT.

During the years ended December 31, 2006 and 2005, the federal income tax provision attributable to the operations of Spirit Management (the Company's consolidated taxable REIT subsidiary) was not material to the consolidated results of operations. No provision for federal income taxes was made for the year ended December 31, 2004 as Spirit Management was not engaged in any active business operations.

**Spirit Finance Corporation**  
**Notes to Consolidated Financial Statements (Continued)**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**New Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 is effective for fiscal years beginning after December 15, 2006. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in accordance with SFAS No. 109, Accounting for Income Taxes and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on various related matters such as derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. Management continues to assess the potential impact, if any, the adoption of FIN 48 will have on the Company s financial position and results of operations.

In September 2006, the Securities and Exchange Commission Staff issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in the Current Year Financial Statements ( SAB No. 108 ). SAB No. 108 was issued to eliminate the diversity in practice surrounding how public companies quantify financial misstatements. SAB No. 108 requires that registrants quantify errors using both a balance sheet and income statement approach and evaluate whether either approach results in a misstated amount that, when all relevant quantitative and qualitative factors are considered, is material. The adoption of SAB No. 108 did not have any impact on the Company s financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is evaluating the impact of this pronouncement but does not expect that the guidance will have a material effect on the Company s financial position or results of operations.

**2. INVESTMENTS**

At December 31, 2006, Spirit Finance had investments in 1,034 real estate properties, including 931 owned real estate properties with a gross acquisition cost of \$2.8 billion (including \$27.7 million of gross related lease intangibles, see Note 3) and mortgage loans receivable with a carrying amount of \$58.0 million. At December 31, 2006, the Company also held equipment and other loans with an aggregate outstanding balance of \$17.2 million. A substantial portion of these investments are pledged as collateral under the Company s debt obligations (see Note 4).

The Company s investments are geographically dispersed throughout 43 states. Including the Company s mortgage and other loans receivable described below and the related lease intangibles, only two states, Wisconsin (12%) and Texas (11%), accounted for 10% or more of the total dollar amount of Spirit Finance s investment portfolio at December 31, 2006.

**Spirit Finance Corporation**  
**Notes to Consolidated Financial Statements (Continued)**

**2. INVESTMENTS (Continued)**

During the year ended December 31, 2006, the Company had the following gross real estate acquisition and loan origination activity (dollars in thousands):

|   | Number of<br>Properties Owned<br>or Financed | Dollar Amount of<br>Investments(a) |
|---|--|------------------------------------|
| Balance, December 31, 2005                  | 684  | \$ 1,487,460                       |
| Acquisitions and loan originations          | 398  | 1,423,600                          |
| Sales (see Note 11)                         | (46 )  | (68,531 )                          |
| Principal payments and premium amortization | (2 )   | (8,651 )                           |
| Balance, December 31, 2006                  | 1,034  | \$ 2,833,878                       |

(a) The dollar amount of investments includes the gross cost of land, buildings and lease intangibles related to properties owned and the carrying amount of loans receivable.

**Real Estate Investments**

The following table reports the amount of real estate investments (excluding \$27.7 million of related lease intangibles described in Note 3) held by the Company at December 31, 2006 (dollars in thousands):

|  | Gross Carrying Amount at December 31, 2006 |                             |                                  |              |
|--|--|-----------------------------|----------------------------------|--------------|
|  | Number<br>of Owned<br>Properties           | Land and<br>Improvements(a) | Buildings<br>and<br>Improvements | Total        |
| General and discount retailer properties         | 178  | \$ 355,228                  | \$ 471,812                       | \$ 827,040   |
| Restaurants                                      | 498  | 281,204                     | 289,838                          | 571,042      |
| Specialty retailer properties                    | 36   | 92,530                      | 175,068                          | 267,598      |
| Movie theaters                                   | 24   | 64,642                      | 146,040                          | 210,682      |
| Industrial properties                            | 26   | 32,296                      | 146,654                          | 178,950      |
| Educational facilities                           | 20   | 34,930                      | 119,549                          | 154,479      |
| Automotive dealers, parts and service facilities | 44   | 72,265                      | 70,823                           | 143,088      |
| Recreational facilities                          | 7  | 25,573                      | 73,836                           | 99,409       |
| Distribution facilities                          | 46   | 23,512                      | 43,456                           | 66,968       |
| Supermarkets                                     | 19   | 12,382                      | 47,731                           | 60,113       |
| Interstate travel plazas                         | 4  | 21,434                      | 16,101                           | 37,535       |
| Call centers                                     | 2  | 4,413                       | 28,557                           | 32,970       |
| Health clubs/gyms                                | 5  | 4,279                       | 18,743                           | 23,022       |
| Medical office                                   | 1  | 1,444                       | 19,113                           | 20,557       |
| Convenience stores/car washes                    | 12   | 10,719                      | 8,554                            | 19,273       |
| Drugstores                                       | 9  | 5,517                       | 12,755                           | 18,272       |
| Total real estate investments                    | 931  | \$ 1,042,368                | \$ 1,688,630                     | \$ 2,730,998 |

(a) Includes land improvements of \$250 million at December 31, 2006.

The Company's properties are leased to customers under long-term operating leases that typically include one or more renewal options. The weighted average remaining noncancelable lease term at December 31, 2006 was approximately 16 years. The leases are generally triple-net, which provides that the

**Spirit Finance Corporation**  
**Notes to Consolidated Financial Statements (Continued)**

**2. INVESTMENTS (Continued)**

lessee is responsible for the payment of all property operating expenses, including property taxes, maintenance and insurance; therefore, Spirit Finance is generally not responsible for repairs or other capital expenditures related to the properties.

Scheduled minimum future rentals to be received under the remaining noncancelable term of the operating leases at December 31, 2006 are as follows (dollars in thousands):

|                                     |                     |
|-------------------------------------|---------------------|
| 2007                                | \$ 238,503          |
| 2008                                | 238,945             |
| 2009                                | 239,347             |
| 2010                                | 239,555             |
| 2011                                | 237,506             |
| Thereafter                          | 2,577,350           |
| <b>Total future minimum rentals</b> | <b>\$ 3,771,206</b> |

Since lease renewal periods are exercisable at the option of the lessee, the above table presents future minimum lease payments due during the initial lease term only. In addition, the future minimum rentals do not include any contingent rentals based on a percentage of the lessee's gross sales or lease escalations based on future changes in the Consumer Price Index. Contingent rental revenue based on a percentage of the lessee's gross sales totaled \$1.0 million in 2006, \$486,000 in 2005 and \$103,000 in 2004.

**Loans Receivable**

At December 31, 2006, the Company held a total of 96 first priority mortgage loans (representing four borrowers) that had an aggregate carrying amount of \$58.0 million, including an unamortized premium of \$1.1 million. As of December 31, 2006, the largest individual mortgage loan receivable had a carrying amount of approximately \$3.0 million and a weighted average contractual and effective interest rate of 9.35%; the loan matures in 2026. The loans, which are secured by single tenant commercial properties, generally provide for monthly collections of principal and interest with scheduled increases in interest rates over the life of the loans. At December 31, 2006, the Company also held equipment and other loans with an outstanding balance of \$17.2 million. The other loans are primarily secured by equipment used in the operation of certain real estate properties owned by the Company. No loan loss allowances were recorded on the loans receivable at December 31, 2006 or 2005.

**Spirit Finance Corporation**  
**Notes to Consolidated Financial Statements (Continued)**

**2. INVESTMENTS (Continued)**

The following table provides additional information on the Company's loans receivable at December 31, 2006 (dollars in thousands):

|  | Number<br>of Loans | Number of<br>Properties<br>Financed | Weighted-<br>Average<br>Contractual<br>Interest Rate | Weighted<br>Average<br>Effective<br>Interest Rate | Final<br>Maturity<br>Date | Carrying<br>Amount of<br>Loans(b) |
|--|--------------------|-------------------------------------|--|---|---------------------------|-----------------------------------|
| Mortgage loans:(a)                         |                    |                                     |  |   |                           |                                   |
| Restaurants                                | 64                 | 69                                  | 9.46 %   | 9.28 %  | 2011-2030                 | \$ 38,206                         |
| Automotive parts and service<br>facilities | 32                 | 32                                  | 9.23 %   | 8.93 %  | 2021                      | 19,827                            |
| Other loans                                | 11                 | 2                                   | 8.46 %   | 8.46 %  | 2007-2026                 | 17,140                            |
| Total loans                                | 107                | 103                                 |  |   |                           | \$ 75,173                         |

(a) One loan matures in 2011, three loans mature in 2016, 63 loans mature in 2021 with a balloon payment of \$13.5 million, one loan matures in 2026 and 28 loans mature in 2030. The loans may be prepaid, with penalties.

(b) The aggregate cost for federal income tax purposes approximates the carrying amount of the loans receivable.

The following is a reconciliation of the carrying amount of loans receivable from December 31, 2003 through December 31, 2006 (dollars in thousands):

|  | Carrying<br>Amount<br>of Loans |
|--|--------------------------------|
| Balance, December 31, 2003             | \$ 40,766                      |
| New loans                              | 450                            |
| Collections of principal               | (301 )                         |
| Amortization of premium                | (60 )                          |
| Balance, December 31, 2004             | 40,855                         |
| New loans                              | 18,645                         |
| Collections of principal               | (429 )                         |
| Amortization of premium                | (63 )                          |
| Balance, December 31, 2005             | 59,008                         |
| New loans                              | 24,816                         |
| Collections of principal               | (8,654 )                       |
| Amortization of premium                | (67 )                          |
| Amortization of other deferred amounts | 70                             |
| Balance, December 31, 2006             | \$ 75,173                      |

Scheduled maturities for the next five years is expected to be as follows: \$3.2 million in 2007, \$2.7 million in 2008, \$1.7 million in 2009, \$1.9 million in 2010 and \$2.2 million in 2011.

**Spirit Finance Corporation**  
**Notes to Consolidated Financial Statements (Continued)**

**3. LEASE INTANGIBLES, NET**

The following is a reconciliation of the gross carrying amount and accumulated amortization related to lease intangibles for the years ended December 31, 2006 and 2005 (dollars in thousands):

|  | Gross Carrying Amount |              | Accumulated  | Net       |
|--|-----------------------|--------------|--------------|-----------|
|  | In-place              | Above-market | Amortization | Carrying  |
|  | leases                | leases       |              | Amount    |
| Balance, December 31, 2004   | \$ 10,600             | \$ 428       | \$ (286 )    | \$ 10,742 |
| Intangibles acquired in conjunction with acquisitions of real estate | 13,022                |              |              | 13,022    |
| Amortization expense   |                       |              | (1,263 )     | (1,263 )  |
| Sales (see Note 11)  | (752 )                | (428 )       | 74           | (1,106 )  |
| Balance, December 31, 2005   | 22,870                |              | (1,475 )     | 21,395    |
| Intangibles acquired in conjunction with acquisitions of real estate | 5,346                 |              |              |           |