WELLS REAL ESTATE INVESTMENT TRUST II INC
Form POS AM
May 24, 2005

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As filed with the Securities and Exchange Commission on May 23, 2005

Registration No. 333-107066

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

POST-EFFECTIVE AMENDMENT NO. 9

TO

FORM S-11

REGISTRATION STATEMENT

Under

THE SECURITIES ACT OF 1933

Wells Real Estate Investment Trust II, Inc.

(Exact name of registrant as specified in its charter)

6200 The Corners Parkway, Suite 250

Norcross, Georgia 30092

(770) 449-7800

(Address, including zip code, and telephone number, including area code, of the registrant s principal executive offices)

Leo F. Wells, III

President

Wells Real Estate Investment Trust II, Inc.

6200 The Corners Parkway, Suite 250

Norcross, Georgia 30092

(770) 449-7800

(Name, address, including zip code and telephone number, including area code, of agent for service)

Copies to:

Robert H. Bergdolt, Esq.

DLA Piper Rudnick Gray Cary US LLP

4700 Six Forks Road, Suite 200

Raleigh, North Carolina 27609-5244

(919) 786-2000

Approximate date of commencement of proposed sale to public: As soon as practicable after the effectiveness of the registration statement.

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If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act of 1933, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration number of the earlier effective registration statement for the same offering. ¨

If this form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration number of the earlier effective registration statement for the same offering. ¨

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. ¨

This Post-Effective Amendment No. 9 consists of the following:

1. The Registrant s final form of Prospectus dated November 26, 2003, previously filed pursuant to Rule 424(b)(4) on December 1, 2003 and refiled herewith.

2. Supplement No. 9 dated May 18, 2004 to the Registrant s Prospectus dated November 26, 2003, previously filed as part of Post-Effective Amendment No. 4, which is refiled herewith.

3. Supplement No. 33 dated May 23, 2005 to the Registrant s Prospectus dated November 26, 2003.

4. Supplement No. 34 dated May 23, 2005 to the Registrant s Prospectus dated November 26, 2003.

5. Part II included herewith.

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WELLS REAL ESTATE INVESTMENT TRUST II, INC.

Maximum Offering of 785,000,000 Shares of Common Stock

Minimum Offering of 250,000 Shares of Common Stock

Wells Real Estate Investment Trust II, Inc. is a newly organized Maryland corporation that intends to qualify as a REIT beginning with the taxable year that will end December 31, 2003. We expect to use substantially all of the net proceeds from this offering to acquire and operate commercial real estate primarily consisting of high quality, income-generating office and industrial properties leased to creditworthy companies and governmental entities. Because we have not yet identified any specific properties to purchase, we are considered to be a blind pool.

We are offering up to 600,000,000 shares of common stock in our primary offering for $10 per share, with discounts available for certain categories of purchasers as described in Plan of Distribution. We are also offering up to 185,000,000 shares to be issued pursuant to our dividend reinvestment plan at a purchase price equal to the higher of $9.55 per share or 95% of the estimated value of a share of our common stock, as estimated by our advisor or another firm we choose for that purpose.

See Risk Factors beginning on page 21 to read about risks you should consider before buying shares of our common stock. These risks include the following:

No public market currently exists for our shares of common stock. If you are able to sell your shares, you would likely have to sell them at a substantial discount.

We have no operating history nor do we currently own any properties. We have not identified any properties to acquire with proceeds from this offering.

If we raise substantially less than the maximum offering, we may not be able to invest in a diverse portfolio of properties and the value of your investment may vary more widely with the performance of specific properties.

We are dependent on our advisor to select investments and conduct our operations. Adverse changes in the financial health of our advisor or our relationship with our advisor could adversely affect us.

Our advisor and its affiliates will face conflicts of interest, including significant conflicts created by our advisor s compensation arrangements with us and similar programs sponsored by our advisor.

We will pay substantial fees and expenses to our advisor, its affiliates and participating broker-dealers, which payments increase the risk that you will not earn a profit on your investment.

Neither the SEC, the Attorney General of the State of New York nor any other state securities regulator has approved or disapproved of our common stock, determined if this prospectus is truthful or complete or passed on or endorsed the merits of this offering. Any representation to the contrary is a criminal offense.

The use of projections or forecasts in this offering is prohibited. No one is permitted to make any oral or written predictions about the cash benefits or tax consequences you will receive from your investment.

	Price to Public*	Selling Commissions*	Dealer Manager Fee*	Net Proceeds (Before Expenses)
Primary Offering				
Per Share	$ 10.00	$ 0.70	$ 0.25	$ 9.05
Total Minimum	$ 2,500,000	$ 175,000	$ 62,500	$ 2,262,500
Total Maximum	$ 6,000,000,000	$ 420,000,000	$ 150,000,000	$ 5,430,000,000
Dividend Reinvestment Plan				
Per Share	$ 9.55	$ 0.4775	$	$ 9.0725
Total Maximum	$ 1,766,750,000	$ 88,337,500	$	$ 1,678,412,500

* The selling commissions and, in some cases, all or a portion of the dealer manager fee will not be charged with regard to shares sold to or for the account of certain categories of purchasers. The reduction in these fees will be accompanied by a corresponding reduction in the per share purchase price, except that all shares sold under the dividend reinvestment plan will be at the higher of $9.55 per share or 95% of the estimated value of a share of our common stock. See Plan of Distribution.

The dealer manager of this offering, Wells Investment Securities, Inc., is our affiliate and will offer the shares on a best-efforts basis. The minimum permitted purchase is generally $1,000. We will not sell any shares unless we sell a minimum of 250,000 shares to the public for $10 per share by November 26, 2004 (one year from the date of this prospectus). Pending satisfaction of this condition, all subscription payments will be placed in an account held by the escrow agent, SouthTrust Bank, in trust for subscribers benefit, pending release to us. If we do not sell at least 250,000 shares for $10 per share by November 26, 2004, we will return all funds in the escrow account (including interest), and we will stop selling shares.

WELLS INVESTMENT SECURITIES, INC.

November 26, 2003

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SUITABILITY STANDARDS

The shares we are offering are suitable only as a long-term investment. Because there is no public market for the shares, you will have difficulty selling your shares. In consideration of these factors, we require initial stockholders and subsequent purchasers to have either:

- a net worth of at least $150,000; or

- gross annual income of at least $45,000 and a net worth of at least $45,000.

In addition, we will not sell shares to investors in the states named below unless they meet special suitability standards.

California, Iowa, Massachusetts, Michigan, Missouri, New Jersey and Tennessee - Investors must have either (1) a net worth of at least $225,000, or (2) gross annual income of at least $60,000 and a net worth of at least $60,000.

Maine - Investors must have either (1) a net worth of at least $200,000, or (2) gross annual income of at least $50,000 and a net worth of at least $50,000.

Iowa, Missouri, Ohio and Pennsylvania - In addition to the suitability requirements described above, investors must have a net worth of at least 10 times their investment in us.

For purposes of determining suitability of an investor, net worth in all cases should be calculated excluding the value of an investor s home, furnishings and automobiles. In the case of sales to fiduciary accounts, these suitability standards must be met by the fiduciary account, by the person who directly or indirectly supplied the funds for the purchase of the shares if such person is the fiduciary or by the beneficiary of the account.

Those selling shares on our behalf must make every reasonable effort to determine that the purchase of shares in this offering is a suitable and appropriate investment for each stockholder based on information provided by the stockholder regarding the stockholder s financial situation and investment objectives. See Plan of Distribution Suitability Standards for a detailed discussion of the determinations regarding suitability that we require of all those selling shares on our behalf.

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QUESTIONS AND ANSWERS ABOUT THIS OFFERING

Below we have provided some of the more frequently asked questions and answers relating to an offering of this type. Please see the Prospectus Summary and the remainder of this prospectus for more detailed information about this offering.

Q: What is a REIT?

A: In general, a REIT is a company that:

- combines the capital of many investors to acquire or provide financing for real estate properties;
- allows individual investors to invest in a large-scale diversified real estate portfolio through the purchase of interests, typically shares, in the REIT;
- is required to pay dividends to investors of at least 90% of its taxable income; and
- avoids the double taxation treatment of income that would normally result from investments in a corporation because a REIT does not generally pay federal corporate income taxes on its net income, provided certain income tax requirements are satisfied.

Q: What is Wells Real Estate Investment Trust II, Inc.?

A: Wells Real Estate Investment Trust II, Inc. is a newly organized Maryland corporation that intends to qualify as a REIT beginning with the taxable year that will end December 31, 2003. We expect to use substantially all of the net proceeds from this offering to acquire and operate commercial real estate primarily consisting of high quality, income-generating office and industrial properties leased to creditworthy companies and governmental entities. We may also invest in entities that make similar investments. We were incorporated in the State of Maryland in July 2003.

Q: What is your relationship to Wells Real Estate Investment Trust, Inc.?

A: Wells Real Estate Investment Trust, Inc., which we refer to as Wells REIT I, is a separate REIT from us. However, we have a common advisor, Wells Capital, Inc., and some of our directors and all of our officers are also directors and officers of Wells REIT I.

Q: Are there any risks involved in an investment in your shares?

A: An investment in our shares involves significant risk. You should read the Risk Factors section of this prospectus beginning on page 21. That section contains a detailed discussion of material risks that you should consider before you invest in the common stock we are selling with this

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prospectus. Some of the more significant risks relating to an investment in our shares include the following:

- No public market currently exists for our shares of common stock. If you are able to sell your shares, you would likely have to sell them at a substantial discount from their public offering price.

- We have no operating history, nor do we currently own any properties. We have not identified any properties to acquire with proceeds from this offering.

- If we raise substantially less than the maximum offering, we may not be able to invest in a diverse portfolio of properties, and the value of your investment may vary more widely with the performance of specific properties.

- We are dependent on our advisor to select investments and conduct our operations; thus, adverse changes in the financial health of our advisor or our relationship with our advisor could adversely affect us.

- We will pay substantial fees and expenses to our advisor, its affiliates and participating broker-dealers, which payments increase the risk that you will not earn a profit on your investment.

- Our advisor and its affiliates will face conflicts of interest, including significant conflicts created by our advisor s compensation arrangements with us and other Wells-sponsored programs.

Q: Who is your advisor?

A: Wells Capital is our advisor. Wells Capital was incorporated in the State of Georgia in 1984. As of September 30, 2003, Wells Capital had sponsored or advised public real estate programs that had raised approximately $4.3 billion from approximately 119,000 investors and that owned and operated more than 22 million square feet of commercial real estate properties.

Q: What will the advisor do?

A: Wells Capital, as our advisor, will manage our daily affairs and make recommendations on all property acquisitions to our board of directors. We expect that a committee of our board of directors comprised of all of our independent directors will exercise its right to approve or reject all proposed property acquisitions. Wells Capital will also provide asset management, marketing, investor relations and other administrative services on our behalf.

Q: How will Wells Capital select potential properties for acquisition?

A:

Wells Capital will generally seek to acquire high quality office and industrial buildings located in densely populated metropolitan markets leased to creditworthy companies and governmental entities. Current tenants of public real estate programs sponsored or advised by Wells Capital

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include The Coca-Cola Company, State Street Bank, AT&T, Siemens Automotive, PricewaterhouseCoopers, Novartis and SYSCO Corporation.

To find properties that best meet our selection criteria for investment, Wells Capital s property acquisition team will study regional demographics and market conditions and interview local brokers to gain the practical knowledge that these studies sometimes lack. An experienced commercial construction engineer will inspect the structural soundness and the operating systems of each building, and an environmental firm will investigate all environmental issues to ensure each property meets our quality specifications.

Q: What conflicts of interest will your advisor face?

A: Some of our directors and all of our officers are directors and officers of the advisor. Additionally, some of our directors are also directors of Wells REIT I, with which we may engage in joint ventures. Wells Capital and its affiliates will receive fees in connection with transactions involving the purchase, management and sale of our properties regardless of the quality of the property acquired or the services provided to us. Wells Capital must determine which investment opportunities to recommend to us or another Wells program or joint venture and may also be in the position of structuring the terms of joint ventures between us and other Wells-sponsored programs. Wells Capital, Wells Investment Securities and their affiliates will also receive fees in connection with our public offerings of equity securities. These conflicts of interest could influence the judgment of our advisor and its affiliates, including our officers and some of our directors, resulting in decisions that are not in our best interests. We discuss these specific conflicts of interest, as well as others arising from these relationships, under Risk Factors Risks Related to Conflicts of Interest and under Conflicts of Interest.

Q: What are the fees that you will pay to the advisor and its affiliates in connection with this offering?

A: We will pay Wells Capital and Wells Investment Securities, Inc. (the dealer manager for this offering) compensation for services they will perform for us. We will pay the advisor acquisition fees in connection with the selection, acquisition, development or construction of properties in an amount equal to 2% of gross offering proceeds. We will also reimburse Wells Capital for expenses it pays on our behalf, including reimbursement for our organization and offering expenses. Our reimbursement obligation for organization and offerings costs, however, may not exceed 2% of our gross offering proceeds.

We will pay a selling commission and a dealer manager fee to Wells Investment Securities equal to 7% and 2.5%, respectively, of the gross proceeds raised in connection with a sale of shares in this offering. The selling commissions will be reallowed to participating broker-dealers, as may a portion of the dealer manager fee. The selling commission and dealer manager fee will be reduced or waived in connection with certain categories of sales, such as sales through investment advisers or banks acting as trustees or fiduciaries and sales under our dividend reinvestment plan.

We will also pay our advisor a monthly asset-management fee of one-twelfth of 0.75% of the sum of the cost of all occupied properties we own plus the cost of investments in joint ventures. This asset-management fee is capped on a quarterly basis at 1.0% of the net asset value of those investments at quarter end after deducting debt used to acquire or refinance properties. We might

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also engage an affiliate of our advisor to provide property-management services. We would pay market rates for such property-management services, possibly including the property manager s costs of providing property-management services. We will reimburse the advisor for the costs and expenses it incurs in providing asset-management services and administrative services, such as the cost of providing investor services.

In connection with the sale of properties, we may pay the advisor or its affiliates a fee of up to 3% of the gross sales price of the properties. This fee, when combined with other real estate commissions paid to our advisor, its affiliates and unaffiliated third parties, may not exceed 6% of the contract sales price. Wells Capital may also receive a subordinated 10% share of the net sales proceeds from the sale of our portfolio if our stockholders have enjoyed an 8% cumulative, non-compounded return or a similar success-based fee if our shares trade at prices reflecting such a return (taking prior dividends into account) upon their listing on a national securities exchange or the Nasdaq National Market.

See Management Compensation and Plan of Distribution for a more detailed description of the fees and expenses payable to our advisor, our dealer manager and their affiliates.

Q: How many real estate properties do you currently own?

A: We currently do not own any properties. We expect to use substantially all of the net proceeds from this offering to acquire and operate commercial real estate primarily consisting of high quality income-generating office and industrial properties leased to creditworthy companies and governmental entities. We may also invest in entities that make similar investments. Because we have not yet identified any specific properties to purchase, we are considered to be a blind pool.

Q: Will you acquire properties in joint ventures?

A: Probably. Among other reasons, we may want to acquire properties through a joint venture in order to diversify our portfolio of properties in terms of geographic region, property type and tenant industry group.

Q: What steps will you take to make sure you purchase environmentally compliant properties?

A: We will obtain a Phase I environmental assessment of each property purchased. In addition, we generally expect to obtain a representation from the seller that, to its knowledge, the property is not contaminated with hazardous materials.

Q: What will be the terms of your leases?

A: We will seek to secure leases with creditworthy tenants before or at the time we acquire a property. We expect that our leases generally will be economically net leases, which means that the tenant would be responsible for the cost of repairs, maintenance, property taxes, utilities, insurance and other operating costs. In most of these leases, we will probably be responsible for the replacement of specific structural components of a property, such as the roof of the building

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or the parking lot. We expect that our leases generally will have terms of five or more years, some of which may have renewal options.

Q: How will Wells REIT II own its real estate properties?

A: As an UPREIT , we expect to own substantially all of our real estate properties through Wells Operating Partnership II, L.P., which we refer to as Wells OP II. We organized Wells OP II to own, operate and manage real properties on our behalf. Wells REIT II is the sole general partner of Wells OP II.

Q: What is an UPREIT ?

A: UPREIT stands for Umbrella Partnership Real Estate Investment Trust. The UPREIT structure is used because a sale of property directly to the REIT is generally a taxable transaction to the selling property owner. In an UPREIT structure, a seller of a property who desires to defer taxable gain on the sale of his property may transfer the property to the UPREIT in exchange for limited partnership units in the UPREIT and defer taxation of gain until the seller later exchanges his UPREIT units on a one-for-one basis for REIT shares. If the REIT shares are publicly traded, the former property owner will achieve liquidity for his investment upon the exchange. Using an UPREIT structure may give us an advantage in acquiring desired properties from persons who may not otherwise sell their properties because of unfavorable tax results.

Q: If I buy shares, will I receive dividends and how often?

A: To maintain our qualification as a REIT, we are required to make aggregate annual distributions to our stockholders of at least 90% of our taxable income (which does not necessarily equal net income as calculated in accordance with accounting principles generally accepted in the United States (GAAP)). We intend to pay dividends quarterly. Our board of directors may authorize distributions in excess of those required for us to maintain REIT status depending on our financial condition and such other factors as our board of directors deems relevant. We have not established a minimum distribution level.

Q: How will you calculate the payment of dividends to stockholders?

A: We expect to calculate our quarterly dividends on a daily basis to stockholders of record so any dividend benefits may begin to accrue immediately upon becoming a stockholder.

Q: May I reinvest my dividends in shares of Wells REIT II?

A:

Yes. You may participate in our dividend reinvestment plan by checking the appropriate box on the Subscription Agreement or by filling out an enrollment form we will provide to you at your request. The purchase price for shares purchased under the dividend reinvestment plan will be the higher of $9.55 or 95% of the estimated value of a share of our common stock, as estimated by our advisor or another firm we choose for that purpose.

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Q: Will the dividends I receive be taxable as ordinary income?

A: Yes and No. Generally, dividends that you receive, including dividends that are reinvested pursuant to our dividend reinvestment plan, will be taxed as ordinary income to the extent they are from current or accumulated earnings and profits. We expect that some portion of your dividends will not be subject to tax in the year in which they are received because depreciation expense reduces the amount of taxable income but does not reduce cash available for distribution. The portion of your distribution that is not subject to tax immediately is considered a return of capital for tax purposes and will reduce the tax basis of your investment. This, in effect, defers a portion of your tax until your investment is sold or Wells REIT II is liquidated, at which time you will be taxed at capital gains rates. However, because each investor s tax considerations are different, we suggest that you consult with your tax advisor. You should also review the section of the prospectus entitled Federal Income Tax Considerations.

Q: What will you do with the money raised in this offering?

A: We intend to use substantially all of the net proceeds from this offering to acquire and operate commercial real estate primarily consisting of high quality, income-generating office and industrial properties leased to creditworthy companies and governmental entities. Depending primarily on the number of shares we sell in this offering and assuming a $9.55 per share price for shares sold under our dividend reinvestment plan, we estimate for each share sold in this offering that between $8.65 and $8.83 will be available for the purchase of real estate, with the remaining proceeds to pay fees and expenses of this offering and an acquisition fee to our advisor.

Until we invest the proceeds of this offering in real estate, we may invest in short-term, highly liquid or other authorized investments. Such short-term investments will not earn as high of a return as we expect to earn on our real estate investments, and we may be not be able to invest the proceeds in real estate promptly.

Q: What kind of offering is this?

A: We are offering up to 785,000,000 shares of common stock on a best efforts basis.

Q: How does a best efforts offering work?

A: When shares are offered on a best efforts basis, the broker-dealers participating in the offering are only required to use their best efforts to sell the shares and have no firm commitment or obligation to purchase any of the shares. Therefore, we may not sell all or any of the shares that we are offering.

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Q: How long will this offering last?

A: This offering will not last beyond November 26, 2005, except that we may continue to offer shares under the dividend reinvestment plan beyond that date until we have sold 185,000,000 shares through the reinvestment of dividends. In some states, we may not be able to continue the offering for these periods without renewing the registration statement or filing a new registration statement.

Q: Who can buy shares?

A: You can buy shares pursuant to this prospectus provided that you have either (1) a net worth of at least $45,000 and an annual gross income of at least $45,000, or (2) a net worth of at least $150,000. For this purpose, net worth does not include your home, home furnishings or personal automobiles. These minimum levels may be higher in certain states, so you should carefully read the more detailed description under Suitability Standards immediately following the cover page of this prospectus.

Q: Is there any minimum investment required?

A: Yes. Generally, you must invest at least $1,000. Except in Ohio, Maine, Minnesota, Nebraska and Washington, investors who have purchased units from an affiliated Wells public real estate program can make purchases for less than the minimum investment. These minimum investment levels may be higher in certain states, so you should carefully read the more detailed description under Plan of Distribution Minimum Purchase Requirements.

Q: How do I subscribe for shares?

A: If you choose to purchase shares in this offering, you will need to fill out a Subscription Agreement, like the one contained in this prospectus as Appendix A, for a specific number of shares and pay for the shares at the time you subscribe.

Q: What happens if you don t sell at least 250,000 shares to the public?

A: If we do not sell at least 250,000 shares to the public at $10 per share before November 26, 2004, we will terminate the offering and stop selling shares. In such event, within ten days after termination of the offering, the escrow agent will return your funds, including interest. Different escrow procedures apply to Pennsylvania investors. See Plan of Distribution Special Notice to Pennsylvania Investors.

Q: If I buy shares in this offering, how may I later sell them?

A: At the time you purchase the shares, they will not be listed for trading on any securities exchange or over-the-counter market. In fact, we expect that there will not be any public market for the shares when you purchase them, and we cannot be sure if one will ever develop. In addition, our charter imposes restrictions on the ownership of our stock, which will apply to potential purchasers of your stock. As a result, you may find it difficult to find a buyer for your shares and

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realize a return on your investment. See Description of Shares Restriction on Ownership of Shares.

After you have held your shares for at least one year, you may be able to have your shares repurchased by us pursuant to our proposed share redemption program. For at least the next five years, the redemption price would generally be $8.40. (The terms of our proposed redemption program would be more generous upon the death of a stockholder.) We do not intend to adopt the proposed share redemption program during this or any other primary offering unless the SEC grants us an exemption from its restrictions on issuers bidding for their securities during a distribution. Without this exemptive relief, the earliest that we could adopt the proposed share redemption program would be after the completion of our primary offering. Even if adopted, we could later amend or terminate the program. See Description of Shares Proposed Share Redemption Program.

We may return all or a portion of your capital contribution in connection with a sale of the company or the properties we will acquire. Alternatively, you may be able to obtain a return of all or a portion of your capital contribution in connection with the sale of your shares.

Q: When will the company seek to list its shares of common stock?

A: We will seek to list our shares of common stock when our independent directors believe listing would be in the best interest of our stockholders. If we do not list our shares of common stock on a national securities exchange or on the Nasdaq National Market by October 2015, our charter requires that we either:

- seek stockholder approval of an extension or amendment of this listing deadline; or

- seek stockholder approval of the liquidation of the corporation.

If we sought and did not obtain stockholder approval of an extension or amendment to the listing deadline, we would then be required to seek stockholder approval of our liquidation. If we sought and failed to obtain stockholder approval of our liquidation, our charter would not require us to list or liquidate and we could continue to operate as before. If we sought and obtained stockholder approval of our liquidation, we would begin an orderly sale of our properties and distribute our net proceeds to you.

Q: What is the experience of your officers and directors?

A: Our management team has extensive experience investing in and managing commercial real estate. Below is a short description of the background of each of our officers. See the Management Executive Officers and Directors section of this prospectus for a more detailed description of the experience of each of our officers and directors.

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Name	Title	Experience
Leo F. Wells, III	President and Director	Founder of Wells Real Estate Funds and has been involved in real estate sales, management and brokerage services for over 30 years
Douglas P. Williams	Executive Vice President, Secretary, Treasurer and Director	Former accounting executive at OneSource, Inc., a supplier of janitorial and landscape services
Charles R. Brown	Director*	President of CRB Realty Associates, a real estate developer, and former President of Technology Park/Atlanta, Inc., which developed Technology Park/Atlanta, a 600-acre office park
Richard W. Carpenter	Director*	Former President and Chairman of the Board of Southmark Properties, an Atlanta-based REIT investing in commercial properties
Bud Carter	Director*	Former broadcast news director and anchorman and current Senior Vice President for the Executive Committee, an organization established to aid corporate presidents and CEOs
Donald S. Moss	Director*	Former executive officer of Avon Products, Inc.
Jack M. Pinkerton	Director*	Former President of the Pinkerton and Laws Company, which was one of the 200 largest construction companies in the world at the time of his retirement in 1988
Walter W. Sessoms	Director*	Former executive officer of BellSouth Telecommunications, Inc.

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Neil H. Strickland	Director*	Founder of Strickland General Agency, Inc., a property and casualty general insurance agency concentrating on commercial customers
Wayne W. Woody	Director*	Interim Chief Financial Officer for Legacy Investment Group, a boutique investment firm, from 2000 to 2001. Senior Partner with KPMG LLP and predecessor firms, where he enjoyed a 31-year career
Randall D. Fretz	Senior Vice President	Former President of US & Canada operations for Larson-Juhl, a world leader in custom art and picture-framing home decor

* Denotes director is not affiliated with our advisor, Wells Capital.

Q: Will I be notified of how my investment is doing?

A: Yes, we will provide you with periodic updates on the performance of your investment with us, including:

Four detailed quarterly dividend reports;

An annual report;

An annual IRS Form 1099-DIV, if required;

Supplements to the prospectus; and

Three quarterly financial reports.

We will provide this information to you via one or more of the following methods, in our discretion and with your consent, if necessary:

U.S. mail or other courier;

Facsimile;

Electronic delivery; and

Posting on our affiliated website, which is www.wellsref.com.

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Q: When will I get my detailed tax information?

A: Your Form 1099-DIV tax information, if required, will be mailed by January 31 of each year.

Q: Who can help answer my questions?

A: If you have more questions about the offering, or if you would like additional copies of this prospectus, you should contact your registered representative or contact:

Investor Services Department

Wells Real Estate Funds, Inc.

Suite 250

6200 The Corners Parkway

Norcross, Georgia 30092

Telephone: (800) 557-4830 or (770) 243-8282

Fax: (770) 243-8198

E-mail: investor.services@wellsref.com

www.wellsref.com

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PROSPECTUS SUMMARY

This prospectus summary highlights material information contained elsewhere in this prospectus. Because it is a summary, it may not contain all of the information that is important to you. To understand this offering fully, you should read the entire prospectus carefully, including the Risk Factors section and the financial statements, before making a decision to invest in our common stock.

Wells Real Estate Investment Trust II, Inc.

Wells Real Estate Investment Trust II, Inc. is a newly organized Maryland corporation that intends to qualify as a REIT beginning with the taxable year that will end December 31, 2003. We expect to use substantially all of the net proceeds from this offering to acquire and operate commercial real estate primarily consisting of high quality, income-generating office and industrial properties leased to creditworthy companies and governmental entities. Because we have not yet identified any specific properties to purchase, we are considered to be a blind pool.

Our office is located at 6200 The Corners Parkway, Suite 250, Norcross, Georgia 30092. Our telephone number outside the State of Georgia is 800-557-4830 (770-243-8282 in Georgia). Our fax number is (770) 243-8198, and the e-mail address of our investor relations department is investor.services@wellsref.com.

We also maintain an Internet site at www.wellsref.com at which there is additional information about us and our affiliates, but the contents of that site are not incorporated by reference in or otherwise a part of this prospectus.

Our Advisor

Our advisor is Wells Capital, which will be responsible for managing our affairs on a day-to-day basis and for identifying and making acquisitions on our behalf.

Our Management

We have a ten-member board of directors, eight of whom are independent of Wells Capital. Our officers and two of our directors are affiliated with Wells Capital. Our charter, which requires that a majority of our directors be independent of Wells Capital, creates a committee of our board comprised solely of all of our independent directors. This committee, which we call the conflicts committee, is responsible for reviewing the performance of Wells Capital and must approve other matters set forth in our charter. See Conflicts of Interest Certain Conflict Resolution Procedures. Our directors are elected annually by the stockholders.

Our REIT Status

If we qualify as a REIT, we generally will not be subject to federal income tax on income that we distribute to our stockholders. Under the Internal Revenue Code, REITs are subject to numerous organizational and operational requirements, including a requirement that they distribute at least 90% of their annual taxable income to their stockholders. If we fail to qualify for taxation as a REIT in any year, our income will be taxed at regular corporate rates, and we may be precluded from qualifying for treatment as a REIT for the four-year period following our failure to qualify. Even if we qualify as a

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REIT for federal income tax purposes, we may still be subject to state and local taxes on our income and property and to federal income and excise taxes on our undistributed income.

Summary Risk Factors

Following are the most significant risks relating to your investment:

- No public market currently exists for our shares of common stock. If you are able to sell your shares, you would likely have to sell them at a substantial discount from their public offering price.

- We have no operating history, nor do we currently own any properties. We have not identified any properties to acquire with proceeds from this offering.

- If we raise substantially less than the maximum offering, we may not be able to invest in a diverse portfolio of properties, and the value of your investment may vary more widely with the performance of specific properties.

- We are dependent on our advisor to select investments and conduct our operations; thus, adverse changes in the financial health of our advisor or our relationship with our advisor could adversely affect us.

- Our advisor and its affiliates will face conflicts of interest, including significant conflicts created by our advisor s compensation arrangements with us and other Wells-sponsored programs.

- We will pay substantial fees and expenses to our advisor, its affiliates and participating broker-dealers, which payments increase the risk that you will not earn a profit on your investment.

Before you invest in us, you should see the complete discussion of the Risk Factors beginning on page 21 of this prospectus.

Description of Real Estate Investments

We expect to use substantially all of the net proceeds from this offering to acquire and operate commercial real estate primarily consisting of high quality income-generating office and industrial properties leased to creditworthy companies and governmental entities. We may also invest in entities that make similar investments. Leo F. Wells, III, Douglas P. Williams, Randall D. Fretz, Donald A. Miller and David H. Steinwedell, acting through our advisor, Wells Capital, will make most of the decisions regarding our investments. We expect that our conflicts committee will exercise its right to approve or reject each of these investments.

Because we have not yet identified any specific properties to purchase, we are considered to be a blind pool. As we acquire properties, we will supplement this prospectus to describe material changes to our portfolio.

Estimated Use of Proceeds of Offering

Depending primarily on the number of shares we sell in this offering and assuming all shares sold under our dividend reinvestment plan are sold at $9.55 per share, we estimate for each share sold in this

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offering that between $8.65 and $8.83 will be available for the purchase of real estate. We will use the remainder of the offering proceeds to pay the costs of the offering, including selling commissions and the dealer manager fee, and to pay the fee to our advisor for its services in connection with the selection, acquisition, development and construction of properties.

Investment Objectives

Our primary investment objectives are:

- to provide current income for you through the payment of cash dividends; and
- to preserve and return your capital contributions.

We also seek capital gain from our investments. See the Investment Objectives and Criteria section of this prospectus for a more complete description of our investment policies and charter-imposed investment restrictions.

Conflicts of Interest

Wells Capital, as our advisor, will experience conflicts of interest in connection with the management of our business affairs, including the following:

- Wells Capital must determine which investment opportunities to recommend to us or another Wells program or joint venture;
- Wells Capital may structure the terms of joint ventures between us and other Wells-sponsored programs;
- Wells Capital must determine which property and leasing managers to retain and may retain Wells Management, Inc., an affiliate, to manage and lease some or all of our properties;
- Wells Capital and its affiliates will have to allocate their time between us and other real estate programs and activities in which they are involved;
- Wells Capital and its affiliates will receive fees in connection with transactions involving the purchase, management and sale of our properties regardless of the quality of the property acquired or the services provided to us; and

Wells Capital and its affiliates will also receive fees in connection with our public offerings of equity securities.

Our officers and two of our directors will also face these conflicts because of their affiliation with Wells Capital. In addition, our officers and eight of our directors serve as officers and directors of Wells REIT I. See the Conflicts of Interest section of this prospectus for a detailed discussion of the various conflicts of interest relating to your investment, as well as the procedures that we have established to mitigate a number of these potential conflicts.

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The following chart shows the ownership structure of the various Wells entities that are affiliated with Wells Capital.

Prior Offering Summary

As of June 30, 2003, Wells Capital and its affiliates had sponsored 15 publicly offered real estate limited partnerships and Wells REIT I on an unspecified property, or blind pool, basis. As of June 30, 2003, they had raised in excess of $3.5 billion from approximately 108,000 investors in these 16 public real estate programs. The Prior Performance Summary of this prospectus contains a discussion of the Wells programs sponsored to date. We also provide certain statistical data relating to the Wells programs with investment objectives similar to ours in the Prior Performance Tables included at the end of this prospectus.

The Offering

We are offering up to 600,000,000 shares of our common stock in our primary offering at $10 per share, with discounts available for certain categories of purchasers as described in Plan of Distribution below. We are also offering 185,000,000 shares of common stock under our dividend reinvestment plan at the higher of $9.55 or 95% of the estimated value of a share of our common stock, as estimated by our advisor or another firm we choose for that purpose. We will offer shares of common stock in our primary offering until the earlier of November 26, 2005 or the date we sell 600,000,000 shares. We may sell shares under the dividend reinvestment plan beyond November 26, 2005 until we have sold 185,000,000 shares through the reinvestment of dividends. In some states, we may not be able to continue the offering

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for these periods without renewing the registration statement or filing a new registration statement. We may terminate this offering at any time.

We will not sell any shares unless we sell a minimum of 250,000 shares to the public for $10 per share by November 26, 2004. Purchases by our directors, officers, advisor or their affiliates will not count toward meeting this minimum threshold. Pending satisfaction of this condition, all subscription payments will be placed in an account held by the escrow agent, SouthTrust Bank, in trust for subscribers benefit, pending release to us. If we do not sell 250,000 shares to the public for $10 per share by November 26, 2004, we will terminate this offering and return all subscribers funds, plus interest, except as noted below regarding procedures for Pennsylvania investors. Funds in escrow will be invested in short-term investments that mature on or before November 26, 2004 or that can be readily sold or otherwise disposed of for cash by such date without any dissipation of the offering proceeds invested.

Notwithstanding our $2.5 million minimum offering amount for all other jurisdictions, we will not sell any shares to Pennsylvania investors unless we raise a minimum of $200 million in gross offering proceeds (including sales made to residents of other jurisdictions). Pending satisfaction of this condition, all Pennsylvania subscription payments will be placed in an account held by the escrow agent, SouthTrust Bank, in trust for Pennsylvania subscribers benefit, pending release to us. If we have not reached this $200 million threshold within 120 days of the date that we first accept a subscription payment from a Pennsylvania investor, we will, within 10 days of the end of that 120-day period, notify Pennsylvania investors in writing of their right to receive refunds, without interest. If you request a refund within 10 days of receiving that notice, we will arrange for the escrow agent to return promptly by check the funds deposited in the Pennsylvania escrow account (or to return your check if the escrow agent has not yet collected on it) to each subscriber. Amounts held in the Pennsylvania escrow account from Pennsylvania investors not requesting a refund will continue to be held for subsequent 120-day periods until we raise at least $200 million or until the end of the subsequent escrow periods. At the end of each subsequent escrow period, we will again notify you of your right to receive refunds with interest from the day after the expiration of the initial 120-day period.

Compensation to Wells Capital and its Affiliates

Wells Capital and its affiliates will receive compensation and reimbursement for services relating to this offering and the investment and management of our assets. The most significant items of compensation are included in the table below. The selling commissions and dealer manager fee may vary for different categories of purchasers. See Plan of Distribution. This table assumes the shares are sold through distribution channels associated with the highest possible selling commissions and dealer manager fees and assumes a $9.55 price for each share sold through our dividend reinvestment program.

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Type of Compensation	*Determination of Amount*	*Estimated Amount for Maximum Offering (785,000,000 shares)*
	Offering Stage	
Selling Commissions	7.0% of gross offering proceeds in primary offering and 5% of gross proceeds from sales under dividend reinvestment plan; all selling commissions will be reallowed to participating broker-dealers	$ 508,337,500
Dealer Manager Fee	Up to 2.5% of gross offering proceeds	$ 150,000,000
Other Organization and Offering Expenses	Up to 2.0% of gross offering proceeds	$ 34,778,830
	Acquisition and Development Stage	
Acquisition Fees	2.0% of gross offering proceeds	$ 155,335,000
	Operational Stage	
Asset Management Fees	Monthly fee equal to one-twelfth of 0.75% of the sum of the cost of all occupied properties we own plus the cost of investments in joint ventures, provided that the amount paid in any calendar quarter may not exceed 1.0% of the net asset value of those investments at quarter end after deducting debt used to acquire or refinance properties; plus costs and expenses incurred by advisor in providing asset-management services	N/A
Property Management Fee	If we retain Wells Management to manage and lease some of our properties, we will pay a market-based property management fee, which may include reimbursement of Wells Management s personnel costs and other costs of managing the properties. Wells Management may also receive a fee for the initial leasing of newly constructed properties, which would generally equal one month s rent.	N/A
Operating Expenses	Reimbursement of our advisor s cost of providing administrative services	N/A

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Type of Compensation	*Determination of Amount*	*Estimated Amount for Maximum Offering (785,000,000 shares)*
	Liquidation/Listing Stage	
Real Estate Commissions	Up to 3.0% of contract price for property sold for substantial assistance in connection with sale	N/A
Subordinated Participation In Net Sale Proceeds (payable only if we are not listed on an exchange)	10.0% of remaining net sale proceeds after return of capital plus payment to investors of an 8.0% cumulative, non-compounded return on the capital contributed by investors	N/A
Subordinated Incentive Listing Fee (payable only if we are listed on an exchange)	10.0% of the amount by which our adjusted market value plus distributions exceeds the aggregate capital contributed by investors plus an amount equal to an 8.0% cumulative, non-compounded return to investors	N/A

Dividend Policy

To maintain our qualification as a REIT, we are required to make aggregate annual distributions to our stockholders of at least 90% of our taxable income (which does not necessarily equal net income as calculated in accordance with GAAP). Our board of directors may authorize distributions in excess of those required for us to maintain REIT status depending on our financial condition and such other factors as our board of directors deems relevant. We have not established a minimum distribution level. We expect to calculate our quarterly dividends based upon daily record and dividend declaration dates so investors may be entitled to dividends immediately upon purchasing our shares.

Listing

We will seek to list our shares of common stock when our independent directors believe listing would be in the best interest of our stockholders. If we do not list our shares of common stock on a national securities exchange or on the Nasdaq National Market by October 2015, our charter requires that we either:

seek stockholder approval of an extension or amendment of this listing deadline; or

seek stockholder approval of the liquidation of the corporation.

If we sought and did not obtain stockholder approval of an extension or amendment to the listing deadline, we would then be required to seek stockholder approval of our liquidation. If we sought and failed to obtain stockholder approval of our liquidation, our charter would not require us to list or liquidate and we could continue to operate as before. If we sought and obtained stockholder approval of our liquidation, we would begin an orderly sale of our properties and distribute our net proceeds to you.

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Dividend Reinvestment Plan

Under our dividend reinvestment plan, you may have the dividends you receive reinvested in additional shares of our common stock. The purchase price per share under our dividend reinvestment plan will be the higher of $9.55 or 95% of the estimated value of a share of our common stock, as estimated by our advisor or another firm we choose for that purpose. Although we will not pay the 5% selling commissions in connection with sales to certain categories of purchasers, the price for all categories of purchasers will be the same. If you participate in the dividend reinvestment plan, you will not receive the cash from your dividends. As a result, you may have a tax liability with respect to your share of our taxable income, but you will not receive cash dividends to pay such liability. We may terminate the dividend reinvestment plan at our discretion at any time upon 10 days prior written notice to you.

Proposed Share Redemption Program

Our board of directors has approved a share redemption program that could enable our stockholders to sell their shares to us in limited circumstances. However, we will not adopt the program during this primary offering or any subsequent primary offering unless the SEC grants us exemptive relief from restrictions on issuer repurchases during a distribution.

Even if we adopt the proposed share redemption program, there would be numerous restrictions on your ability to sell your shares to us under the proposed program. You generally would have to hold your shares for one year before selling your shares to us under the plan. In addition, we would limit the number of shares redeemed pursuant to our proposed share redemption program as follows: (1) during any calendar year, we would not redeem in excess of 5% of the weighted average number of shares outstanding during the prior calendar year; and (2) funding for the redemption of shares would come exclusively from the net proceeds we received from the sale of shares under our dividend reinvestment plan. These limits may prevent us from accommodating all requests made in any year. For three years after we complete this offering or any subsequent public equity offerings we commence within one year of the completion of a public equity offering, the price at which we would repurchase your stock would be $8.40 per share. Thereafter, the redemption price would equal 95% of our per share value as estimated by Wells Capital or another financial advisor or valuation firm we chose for this purpose. The proposed share redemption program would have different rules if shares were being redeemed in connection with the death of a stockholder. See Description of Shares Proposed Share Redemption Program for more information about the proposed share redemption program. Our board of directors could amend or terminate the proposed share redemption program with 30 days advance notice.

Wells Operating Partnership II, L.P.

We expect to own substantially all of our real estate properties through Wells Operating Partnership II, L.P. (Wells OP II), our operating partnership. We are the sole general partner of Wells OP II. Wells Capital has purchased $200,000 of limited partner units in Wells OP II. This UPREIT structure may allow sellers of properties to transfer their properties to Wells OP II in exchange for limited partnership interests of Wells OP II and defer gain recognition for tax purposes with respect to such transfers of properties. The holders of units in Wells OP II may have their units redeemed for cash or, at our option, shares of our common stock. At present, we have no plans to acquire any specific properties in exchange for units of Wells OP II.

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ERISA Considerations

The section of this prospectus entitled ERISA Considerations describes the effect the purchase of shares will have on individual retirement accounts and retirement plans subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA), and/or the Internal Revenue Code. ERISA is a federal law that regulates the operation of certain tax-advantaged retirement plans. Any retirement plan trustee or individual considering purchasing shares for a retirement plan or an individual retirement account should read this section of the prospectus very carefully.

Description of Shares

Uncertificated Shares

Our board of directors has authorized the issuance of shares of our capital stock without certificates. We expect that, until our shares are listed on a national securities exchange or the Nasdaq National Market, we will not issue shares in certificated form. We maintain a stock ledger that contains the name and address of each stockholder and the number of shares that the stockholder holds. With respect to uncertificated stock, we will continue to treat the stockholder registered on our stock ledger as the owner of the shares until the new owner delivers a properly executed form to us, which we will provide to any registered holder upon request.

Stockholder Voting Rights and Limitations

We intend to hold annual meetings of our stockholders for the purpose of electing our directors or conducting other business matters that may be presented at such meetings. We may also call a special meeting of stockholders from time to time. You are entitled to one vote for each share of common stock you own at any of these meetings.

Restriction on Share Ownership

Our charter contains restrictions on ownership of the shares that prevent any one person from owning more than 9.8% of our outstanding shares unless exempted by our board of directors. These restrictions are designed to enable us to comply with ownership restrictions imposed on reits by the internal revenue code. see Description of Shares Restriction on Ownership of Shares. Our charter also limits your ability to transfer your shares to prospective stockholders unless (i) they meet suitability standards regarding income or net worth, which are described above at Suitability Standards immediately following the cover page of this prospectus, and (ii) the transfer complies with minimum purchase requirements, which are described below at Plan of Distribution Minimum Purchase Requirements.

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RISK FACTORS

An investment in our common stock involves various risks and uncertainties. You should carefully consider the following risk factors in conjunction with the other information contained in this prospectus before purchasing our common stock. The risks discussed in this prospectus can adversely affect our business, operating results, prospects and financial condition. This could cause the value of our common stock to decline and could cause you to lose all or part of your investment. The risks and uncertainties described below are not the only ones we face but do represent those risks and uncertainties that we believe are material to our business, operating results, prospects and financial condition. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also harm our business.

Risks Related to an Investment In Us

There is no public trading market for your shares; therefore, it will be difficult for you to sell your shares.

There is no current public market for the shares. You may not sell your shares unless the buyer meets applicable suitability and minimum purchase standards. Our charter also prohibits the ownership of more than 9.8% of our stock, unless exempted by our board of directors, which may inhibit large investors from desiring to purchase your shares. Moreover, we have delayed adoption of our proposed share redemption program until the earlier of (i) the completion of this primary offering, which may last until November 26, 2005, or (ii) the receipt by us of SEC exemptive relief from rules restricting issuer purchases during distributions, which relief we may not be able to obtain. Even when one of these conditions is met, our board of directors could choose not to adopt the proposed share redemption program or to amend its proposed terms without stockholder approval. Our board would also be free to amend or terminate the program upon 30 days notice after its adoption. In addition, the proposed share redemption program includes numerous restrictions that would limit your ability to sell your shares. We describe these restrictions in more detail under Description of Shares Proposed Share Redemption Program. Therefore, it will be difficult for you to sell your shares promptly or at all. If you are able to sell your shares, you would likely have to sell them at a substantial discount to their public offering price. It is also likely that your shares would not be accepted as the primary collateral for a loan. You should purchase the shares only as a long-term investment because of the illiquid nature of the shares.

If we are unable to find suitable investments, we may not be able to achieve our investment objectives or pay dividends.

Our ability to achieve our investment objectives and to pay dividends depends upon the performance of Wells Capital, our advisor, in the acquisition of our investments and the determination of any financing arrangements and upon the performance of our property managers in the selection of tenants and negotiation of leasing arrangements. Except for the investments described in one or more supplements to this prospectus, you will have no opportunity to evaluate the terms of transactions or other economic or financial data concerning our investments. You must rely entirely on the management abilities of Wells Capital, the property managers Wells Capital selects (which may include Wells Management) and the oversight of our board of directors. We cannot be sure that Wells Capital will be successful in obtaining suitable investments on financially attractive terms or that, if Wells Capital makes investments on our behalf, our objectives will be achieved. The more money we raise in this offering, the greater will be our challenge to invest all of the net offering proceeds on attractive terms. Therefore, the large size of this offering increases the risk that we may pay too much for real estate acquisitions.

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If we, through Wells Capital, are unable to find suitable investments promptly, we will hold the proceeds from this offering in an interest-bearing account or invest the proceeds in short-term, investment-grade investments and may, ultimately, liquidate. In such an event, our ability to pay dividends to our stockholders would be adversely affected.

We may suffer from delays in locating suitable investments, which could adversely affect our ability to make distributions and the value of your investment.

We could suffer from delays in locating suitable investments, particularly as a result of our reliance on our advisor at times when management of our advisor is simultaneously seeking to locate suitable investments for other affiliated programs. Of course, the more money we raise in this offering, the more difficult it will be to invest the net offering proceeds promptly. Therefore, the large size of this offering increases the risk of delays in investing our net offering proceeds. Delays we encounter in the selection, acquisition and development of income-producing properties would likely adversely affect our ability to pay dividends to our stockholders and our stockholders overall returns. This, in turn, would reduce the value of your investment. In particular, where we acquire properties prior to the start of construction or during the early stages of construction, it will typically take several months to complete construction and rent available space. Therefore, you could suffer delays in the distribution of cash dividends attributable to those particular properties. You should expect to wait several months after the closing of a property acquisition before we are in a position to pay cash dividends attributable to such property.

Because this is a blind pool offering, you will not have the opportunity to evaluate our investments before we make them, which makes your investment more speculative.

Because we have not yet acquired or identified any investments that we may make, we are not able to provide you with information to evaluate our investments prior to acquisition. We will seek to invest substantially all of the offering proceeds available for investment, after the payment of fees and expenses, in the acquisition of commercial properties. However, you will be unable to evaluate the economic merit of real estate projects before we invest in them and will be entirely relying on the ability of our advisor to select well-performing investment properties. Furthermore, our board of directors will have broad discretion in implementing policies regarding tenant or mortgagor creditworthiness, and you will not have the opportunity to evaluate potential tenants, managers or borrowers. These factors increase the risk that your investment may not generate returns comparable to our competitors.

If we are unable to raise substantial funds, we will be limited in the number and type of investments we may make, and the value of your investment in us will fluctuate with the performance of the specific properties we acquire.

This offering is being made on a best efforts basis, whereby the brokers participating in the offering are only required to use their best efforts to sell our shares and have no firm commitment or obligation to purchase any of the shares. As a result, the amount of proceeds we raise in this offering may be substantially less than the amount we would need to achieve a broadly diversified property portfolio. We may be unable to raise even the minimum offering amount. If we are unable to raise substantially more than the minimum offering amount, we will make fewer investments resulting in less diversification in terms of the number of investments owned, the geographic regions in which our investments are located and the types of investments that we make. In that case, the likelihood that any single property s performance would adversely affect our profitability will increase. For example, if we only raise the minimum amount of $2.5

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million, we will most likely make our investments through one or more joint ventures and may only be able to make one investment. If we only make one investment, we would not achieve any asset diversification. Additionally, we are not limited in the number or size of our investments or the percentage of net proceeds we may dedicate to a single investment. Your investment in our shares will be subject to greater risk to the extent that we lack a diversified portfolio of investments. In addition, our inability to raise substantial funds would increase our fixed operating expenses as a percentage of gross income, and our financial condition and ability to pay distributions could be adversely affected.

Our lack of prior operating history or established financing sources hinders your ability to evaluate this investment.

We have no operating history. You should not rely upon the past performance of other real estate investment programs our advisor or its affiliates sponsored. Such past performance may not predict our future results. We were incorporated in July 2003, and as of the date of this prospectus we have not made any investments in real estate or otherwise. This lack of operating history significantly increases the risk and uncertainty you face in making an investment in our shares.

Our loss of or inability to obtain key personnel could delay or hinder implementation of our investment strategies, which could adversely affect our ability to make distributions and the value of your investment.

Our success depends to a significant degree upon the contributions of Leo F. Wells, III, Douglas P. Williams and Randall D. Fretz, each of whom would be difficult to replace. We do not have employment agreements with Messrs. Wells, Williams or Fretz, and we cannot guarantee that such persons will remain affiliated with us. Although Messrs. Wells, Williams and Fretz have entered into employment agreements with Wells Capital, these agreements are terminable at will by either party; thus, such persons may not remain affiliated with Wells Capital or us. If any of our key personnel were to cease their affiliation with us, we may be unable to find suitable replacement personnel, and our operating results could suffer. We do not intend to maintain key person life insurance on any person. We believe that our future success depends, in large part, upon our advisor s and our property managers ability to hire and retain highly skilled managerial, operational and marketing personnel. Competition for such personnel is intense, and our advisor and any property managers we retain may be unsuccessful in attracting and retaining such skilled personnel. Further, we intend to establish strategic relationships with firms that have special expertise in certain services or as to real properties in certain geographic regions. Maintaining such relationships will be important for us to effectively compete with other investors for properties in such regions. We may be unsuccessful in attracting and retaining such relationships. If we lose or are unable to obtain the services of highly skilled personnel or do not establish or maintain appropriate strategic relationships, our ability to implement our investment strategies could be delayed or hindered, and the value of your investment may decline.

Our rights and the rights of our stockholders to recover claims against our independent directors are limited, which could reduce your and our recovery against them if they negligently cause us to incur losses.

Maryland law provides that a director has no liability in that capacity if he performs his duties in good faith, in a manner he reasonably believes to be in our best interests and with the care that an ordinarily prudent person in a like position would use under similar circumstances. Our charter provides that no independent director shall be liable to us or our stockholders for

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monetary damages and that we will generally indemnify them for losses unless they are grossly negligent or engage in willful misconduct. As a result, you and we may have more limited rights against our independent directors than might otherwise exist under common law, which could reduce your and our recovery from these persons if they act in a negligent manner. In addition, we may be obligated to fund the defense costs incurred by our independent directors (as well as by our other directors, officers, employees and agents) in some cases, which would decrease the cash otherwise available for distributions to you.

Risks Related to Conflicts of Interest

Wells Capital and possibly Wells Management will face conflicts of interest relating to the purchase and leasing of properties, and such conflicts may not be resolved in our favor, which could adversely affect our investment opportunities and hence our ability to pay dividends.

We rely on our advisor to identify suitable investment opportunities. Other Wells-sponsored programs, especially those that are currently raising offering proceeds, such as Wells Fund XIV and Wells REIT I, also rely on Wells Capital for investment opportunities. Many investment opportunities would be suitable for us as well as other Wells programs. If Wells Capital directs an investment opportunity to a Wells-sponsored program, it is to offer the investment opportunity to the program for which the opportunity, in the discretion of Wells Capital, is most suitable. Likewise, we may rely at least in part on Wells Management to attract and retain creditworthy tenants. Other Wells-sponsored programs rely on Wells Management for the same tasks. If Wells Management directs creditworthy prospective tenants to another Wells-sponsored program where it could direct such tenants to our properties, our tenant base may have more inherent risk than might otherwise be the case. Our charter disclaims any interest in an investment opportunity known to Wells Capital that Wells Capital has not recommended to us. Wells Capital could direct attractive investment opportunities to other entities or even make such investments for its own account. Wells Management could direct attractive tenants to other entities. Such events could result in our investing in properties that provide less attractive returns or leasing properties to tenants that are more likely to default under their leases, thus reducing the level of dividends we may be able to pay you.

Wells Capital will face conflicts of interest relating to joint ventures that we may form with affiliates of Wells Capital, which conflicts could result in a disproportionate benefit to the other venture partners at our expense.

We are likely to enter into joint venture agreements with other Wells programs for the acquisition, development or improvement of properties. Wells Capital may have conflicts of interest in determining which Wells program should enter into any particular joint venture agreement. The co-venturer may have economic or business interests or goals that are or may become inconsistent with our business interests or goals. In addition, Wells Capital may face a conflict in structuring the terms of the relationship between our interests and the interest of the affiliated co-venturer and in managing the joint venture. Since Wells Capital and its affiliates will control both the affiliated co-venturer and, to a certain extent, us, agreements and transactions between the co-venturers with respect to any such joint venture will not have the benefit of arm s-length negotiation of the type normally conducted between unrelated co-venturers. Co-venturers may thus benefit to our and your detriment.

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Wells Capital, its affiliates and our officers will face competing demands relating to their time, and this may cause our operations to suffer.

We rely on Wells Capital and its affiliates for the day-to-day operation of our business. Wells Capital and its affiliates, including our officers, have interests in other Wells programs and engage in other business activities. As a result, they will have conflicts of interest in allocating their time between us and other Wells programs and activities in which they are involved. Because these persons have competing interests on their time and resources, they may have conflicts of interest in allocating their time between our business and these other activities. During times of intense activity in other programs and ventures, they may devote less time and fewer resources to our business than are necessary or appropriate to manage our business. If this occurs, the returns on our investments may suffer.

Our officers and some of our directors face conflicts of interest related to the positions they hold with Wells Capital and its affiliates, which could hinder our ability to successfully implement our business strategy and to generate returns to you.

Our executive officers and some of our directors are also officers and directors of our advisor, our dealer manager and other affiliated entities. As a result, they owe fiduciary duties to these various entities and their stockholders and limited partners, which fiduciary duties may from time to time conflict with the fiduciary duties that they owe to us and our stockholders. Their loyalties to these other entities could result in actions or inactions that are detrimental to our business, which could harm the implementation of our business strategy and our investment and leasing opportunities. If we do not successfully implement our business strategy, we may be unable to generate cash needed to make distributions to you and to maintain or increase the value of our assets.

Wells Capital and its affiliates, including our officers and some of our directors, will face conflicts of interest caused by compensation arrangements with us and other Wells-sponsored programs, which could result in actions that are not in the long-term best interests of our stockholders.

Wells Capital and its affiliates will receive substantial fees from us. These fees could influence our advisor s advice to us, as well as the judgment of the affiliates of Wells Capital who serve as our officers or directors. Among other matters, the compensation arrangements could affect their judgment with respect to:

- the continuation, renewal or enforcement of our agreements with Wells Capital and its affiliates, including the advisory agreement, the dealer manager agreement and any property management and leasing agreement;
- public offerings of equity by us, which entitle Wells Investment Securities to dealer manager fees and entitle Wells Capital to increased acquisition and asset management fees;
- property sales, which entitle Wells Capital to real estate commissions and possible success-based sale fees;
- property acquisitions from other Wells-sponsored programs, which might entitle Wells Capital to real estate commissions and possible success-based sale fees in connection with its services for the seller;

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property acquisitions from third parties, which utilize proceeds from our public offerings, thereby increasing the likelihood of continued equity offerings and related fee income for Wells Investment Securities and Wells Capital;

whether and when we seek to list our common stock on a national securities exchange or the Nasdaq National Market, which listing could entitle Wells Capital to a success-based listing fee but could also adversely affect its sales efforts for other programs if the price at which our shares trade is lower than the price at which we offered shares to the public; and

whether and when we seek to sell the company or its assets, which sale could entitle Wells Capital to a success-based fee but could also adversely affect its sales efforts for other programs if the sales price for the company or its assets resulted in proceeds less than the amount needed to preserve our stockholders capital.

The acquisition fees paid to Wells Capital and management and leasing fees that would be paid to its affiliate, Wells Management, if Wells Management were retained to manage some of our properties, will be paid irrespective of the quality of their acquisition or property-management services during the term of the related agreement. Moreover, Wells Capital and Wells Management will have considerable discretion with respect to the terms and timing of acquisition, disposition and leasing transactions. Considerations relating to their compensation from other programs could result in decisions that are not in the best interests of our stockholders, which could hurt our ability to pay you dividends or result in a decline in the value of your investment.

Our board s loyalties to Wells REIT I (and possibly to future Wells-sponsored programs) could influence its judgment.

Eight of our ten directors are also directors of Wells REIT I. The loyalties of those eight directors to Wells REIT I may influence the judgment of our board when considering issues for us that may affect Wells REIT I, such as the following:

The conflicts committee of the board of directors must evaluate the performance of Wells Capital with respect to whether Wells Capital is presenting to us our fair share of investment opportunities. If our advisor is not presenting a sufficient number of investment opportunities to us because it is presenting many opportunities to Wells REIT I or if our advisor is giving preferential treatment to Wells REIT I in this regard, our conflicts committee may not be well suited to enforce our rights under the terms of the advisory agreement or to seek a new advisor.

The conflicts committee may have to make a similar evaluation with respect to the performance of Wells Management if we retain Wells Management to manage and lease any of our properties. If Wells Management is not performing well as our property manager because of its services for Wells REIT I, the divided loyalties of the members of our conflicts committee could adversely affect their willingness to insist on improvement in the performance of Wells Management or to seek another property manager.

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The conflicts committee will likely decide whether we purchase a property. This decision could be influenced by the hope that Wells Capital would present the opportunity to Wells REIT I if we did not pursue it.

We could enter into transactions with Wells REIT I, such as property sales or acquisitions, joint ventures or financing arrangements. Decisions of the board or the conflicts committee regarding the terms of those transactions may be influenced by the board s or committee s loyalties to Wells REIT I.

A decision of the board or the conflicts committee regarding the timing of a debt or equity offering could be influenced by concerns that the offering would compete with an offering of Wells REIT I.

A decision of the board or the conflicts committee regarding the timing of property sales could be influenced by concerns that the sales would compete with those of Wells REIT I.

We could also face similar conflicts if our promoters sponsor additional REITs, such as Wells Real Estate Investment Trust III, Inc. See Conflicts of Interest Our Advisor s Interest in Other Wells Real Estate Programs General.

Our operating performance could suffer if Wells Capital incurs significant losses, including those losses that may result from being the general partner of other entities.

We are dependent on Wells Capital to select investments and conduct our operations; thus, adverse changes in the financial health of Wells Capital or our relationship with Wells Capital could adversely affect us. As a general partner to many Well-sponsored programs, Wells Capital may have contingent liability for the obligations of such partnerships. Enforcement of such obligations against Wells Capital could result in a substantial reduction of its net worth. If such liabilities affected the level of services that Wells Capital could provide, our operations and financial performance could suffer as well, which would adversely affect your ability to receive distributions and the value of your investment.

There is no separate counsel for our affiliates and us, which could result in conflicts of interest and our pursuit of actions not in our stockholders best interests.

Alston & Bird LLP is counsel both to us and to Wells Capital and its affiliates, including Wells Investment Securities, Wells Management Company and Wells Development Corporation. As discussed above, there is a possibility that the interests of the various parties may conflict. If we do not obtain separate counsel when our interests conflict with those of Wells Capital and its affiliates, our counsel s loyalties to Wells Capital and its affiliates could interfere with its independent professional judgment in considering alternatives that we should pursue, which could result in our pursuing courses of action that are not in our stockholders best interests.

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Risks Related to This Offering and Our Corporate Structure

Our charter limits the number of shares a person may own, which may discourage a takeover that could otherwise result in a premium price to our stockholders.

Our charter, with certain exceptions, authorizes our directors to take such actions as are necessary and desirable to preserve our qualification as a REIT. Unless exempted by our board of directors, no person may own more than 9.8% of our outstanding common stock. This restriction may have the effect of delaying, deferring or preventing a change in control of us, including an extraordinary transaction (such as a merger, tender offer or sale of all or substantially all of our assets) that might provide a premium price for holders of our common stock.

Our charter permits our board of directors to issue stock with terms that may subordinate the rights of our common stockholders or discourage a third party from acquiring us in a manner that could result in a premium price to our stockholders.

Our board of directors may classify or reclassify any unissued common stock or preferred stock and establish the preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends and other distributions, qualifications and terms or conditions of redemption of any such stock. Thus, our board of directors could authorize the issuance of preferred stock with terms and conditions that could have priority as to distributions and amounts payable upon liquidation over the rights of the holders of our common stock. Such preferred stock could also have the effect of delaying, deferring or preventing a change in control of us, including an extraordinary transaction (such as a merger, tender offer or sale of all or substantially all of our assets) that might provide a premium price to holders of our common stock.

Your investment return may be reduced if we are required to register as an investment company under the Investment Company Act; if we become an unregistered investment company, we could not continue our business.

We do not intend to register as an investment company under the Investment Company Act of 1940, as amended. If we were obligated to register as an investment company, we would have to comply with a variety of substantive requirements under the Investment Company Act that impose, among other things:

- limitations on capital structure;
- restrictions on specified investments;
- prohibitions on transactions with affiliates; and
- compliance with reporting, record keeping, voting, proxy disclosure and other rules and regulations that would significantly increase our operating expenses.

In order to maintain our exemption from regulation under the Investment Company Act, we must engage primarily in the business of buying real estate, and these investments must be made within a year after this offering ends. If we are unable to invest a significant portion of the proceeds of this offering in properties within one year of the termination of this offering, we may avoid being required to register as an investment company by temporarily investing any unused

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proceeds in government securities with low returns. This would reduce the cash available for distribution to investors and possibly lower your returns.

To maintain compliance with the Investment Company Act exemption, we may be unable to sell assets we would otherwise want to sell and may need to sell assets we would otherwise wish to retain. In addition, we may have to acquire additional income or loss generating assets that we might not otherwise have acquired or may have to forego opportunities to acquire interests in companies that we would otherwise want to acquire and would be important to our investment strategy. If we were required to register as an investment company but failed to do so, we would be prohibited from engaging in our business, and criminal and civil actions could be brought against us. In addition, our contracts would be unenforceable unless a court required enforcement, and a court could appoint a receiver to take control of us and liquidate our business.

You will have limited control over changes in our policies and operations.

Our board of directors determines our major policies, including our policies regarding financing, growth, debt capitalization, REIT qualification and distributions. Our board of directors may amend or revise these and other policies without a vote of the stockholders. Under the Maryland General Corporation Law and our charter, our stockholders have a right to vote only on limited matters. Our board s broad discretion in setting policies and our stockholders inability to exert control over those policies increases the uncertainty and risks you face as a stockholder.

You may not be able to sell your shares under the proposed share redemption program.

We will not adopt the proposed share redemption program until the earlier of (i) the completion of this primary offering, which may last until November 26, 2005, or (ii) the receipt by us of SEC exemptive relief from rules restricting issuer purchases during distributions, which relief we may never obtain. Even when one of these conditions is met, our board of directors could choose not to adopt the proposed share redemption program or to amend its proposed terms without stockholder approval. Our board would also be free to amend or terminate the program upon 30 days notice after its adoption. In addition, the proposed share redemption program includes numerous restrictions that would limit your ability to sell your shares.

Generally, you would have to have held your shares for at least one year in order to participate in our proposed share redemption program. Subject to funds being available, we would limit the number of shares redeemed pursuant to our proposed share redemption program as follows: (1) during any calendar year, we would not redeem in excess of 5% of the weighted average number of shares outstanding during the prior calendar year; and (2) funding for the redemption of shares would come exclusively from the net proceeds we received from the sale of shares under our dividend reinvestment plan. These limits might prevent us from accommodating all redemption requests made in any year. Furthermore, for three years after we complete this offering or any subsequent public equity offerings we commence within one year of the completion of a public equity offering, the price at which we would repurchase your stock would be $8.40 per share. Thereafter, the redemption price would equal 95% of our per share value as estimated by Wells Capital or another firm we chose for that purpose. The share redemption program would have different rules if shares were being redeemed in connection with the death of a stockholder. See Description of Shares Proposed Share Redemption Program for more information about the proposed share redemption program. Even if we adopt the proposed share redemption program, these restrictions would severely limit your ability to sell your shares should you require liquidity and would limit your ability to recover the value you invested.

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The offering price was not established on an independent basis; the actual value of your investment may be substantially less than what you pay.

The selling price of the shares bears no relationship to our book or asset values or to any other established criteria for valuing shares. The board of directors considered the following factors in determining the offering price:

- the offering price of Wells REIT I;
- the range of offering prices of comparable unlisted REITs; and
- the recommendation of the dealer manager.

Because the offering price is not based upon any independent valuation, the offering price may not be indicative of the proceeds that you would receive upon liquidation. Further, the offering price may be significantly more than the price at which the shares would trade if they were to be listed on an exchange or actively traded by broker-dealers.

Because the dealer manager is one of our affiliates, you will not have the benefit of an independent review of us or the prospectus customarily undertaken in underwritten offerings.

The dealer manager, Wells Investment Securities, is one of our affiliates and will not make an independent review of us or the offering. Accordingly, you do not have the benefit of an independent review of the terms of this offering. Further, the due diligence investigation of us by the dealer manager cannot be considered to be an independent review and, therefore, may not be as meaningful as a review conducted by an unaffiliated broker-dealer or investment banker.

Your interest in us will be diluted if we issue additional shares.

Potential investors in this offering do not have preemptive rights to any shares we issue in the future. Our charter authorizes us to issue 1,000,000,000 shares of capital stock, of which 900,000,000 shares are designated as common stock and 100,000,000 are designated as preferred stock. Our board of directors may increase the number of authorized shares of capital stock without stockholder approval. After your purchase in this offering, our board may elect to (1) sell additional shares in this or future public offerings, (2) issue equity interests in private offerings, (3) issue shares of our common stock upon the exercise of the options we may grant to our independent directors or to Wells Capital or Wells Management employees, (4) issue shares to our advisor, its successors or assigns, in payment of an outstanding fee obligation, or (5) issue shares of our common stock to sellers of properties we acquire in connection with an exchange of limited partnership interests of Wells OP II. To the extent we issue additional equity interests after your purchase in this offering, your equity interest in us will be diluted.

Payment of fees to Wells Capital and its affiliates will reduce cash available for investment and distribution.

Wells Capital and its affiliates will perform services for us in connection with the offer and sale of the shares, the selection and acquisition of our investments, the management and leasing of our properties and the administration of our other investments and possibly the management and leasing of our properties. We will pay them substantial fees for these services, which will result in immediate dilution to the value of your investment and will reduce the

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amount of cash available for investment in properties or distribution to stockholders. As a result of these substantial fees, we expect that for each share sold in this offering only between $8.65 and $8.83 will be available for the purchase of real estate, depending primarily upon the number of shares we sell and assuming all shares sold under the dividend reinvestment plan are sold for $9.55 per share. Therefore, these fees increase the risk that the amount available for distribution to common stockholders upon a liquidation of our portfolio would be less than the purchase price of the shares in this offering. Substantial up-front fees also increase the risk that you will not be able to resell your shares at a profit, even if our shares are listed on a national securities exchange or on the Nasdaq National Market.

We may be unable to pay or maintain cash distributions or increase distributions over time.

There are many factors that can affect the availability and timing of cash distributions to you. We will make distributions principally from cash available from our operations. With no prior operations, no one can predict the amount of distributions you may receive. We may be unable to pay or maintain cash distributions or increase distributions over time.

Adverse economic and geopolitical conditions could negatively affect our returns and profitability.

Recent geopolitical events have exacerbated the general economic slowdown that has affected the nation as a whole and the local economies where our properties may be located. The following market and economic challenges may adversely affect our operating results:

- poor economic times may result in tenant defaults under leases;
- job transfers and layoffs may increase vacancies;
- maintaining occupancy levels may require increased concessions or reduced rental rates; and
- increased insurance premiums, resulting in part from the increased risk of terrorism, may reduce funds available for distribution or, to the extent we can pass such increases through to tenants, may lead to tenant defaults. Increased insurance premiums also may make it difficult to increase rents to tenants on turnover, which may adversely affect our ability to increase our returns.

Our operations could be negatively affected to the extent that an economic downturn is prolonged or becomes more severe.

If we are unable to obtain funding for future capital needs, cash distributions to our stockholders and the value of our investments could decline.

When tenants do not renew their leases or otherwise vacate their space, we will often need to expend substantial funds for tenant improvements to the vacated space in order to attract replacement tenants. In addition, although we expect that our leases with tenants will require tenants to pay routine property maintenance costs, we will likely be responsible for any major structural repairs, such as repairs to the foundation, exterior walls and rooftops.

We will use substantially all of this offering s gross proceeds to buy real estate and pay various fees and expenses. We do not intend to reserve any proceeds from this offering for future

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capital needs. Accordingly, if we need additional capital in the future to improve or maintain our properties or for any other reason, we will have to obtain financing from other sources, such as cash flow from operations, borrowings, property sales or future equity offerings. These sources of funding may not be available on attractive terms or at all. If we cannot procure additional funding for capital improvements, our investments may generate lower cash flows or decline in value, or both.

You may be more likely to sustain a loss on your investment because our promoters do not have as strong an economic incentive to avoid losses as do promoters who have made significant equity investments in their company.

Our promoters have only invested $201,000 in us, which investment was made primarily through a purchase of limited partnership interests in our operating partnership, Wells OP II. Therefore, if we are successful in raising enough proceeds to be able to reimburse our promoters for our significant organization and offering expenses, our promoters have little exposure to losses in the value of our shares. Without this exposure, our investors may be at a greater risk of loss because our promoters do not have as much to lose from a decrease in the value of our shares as do those promoters who make more significant equity investments in their companies.

General Risks Related To Investments In Real Estate

Economic and regulatory changes that impact the real estate market may adversely affect our operating results and the value of our real estate properties.

Our operating results will be subject to risks generally incident to the ownership of real estate, including:

- changes in general or local economic conditions;
- changes in supply of or demand for similar or competing properties in an area;
- changes in interest rates and availability of permanent mortgage funds which may render the sale of a property difficult or unattractive;
- changes in tax, real estate, environmental and zoning laws; and
- periods of high interest rates and tight money supply.

These and other reasons may prevent us from being profitable or from realizing growth or maintaining the value of our real estate properties.

Properties that have significant vacancies could be difficult to sell, which could diminish the return on your investment.

A property may incur vacancies either by the continued default of tenants under their leases or the expiration of tenant leases. If vacancies continue for a long period of time, we may suffer reduced revenues resulting in less cash available to distribute to stockholders. In addition, because properties market values depend principally upon the value of the properties leases, the resale value of properties with high or prolonged vacancies could suffer, which could further reduce your return.

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We depend on tenants for our revenue, and lease terminations could reduce our distributions to our stockholders.

The success of our investments materially depends on the financial stability of our tenants. A default by a significant tenant on its lease payments to us would cause us to lose the revenue associated with such lease and require us to find an alternative source of revenue to meet mortgage payments and prevent a foreclosure if the property is subject to a mortgage. In the event of a tenant default or bankruptcy, we may experience delays in enforcing our rights as landlord and may incur substantial costs in protecting our investment and re-letting our property. If significant leases are terminated, we may be unable to lease the property for the rent previously received or sell the property without incurring a loss. These events could cause us to reduce the amount of distributions to stockholders.

Our inability to sell a property when we want could adversely impact our ability to pay cash distributions to you.

General economic conditions, availability of financing, interest rates and other factors, including supply and demand, all of which are beyond our control, affect the real estate market. We may be unable to sell a property for the price, on the terms, or within the time frame we want. That inability could adversely affect our cash flow and results of operations.

Uninsured losses relating to real property or excessively expensive premiums for insurance coverage may adversely affect your returns.

Wells Capital will attempt to obtain adequate insurance on all of our properties to cover casualty losses. However, there are types of losses, generally catastrophic in nature, such as losses due to wars, acts of terrorism, earthquakes, floods, hurricanes, pollution or environmental matters, which are uninsurable or not economically insurable, or may be insured subject to limitations, such as large deductibles or co-payments. Insurance risks associated with potential terrorism acts could sharply increase the premiums we pay for coverage against property and casualty claims. Additionally, mortgage lenders in some cases have begun to insist that commercial property owners purchase coverage against terrorism as a condition for providing mortgage loans. Such insurance policies may not be available at reasonable cost, if at all, which could inhibit our ability to finance or refinance our properties. In such instances, we may be required to provide other financial support, either through financial assurances or self-insurance, to cover potential losses. We may not have adequate coverage for such losses. If any of our properties incurs a casualty loss that is not fully insured, the value of our assets will be reduced by any such uninsured loss. In addition, other than any working capital reserve or other reserves we may establish, we have no source of funding to repair or reconstruct any uninsured damaged property. Also, to the extent we must pay unexpectedly large amounts for insurance, we could suffer reduced earnings that would result in lower distributions to stockholders.

Our operating results may be negatively affected by potential development and construction delays and resultant increased costs and risks.

We may use proceeds from this offering to acquire and develop properties upon which we will construct improvements. We will be subject to uncertainties associated with re-zoning for development, environmental concerns of governmental entities and/or community groups, and our builders ability to build in conformity with plans, specifications, budgeted costs, and timetables. If a builder fails to perform, we may resort to legal action to rescind the purchase or the construction contract or to compel performance. A builder s performance may also be

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affected or delayed by conditions beyond the builder s control. Delays in completing construction could also give tenants the right to terminate preconstruction leases. We may incur additional risks when we make periodic progress payments or other advances to builders before they complete construction. These and other factors can result in increased costs of a project or loss of our investment. In addition, we will be subject to normal lease-up risks relating to newly constructed projects. We also must rely on rental income and expense projections and estimates of the fair market value of property upon completion of construction when agreeing upon a purchase price at the time we acquire the property. If our projections are inaccurate, we may pay too much for a property, and our return on our investment could suffer.

We may invest in unimproved real property. Returns from developing unimproved properties are also subject to risks associated with re-zoning the land for development and environmental concerns of governmental entities and/or community groups. Although we intend to limit any investment in unimproved property to property we intend to develop, your investment may nevertheless be subject to the risks associated with investments in unimproved real property.

Competition with third parties in acquiring properties and other investments may reduce our profitability and the return on your investment.

We compete with many other entities engaged in real estate investment activities, including individuals, corporations, bank and insurance company investment accounts, other REITs, real estate limited partnerships, and other entities engaged in real estate investment activities, many of which have greater resources than we do. Larger REITs may enjoy significant competitive advantages that result from, among other things, a lower cost of capital and enhanced operating efficiencies. In addition, the number of entities and the amount of funds competing for suitable investments may increase. Any such increase would result in increased demand for these assets and therefore increased prices paid for them. If we pay higher prices for properties and other investments, our profitability will be reduced and you may experience a lower return on your investment.

Uncertain market conditions relating to the future disposition of properties could adversely affect the return on your investment.

We intend to hold the properties in which we invest until we determine that selling or otherwise disposing of properties would help us to achieve our investment objectives. Various real estate market conditions may affect the future disposition of our properties, and we may not be able to sell our properties at a profit. Accordingly, the extent to which you will receive cash distributions and realize potential appreciation on our real estate investments will depend upon fluctuating market conditions.

Actions of our joint venture partners could negatively impact our performance.

We are likely to enter into joint ventures with other Wells programs as well as third parties to acquire, develop or improve properties. We may also purchase and develop properties in joint ventures or in partnerships, co-tenancies or other co-ownership arrangements. Such investments may involve risks not otherwise present with other methods of investment in real estate, including, for example:

the possibility that our co-venturer, co-tenant or partner in an investment might become bankrupt;

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that such co-venturer, co-tenant or partner may at any time have economic or business interests or goals which are or which become inconsistent with our business interests or goals; or

that such co-venturer, co-tenant or partner may be in a position to take action contrary to our instructions or requests or contrary to our policies or objectives.

Any of the above might subject a property to liabilities in excess of those contemplated and thus reduce your returns.

Costs of complying with governmental laws and regulations may adversely affect our income and the cash available for any distributions.

All real property and the operations conducted on real property are subject to federal, state and local laws and regulations relating to environmental protection and human health and safety. Some of these laws and regulations may impose joint and several liability on tenants, owners or operators for the costs to investigate or remediate contaminated properties, regardless of fault or whether the acts causing the contamination were legal. In addition, the presence of hazardous substances, or the failure to properly remediate these substances, may adversely affect our ability to sell, rent or pledge such property as collateral for future borrowings.

Some of these laws and regulations have been amended so as to require compliance with new or more stringent standards as of future dates. Compliance with new or more stringent laws or regulations or stricter interpretation of existing laws may require us to incur material expenditures. Future laws, ordinances or regulations may impose material environmental liability. Additionally, our tenants operations, the existing condition of land when we buy it, operations in the vicinity of our properties, such as the presence of underground storage tanks, or activities of unrelated third parties may affect our properties. In addition, there are various local, state and federal fire, health, life-safety and similar regulations with which we may be required to comply, and which may subject us to liability in the form of fines or damages for noncompliance. Any material expenditures, fines, or damages we must pay will reduce our ability to make distributions and may reduce the value of your investment.

Discovery of previously undetected environmentally hazardous conditions may adversely affect our cash flows.

Under various federal, state and local environmental laws, ordinances and regulations, a current or previous real property owner or operator may be liable for the cost to remove or remediate hazardous or toxic substances on, under or in such property. These costs could be substantial. Such laws often impose liability whether or not the owner or operator knew of, or was responsible for, the presence of such hazardous or toxic substances. Environmental laws also may impose restrictions on the manner in which property may be used or businesses may be operated, and these restrictions may require substantial expenditures or prevent us from entering into leases with prospective tenants that may be impacted by such laws. Environmental laws provide for sanctions for noncompliance and may be enforced by governmental agencies or, in certain circumstances, by private parties. Certain environmental laws and common law principles could be used to impose liability for release of and exposure to hazardous substances, including asbestos-containing materials into the air. Third parties may seek recovery from real property owners or operators for personal injury or property damage associated with exposure to released hazardous substances. The cost of defending against claims of liability, of complying with

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environmental regulatory requirements, of remediating any contaminated property, or of paying personal injury claims could reduce the amounts available for distribution to you.

If we sell properties and provide financing to purchasers, defaults by the purchasers would adversely affect our cash flows.

If we decide to sell any of our properties, we intend to use our best efforts to sell them for cash. However, in some instances we may sell our properties by providing financing to purchasers. When we provide financing to purchasers, we will bear the risk that the purchaser may default, which could negatively impact our cash dividends to stockholders. Even in the absence of a purchaser default, the distribution of the proceeds of sales to our stockholders, or their reinvestment in other assets, will be delayed until the promissory notes or other property we may accept upon a sale are actually paid, sold, refinanced or otherwise disposed of.

Risks Associated with Debt Financing

We may incur mortgage indebtedness and other borrowings, which may increase our business risks.

We may, in some instances, acquire real properties by borrowing funds. In addition, we may incur mortgage debt and pledge some or all of our real properties as security for that debt to obtain funds to acquire additional real properties. We may borrow if we need funds to satisfy the REIT tax qualification requirement that we distribute at least 90% of our annual REIT taxable income to our stockholders. We may also borrow if we otherwise deem it necessary or advisable to ensure that we maintain our qualification as a REIT for federal income tax purposes.

If there is a shortfall between the cash flow from a property and the cash flow needed to service mortgage debt on that property, then the amount available for distributions to stockholders may be reduced. In addition, incurring mortgage debt increases the risk of loss since defaults on indebtedness secured by a property may result in lenders initiating foreclosure actions. In that case, we could lose the property securing the loan that is in default, thus reducing the value of your investment. For tax purposes, a foreclosure of any of our properties would be treated as a sale of the property for a purchase price equal to the outstanding balance of the debt secured by the mortgage. If the outstanding balance of the debt secured by the mortgage exceeds our tax basis in the property, we would recognize taxable income on foreclosure, but we would not receive any cash proceeds. We may give full or partial guarantees to lenders of mortgage debt to the entities that own our properties. When we give a guaranty on behalf of an entity that owns one of our properties, we will be responsible to the lender for satisfaction of the debt if it is not paid by such entity. If any mortgages contain cross-collateralization or cross-default provisions, a default on a single property could affect multiple properties. If any of our properties are foreclosed upon due to a default, our ability to pay cash distributions to our stockholders will be adversely affected.

High mortgage rates may make it difficult for us to finance or refinance properties, which could reduce the number of properties we can acquire and the amount of cash distributions we can make.

If mortgage debt is unavailable at reasonable rates, we may not be able to finance the purchase of properties. If we place mortgage debt on properties, we run the risk of being unable to refinance the properties when the loans come due, or of being unable to refinance on favorable terms. If interest rates are higher when we refinance the properties, our income could be reduced.

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We may be unable to refinance properties. If any of these events occurs, our cash flow would be reduced. This, in turn, would reduce cash available for distribution to you and may hinder our ability to raise more capital by issuing more stock or by borrowing more money.

Lenders may require us to enter into restrictive covenants relating to our operations, which could limit our ability to make distributions to our stockholders.

When providing financing, a lender may impose restrictions on us that affect our distribution and operating policies and our ability to incur additional debt. Loan documents we enter into may contain covenants that limit our ability to further mortgage the property, discontinue insurance coverage, or replace Wells Capital as our advisor. These or other limitations may adversely affect our flexibility and our ability to achieve our operating plans.

Increases in interest rates could increase the amount of our debt payments and adversely affect our ability to pay dividends to our stockholders.

We expect that we will incur indebtedness in the future. Interest we pay could reduce cash available for distributions. Additionally, if we incur variable rate debt, increases in interest rates would increase our interest costs, which would reduce our cash flows and our ability to pay dividends to you. In addition, if we need to repay existing debt during periods of rising interest rates, we could be required to liquidate one or more of our investments in properties at times which may not permit realization of the maximum return on such investments.

We have broad authority to incur debt, and high debt levels could hinder our ability to make distributions and could decrease the value of your investment.

Our policies do not limit us from incurring additional debt until debt would exceed 50% of the cost of our assets, and we may exceed this limit under some circumstances. High debt levels would cause us to incur higher interest charges, would result in higher debt service payments, and could be accompanied by restrictive covenants. These factors could limit the amount of cash we have available to distribute and could result in a decline in the value of your investment.

Section 1031 Exchange Program Risks

We may have increased exposure to liabilities from litigation as a result of our participation in the Section 1031 Exchange Program.

Wells Development Corporation, an affiliate of Wells Capital, our advisor, has developed a program to facilitate real estate acquisitions for persons (1031 Participants) who seek to reinvest proceeds from a real estate sale and qualify that reinvestment for like-kind exchange treatment under Section 1031 of the Internal Revenue Code (Section 1031 Exchange Program). The program is described in greater detail under Investment Objectives and Criteria Acquisition and Investment Policies Section 1031 Exchange Program. The Section 1031 Exchange Program involves a private placement of co-tenancy interests in real estate. There will be significant tax and securities disclosure risks associated with these private placement offerings of co-tenancy interests to 1031 Participants. For example, in the event that the Internal Revenue Service conducts an audit of the purchasers of co-tenancy interests and successfully challenges the qualification of the transaction as a like-kind exchange, purchasers of co-tenancy interests may file a lawsuit against the entity offering the co-tenancy interests and its sponsors. We may be involved in one or more such offerings and could therefore be named in or otherwise required to defend against lawsuits brought by 1031 Participants. Any amounts we are required to expend

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for any such litigation claims may reduce the amount of funds available for distribution to you. In addition, disclosure of any such litigation may adversely affect our future ability to raise additional capital through the sale of stock or borrowings.

We will be subject to risks associated with co-tenancy arrangements that are not otherwise present in a real estate investment.

Our participation in the Section 1031 Exchange Program likely would involve an obligation of Wells OP II to purchase any co-tenancy interests in a property that remain unsold at the completion of a Section 1031 Exchange Program private placement offering. Accordingly, Wells OP II could be required to purchase the unsold co-tenancy interests and thus become subject to the risks of ownership of properties in a co-tenancy arrangement with unrelated third parties.

Ownership of co-tenancy interests involves risks not otherwise present with an investment in real estate such as the following:

- the risk that a co-tenant may at any time have economic or business interests or goals that are inconsistent with our business interests or goals;
- the risk that a co-tenant may be in a position to take action contrary to our instructions or requests or contrary to our policies or objectives; or
- the possibility that a co-tenant might become insolvent or bankrupt, which may be an event of default under mortgage loan financing documents or allow the bankruptcy court to reject the tenants in common agreement or management agreement entered into by the co-tenants owning interests in the property.

Any of the above might subject a property to liabilities in excess of those contemplated and thus reduce your returns.

In the event that our interests become adverse to those of the other co-tenants, we will not have the contractual right to purchase the co-tenancy interests from the other co-tenants. Even if we are given the opportunity to purchase such co-tenancy interests in the future, we cannot guarantee that we will have sufficient funds available at the time to purchase co-tenancy interests from the 1031 Participants.

We might want to sell our co-tenancy interests in a given property at a time when the other co-tenants in such property do not desire to sell their interests. Therefore, we may not be able to sell our interest in a property at the time we would like to sell. In addition, we anticipate that it will be much more difficult to find a willing buyer for our co-tenancy interests in a property than it would be to find a buyer for a property we owned outright.

Our participation in the Section 1031 Exchange Program may limit our ability to borrow funds in the future.

Institutional lenders may view our obligations under agreements to acquire unsold co-tenancy interests in properties as a contingent liability against our cash or other assets, which may limit our ability to borrow funds in the future. Lenders providing lines of credit may restrict our ability to draw on our lines of credit by the amount of our potential obligation. Further, our lenders may view such obligations in such a manner as to limit our ability to borrow funds based

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on regulatory restrictions on lenders which limit the amount of loans they can make to any one borrower.

Federal Income Tax Risks

Failure to qualify as a REIT would adversely affect our operations and our ability to make distributions.

Alston & Bird LLP, our legal counsel, has rendered its opinion that we will qualify as a REIT, based upon our representations as to the manner in which we are and will be owned, invest in assets and operate, among other things. However, our qualification as a REIT will depend upon our ability to meet, through investments, actual operating results, distributions and satisfaction of specific stockholder rules, the various tests imposed by the Internal Revenue Code. Alston & Bird LLP will not review these operating results or compliance with the qualification standards on an ongoing basis. This means that we may fail to satisfy the REIT requirements in the future. Also, this opinion represents Alston & Bird LLP s legal judgment based on the law in effect as of the date of this prospectus. Alston & Bird s opinion is not binding on the Internal Revenue Service or the courts. Future legislative, judicial or administrative changes to the federal income tax laws could be applied retroactively, which could result in our disqualification as a REIT.

If we fail to qualify as a REIT for any taxable year, we will be subject to federal income tax on our taxable income at corporate rates. In addition, we would generally be disqualified from treatment as a REIT for the four taxable years following the year of losing 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. In addition, distributions to stockholders would no longer qualify for the dividends-paid deduction, and we would no longer be required to make distributions. If this occurs, we might be required to borrow funds or liquidate some investments in order to pay the applicable tax.

Certain fees paid to Wells OP II may cause us to lose our REIT status.

In connection with any transactions under the Section 1031 Exchange Program, Wells OP II would enter into a number of contractual arrangements that would, in effect, guarantee the sale of the co-tenancy interests being offered under the Section 1031 Exchange Program. In consideration for entering into these agreements, Wells OP II would be paid fees which could be characterized by the Internal Revenue Service as non-qualifying income for purposes of satisfying the REIT qualification income tests . If this fee income were, in fact, treated as non-qualifying, and if the aggregate of such fee income and any other non-qualifying income in any taxable year exceeded 5.0% of our gross revenues for such year, we could lose our REIT status for that taxable year and the four ensuing taxable years. Our failure to qualify as a REIT would adversely affect your return on your investment.

Recharacterization of transactions under the Section 1031 Exchange Program may result in a 100% tax on income from a prohibited transaction, which would diminish our cash distributions to our stockholders.

The Internal Revenue Service could recharacterize transactions under the Section 1031 Exchange Program such that Wells OP II is treated as the bona fide owner, for tax purposes, of properties acquired and resold by the entity established to facilitate the transaction. Such recharacterization could result in the income realized on these transactions by Wells OP II being treated as gain on the sale of property that is held as inventory or otherwise held primarily for the

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sale to customers in the ordinary course of its trade or business. In such event, the gain would constitute income from a prohibited transaction and would be subject to a 100% penalty tax. If this occurs, our ability to pay cash distributions to our stockholders will be adversely affected.

Recharacterization of sale-leaseback transactions may cause us to lose our REIT status.

We may purchase properties and lease them back to the sellers of such properties. While we will use our best efforts to structure any such sale-leaseback transaction such that the lease will be characterized as a true lease, thereby allowing us to be treated as the owner of the property for federal income tax purposes, we cannot assure you that the IRS will not challenge such characterization. In the event that any such sale-leaseback transaction is challenged and recharacterized as a financing transaction or loan for federal income tax purposes, deductions for depreciation and cost recovery relating to such property would be disallowed. If a sale-leaseback transaction were so recharacterized, we might fail to satisfy the REIT qualification asset tests or the income tests and, consequently, lose our REIT status effective with the year of recharacterization. Alternatively, the amount of our REIT taxable income could be recalculated which might also cause us to fail to meet the distribution requirement for a taxable year.

You may have current tax liability on distributions you elect to reinvest in our common stock.

If you participate in our dividend reinvestment plan, you will be deemed to have received, and for income tax purposes will be taxed on, the amount reinvested in common stock to the extent the amount reinvested was not a tax-free return of capital. As a result, unless you are a tax-exempt entity, you may have to use funds from other sources to pay your tax liability on the value of the common stock received.

In certain circumstances, we may be subject to federal and state income taxes as a REIT, which would reduce our cash available for distribution to you.

Even if we qualify and maintain our status as a REIT, we may be subject to federal income taxes or state taxes. For example, net income from a prohibited transaction will be subject to a 100% tax. We may not be able to make sufficient distributions to avoid excise taxes applicable to REITs. We may also decide to retain income we earn from the sale or other disposition of our property and pay income tax directly on such income. In that event, our stockholders would be treated as if they earned that income and paid the tax on it directly. However, stockholders that are tax-exempt, such as charities or qualified pension plans, would have no benefit from their deemed payment of such tax liability. We may also be subject to state and local taxes on our income or property, either directly or at the level of Wells OP II or at the level of the other companies through which we indirectly own our assets. Any federal or state taxes we pay will reduce our cash available for distribution to you.

Legislative or regulatory action tax changes could adversely affect you.

At any time, the federal income tax laws governing REITs or the administrative interpretations of those laws may be amended. Any of those new laws or interpretations may take effect retroactively and could adversely affect the taxation of us or of you as a stockholder. Therefore, changes in laws could diminish the value of an investment in our common stock or the value or the resale potential of our properties. On May 23, 2003, Congress passed the Jobs and Growth Tax Relief Reconciliation Act of 2003, which decreases the tax rate on most dividends paid by corporations to individual investors to a maximum of 15% from current rates, and such rates are retroactive to the beginning of January 2003.

REIT dividends, with limited exceptions,

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will not benefit from the rate reduction, because a REIT s income generally is not subject to corporate level tax. As such, this legislation could cause shares in non-REIT corporations to be a more attractive investment to individual investors than shares in REITs, and could have an adverse effect on the value of our common stock. You are urged to consult with your own tax advisor with respect to the impact of the Jobs and Growth Tax Relief Reconciliation Act of 2003 and any other relevant legislation on your investment in our common stock and the status of legislative, regulatory or administrative developments and proposals and their potential effect on an investment in our common stock.

Retirement Plan Risks

If you fail to meet the fiduciary and other standards under ERISA or the Internal Revenue Code as a result of an investment in our stock, you could be subject to criminal and civil penalties.

There are special considerations that apply to pension or profit sharing trusts or IRAs investing in shares. If you are investing the assets of a pension, profit sharing, 401(k), Keogh or other qualified retirement plan or the assets of an IRA in our common stock, you should satisfy yourself that:

- your investment is consistent with your fiduciary obligations under ERISA and the Internal Revenue Code;
- your investment is made in accordance with the documents and instruments governing your plan or IRA, including your plan s investment policy;
- your investment satisfies the prudence and diversification requirements of Sections 404(a)(1)(B) and 404(a)(1)(C) of ERISA and other applicable provisions of ERISA and the Internal Revenue Code;
- your investment will not impair the liquidity of the plan or IRA;
- your investment will not produce unrelated business taxable income for the plan or IRA;
- you will be able to value the assets of the plan annually in accordance with ERISA requirements and applicable provisions of the plan or IRA; and
- your investment will not constitute a prohibited transaction under Section 406 of ERISA or Section 4975 of the Internal Revenue Code.

Failure to satisfy the fiduciary standards of conduct and other applicable requirements of ERISA and the Internal Revenue Code may result in imposition of civil and criminal penalties, and can subject the fiduciary to equitable remedies. In addition, if an investment in our shares constitutes a prohibited transaction under ERISA or the Internal Revenue Code, the fiduciary who authorized or directed the investment may be subject to imposition of excise taxes with respect to the amount invested.

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Some of the information in this prospectus may contain forward-looking statements. Such statements include, in particular, statements about our plans, strategies and prospects. You can generally identify forward-looking statements by our use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, believe, continue or other similar words. You should not rely on our forward-looking stateme because the matters they describe are subject to known and unknown risks, uncertainties and other unpredictable factors, many of which are beyond our control.

These forward-looking statements are subject to various risks and uncertainties, including those discussed above under Risk Factors, that could cause our actual results to differ materially from those projected in any forward-looking statement we make. We do not undertake to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

ESTIMATED USE OF PROCEEDS

The following tables set forth information about how we intend to use the proceeds raised in this offering assuming that we sell the minimum of 250,000 shares, a mid-point of 392,500,000 shares and the maximum of 785,000,000 shares, respectively, of common stock. For the mid-point and maximum offerings, we estimate that we would sell 11% of the shares through distribution channels involving a reduced dealer manager fee and no selling commissions at purchase prices ranging from $9.20 to $9.30. With respect to the mid-point and maximum offerings, we assume that we would sell 24% of the shares through our dividend reinvestment program for a price of $9.55 per share. Many of the figures set forth below represent management s best estimate since they cannot be precisely calculated at this time. Depending primarily on the number of shares we sell in this offering and assuming a $9.55 purchase price for shares sold under the dividend reinvestment plan, we estimate that 86.5% to 90.0% of our gross offering proceeds, or between $8.65 and $8.83 per share, will be used for investments, while the remainder will be used to pay offering expenses, including selling commissions and the dealer manager fee, and to pay a fee to our advisor for its services in connection with the selection, acquisition, development and construction of our real estate investments.

	250,000 Shares		392,500,000 Shares		785,000,000 Shares	
	Amount	Percent	Amount	Percent	Amount	Percent
Gross Offering Proceeds	$ 2,500,000	100.0%	$ 3,851,875,000	100.0%	$ 7,703,750,000	100.0%
Selling Commissions and Dealer Manager Fee (1)	$ 237,500	9.5%	$ 290,865,625	7.6%	$ 581,731,250	7.6%
Other Organization and Offering Expenses (2)	$ 50,000	2.0%	$ 25,607,835	0.7%	$ 34,778,830	0.5%
Acquisition Fees (3)	$ 50,000	2.0%	$ 77,037,500	2.0%	$ 154,075,000	2.0%
Initial Working Capital Reserve (4)						
Amount Available for Investment (5)(6)	$ 2,162,500	86.5%	$ 3,458,364,040	89.8%	$ 6,933,164,920	90.0%

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1. For the mid-point and maximum offerings, includes selling commissions equal to 7.0% of aggregate gross offering proceeds and a dealer manager fee equal to 2.5% of aggregate offering proceeds on 66% of shares sold; selling commissions equal to 5.0% of aggregate gross offering proceeds and a dealer manager fee equal to 0.0% of aggregate offering proceeds on 20% of shares sold (through the dividend reinvestment plan); no selling commissions or dealer manager fee on 3% of shares sold, which are shares sold under the dividend reinvestment plan through investment advisers compensated on a fee-for-service basis; and no selling commissions and a dealer manager fee of between 1.5% and 2.5% on the remaining shares sold through investment advisers compensated on a fee-for-service basis. See Plan of Distribution.

2. Includes all expenses (other than selling commissions and the dealer manager fee) to be paid by us in connection with the offering, including our legal, accounting, printing, mailing and filing fees, charges of our escrow holder, reimbursing the due diligence expenses of participating broker-dealers, and amounts to reimburse Wells Capital for the salaries of its employees and other costs in connection with preparing supplemental sales materials, holding educational conferences and attending retail seminars conducted by broker-dealers. Wells Capital has agreed to reimburse us to the extent organizational and offering expenses incurred by us, other than selling commissions and the dealer manager fee, exceed 2% of aggregate gross offering proceeds.

3. We will pay Wells Capital, as our advisor, acquisition fees of 2.0% of gross offering proceeds for its services in connection with the selection, purchase, development and construction of real estate. We will pay Wells Capital the acquisition fee amount upon receipt of the offering proceeds rather than at the time a property is acquired. In addition to this acquisition fee, we may also incur customary third-party acquisition expenses in connection with the acquisition (or attempted acquisition) of a property. See note 6 below.

4. Because we expect that the vast majority of leases for the properties acquired by us will provide for tenant reimbursement of operating expenses, we do not anticipate that a permanent reserve for maintenance and repairs of real estate properties will be established. However, to the extent that we have insufficient funds for such purposes, we may establish reserves from gross offering proceeds, out of cash flow generated by operating properties or out of nonliquidating net sale proceeds, defined generally to mean the net cash proceeds received by us from any sale or exchange of properties.

5. Amount available for investment will include customary third-party acquisition expenses such as legal fees and expenses, costs of appraisals, accounting fees and expenses, title insurance premiums and other closing costs and miscellaneous expenses relating to the acquisition of real estate. We estimate that these third-party costs would average 0.5% of the contract purchase prices of property acquisitions. If our proposed share redemption program is adopted, up to 100% of the net proceeds from sales under our dividend reinvestment plan could be used to repurchase shares of our common stock. See Description of Shares Proposed Share Redemption Program.

6. Until required in connection with the acquisition and development of properties, substantially all of the net proceeds of the offering and, thereafter, our working capital reserves, may be invested in short-term, highly liquid investments including government obligations, bank certificates of deposit, short-term debt obligations and interest-bearing accounts or other authorized investments as determined by our board of directors.

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MANAGEMENT

Board of Directors

We operate under the direction of our board of directors. The board is responsible for the management and control of our affairs. The board has retained Wells Capital to manage our day-to-day affairs and the acquisition and disposition of our investments, subject to the board s supervision. Because of the numerous conflicts of interest created by the relationships among us, Wells Capital and various affiliates, many of the responsibilities of the board have been delegated to a committee comprised of all of our independent directors. See Conflicts of Interest.

We have a ten-member board of directors. Our board may change the size of the board, but not to fewer than three board seats. Our charter provides that a majority of the directors must be independent directors. We have eight independent directors. An independent director is a person who is not one of our officers or employees or an officer or employee of Wells Capital or its affiliates and has not been so for the previous two years. Serving as a director of, or having an ownership interest in, another Wells-sponsored program will not, by itself, preclude independent-director status.

Each director will serve until the next annual meeting of stockholders or until his successor has been duly elected and qualified. Although the number of directors may be increased or decreased, a decrease shall not have the effect of shortening the term of any incumbent director. Any director may resign at any time and may be removed with or without cause by the stockholders upon the affirmative vote of at least a majority of all the votes entitled to be cast at a meeting called for the purpose of the proposed removal. The notice of the meeting shall indicate that the purpose, or one of the purposes, of the meeting is to determine if the director shall be removed.

Unless filled by a vote of the stockholders as permitted by the Maryland General Corporation Law, a vacancy created by an increase in the number of directors or the death, resignation, removal, adjudicated incompetence or other incapacity of a director shall be filled by a vote of a majority of the remaining directors. As provided in our charter, nominations of individuals to fill the vacancy of a board seat previously filled by an independent director will be made by the remaining independent directors.

Our directors and officers are not required to devote all of their time to our business and are only required to devote the time to our affairs as their duties may require. In addition to meetings of the various committees of the board, which committees we describe below, we expect to hold seven regular board meetings each year. We do not expect that our directors will be required to devote a substantial portion of their time in discharging their duties. Our board is empowered to fix the compensation of all officers that it selects and may pay compensation to directors for services rendered to us in any other capacity.

Our general investment and borrowing policies are set forth in this prospectus. Our directors may establish further written policies on investments and borrowings and shall monitor our administrative procedures, investment operations and performance to ensure that the policies are fulfilled and are in the best interest of the stockholders. We will follow the policies on investments and borrowings set forth in this prospectus unless they are modified by our directors.

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Committees of the Board of Directors

Many of the powers of the board of directors may be delegated to one or more committees. Our charter requires that each committee consist of at least a majority of independent directors.

Audit Committee

Our bylaws require that the audit committee of the board of directors consist solely of independent directors. The audit committee selects the independent public accountants to audit our annual financial statements, reviews with the independent public accountants the plans and results of the audit engagement, approves the audit and non-audit services provided by the independent public accountants, reviews the independence of the independent public accountants, considers the range of audit and non-audit fees and reviews the adequacy of our internal accounting controls. Our audit committee consists of Donald S. Moss, Walter W. Sessoms, Neil H. Strickland and W. Wayne Woody.

Conflicts Committee

In order to reduce or eliminate certain potential conflicts of interest, our charter creates a conflicts committee of our board of directors comprised of all of our independent directors, that is, all of our directors who are not affiliated with our advisor. Serving on the board of, or owning an interest in, another Wells-sponsored program will not, by itself, preclude a director from serving on the conflicts committee. The conflicts committee, which is authorized to retain its own legal and financial advisors, is empowered to act on any matter permitted under Maryland law provided that it first determines that the matter at issue is such that the exercise of independent judgment by Wells Capital affiliates could reasonably be compromised. Those conflict-of-interest matters that cannot be delegated to a committee under Maryland law must be acted upon by both the board of directors and the conflicts committee. See Conflicts of Interest Certain Conflict Resolution Procedures.

Because many of our independent directors are also independent directors of Wells REIT I, these independent directors would face conflicts of interests with respect to transactions between Wells REIT I and us. (See Risk Factors Risks Related to Conflicts of Interest Our board s loyalties to Wells REIT I (and possibly future Wells-sponsored programs) could influence its judgment.) To address these conflicts, the conflicts committee has created a subcommittee of the conflicts committee comprised of all directors on the conflicts committee who are unaffiliated with another Wells-sponsored program. The conflicts subcommittee is empowered to act on any matter permitted by Maryland law if (1) the conflicts committee delegates the matter to the conflicts subcommittee or (2) the conflicts subcommittee disagrees with the conflict committee s handling of a matter and its minutes reflect that it determined that the matter at issue was such that the exercise of independent judgment by both the affiliates of Wells Capital and the affiliates of another Wells-sponsored program could reasonably have been compromised. (See Conflicts of Interest Certain Conflict Resolution Procedures.) Two of our directors serve on the conflicts subcommittee.

Our conflicts committee will also discharge the board s responsibilities relating to compensation of our executives. The conflicts committee will administer the granting of stock options to selected employees of Wells Capital and Wells Management based upon recommendations from Wells Capital and Wells Management, and set the terms and conditions of such options in accordance with the Stock Option Plan, which we describe below. The conflicts

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committee will also have authority to amend the Stock Option Plan or create other incentive compensation and equity-based plans.

Advisory Committees

The board of directors may establish various advisory committees on which certain members of the board would sit to assist Wells Capital and its affiliates in areas that have a direct impact on our operations, such as the following: asset management; finance and planning; and shareholder relations, communications and development.

Executive Officers and Directors

We have provided below certain information about our executive officers and directors.

Name	*Age*	*Positions*
Leo F. Wells, III	59	President and Director
Douglas P. Williams	52	Executive Vice President, Secretary, Treasurer and Director
Charles R. Brown	65	Director*
Richard W. Carpenter	66	Director*
Bud Carter	65	Director*
Donald S. Moss	67	Director*
Jack M. Pinkerton	76	Director*
Walter W. Sessoms	69	Director*
Neil H. Strickland	67	Director*
W. Wayne Woody	61	Director*
Randall D. Fretz	51	Senior Vice President

* Denotes director is not affiliated with our advisor, Wells Capital.

Leo F. Wells, III is our President and one of our directors. He is also the President and a director of Wells REIT I and is the President, Treasurer and sole director of Wells Capital, our advisor. He is also the sole stockholder, sole director, President and Treasurer of Wells Real Estate Funds, Inc., the parent corporation of Wells Capital. Mr. Wells is President of Wells & Associates, Inc., a real estate brokerage and investment company formed in 1976 and incorporated in 1978, for which he serves as principal broker. He is also a trustee of the Wells Family of Real Estate Funds, an open-end management investment company organized as an Ohio business trust, which includes as one of its series the Wells S&P REIT Index Fund. He is also the President, Treasurer and sole director of:

Wells Management Company, Inc., a company we may engage to manage some or all of our properties;

Wells Advisors, Inc., a company he organized in 1991 to act as a non-bank custodian for IRAs;

Wells Development Corporation, a company he organized in 1997 to develop real properties; and

Wells Asset Management, Inc., a company he organized in 1997, which serves as an investment adviser to the Wells Family of Real Estate Funds.

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Mr. Wells was a real estate salesman and property manager from 1970 to 1973 for Roy D. Warren & Company, an Atlanta-based real estate company, and he was associated from 1973 to 1976 with Sax Gaskin Real Estate Company, during which time he became a Life Member of the Atlanta Board of Realtors Million Dollar Club. From 1980 to February 1985 he served as Vice President of Hill-Johnson, Inc., a Georgia corporation engaged in the construction business. Mr. Wells holds a Bachelor of Business Administration degree in economics from the University of Georgia. Mr. Wells is a member of the International Association for Financial Planning.

Mr. Wells has over 30 years of experience in real estate sales, management and brokerage services. In addition to being the President and a director of Wells REIT I, he is currently a general partner in a total of 27 real estate limited partnerships formed for the purpose of acquiring, developing and operating office buildings and other commercial properties. As of December 31, 2002, these 27 real estate limited partnerships represented investments totaling approximately $347,000,000 from approximately 28,300 investors.

On August 26, 2003, Mr. Wells and Wells Investment Securities entered into a Letter of Acceptance, Waiver and Consent (AWC) with the NASD relating to alleged rule violations. The AWC set forth the NASD s findings that Wells Investment Securities and Mr. Wells had violated conduct rules relating to the provision of non-cash compensation of more than $100 to associated persons of NASD member firms in connection with their attendance at the annual educational and due diligence conferences sponsored by Wells Investment Securities in 2001 and 2002. See Affiliated Companies Dealer Manager below.

Douglas P. Williams is our Executive Vice President, Secretary and Treasurer and one of our directors. Since 1999, he has also served as Executive Vice President, Secretary and Treasurer and a director of Wells REIT I, a Senior Vice President of Wells Capital, our advisor, and is also a Vice President of:

- Wells Investment Securities, Inc., our dealer manager, of which he is also a director and the CFO and Treasurer;
- Wells Real Estate Funds, Inc.;
- Wells Advisors, Inc.; and
- Wells Asset Management, Inc.

From 1996 to 1999, Mr. Williams served as Vice President and Controller of OneSource, Inc., a leading supplier of janitorial and landscape services, where he was responsible for corporate-wide accounting activities and financial analysis. Mr. Williams was employed by ECC International Inc., a supplier to the paper industry and to the paint, rubber and plastic industries, from 1982 to 1995. While at ECC, Mr. Williams served in a number of key accounting positions, including: Corporate Accounting Manager, U.S. Operations; Division Controller, Americas Region; and Corporate Controller, America/Pacific Division. Prior to joining ECC and for one year after leaving ECC, Mr. Williams was employed by Lithonia Lighting, a manufacturer of lighting fixtures, as a Cost and General Accounting Manager and Director of Planning and Control. Mr. Williams started his professional career as an auditor for a predecessor firm of KPMG LLP.

Mr. Williams is a member of the American Institute of Certified Public Accountants and the Georgia Society of Certified Public Accountants and is licensed with the NASD as a financial

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and operations principal. Mr. Williams received a Bachelor of Arts degree from Dartmouth College and a Masters of Business Administration degree from the Amos Tuck School of Graduate Business Administration at Dartmouth College.

Charles R. Brown is one of our independent directors. He has been involved in real estate activities for over 40 years. From 1971 to 1976, he served as Director of Marketing and Project Manager for Atlantic Center, one of the South s largest multi-use complexes. Atlantic Center is a two-million square-foot project in the central business district of Atlanta and includes a Hilton Hotel, a bank and office and retail establishments. From 1976 to 1997, Mr. Brown was President of Technology Park/Atlanta, Inc., where he was instrumental in developing Technology Park/Atlanta, a 600-acre office park in Peachtree Corners just north of Atlanta, which was selected for the Governor s Award for its contribution to community economic development. He still serves on the Board of directors of Technology Park/Atlanta.

Mr. Brown has been President of CRB Realty Associates, a private real estate consulting firm, since the 1980s. He has previously been president and vice chairman of Atlantic Station, LLC, where he was involved in the planning and development of Atlantic Station, a redevelopment project of the Atlantic Steel mill in Atlanta, Georgia. He has also represented one of the partnerships developing an office building constituting part of the Atlantic Station project.

Mr. Brown is a past President of Georgia Tech Foundation, past Chairman of the Gwinnett Chamber of Commerce and Georgia Chamber of Commerce and past Vice Chairman of the Georgia Governor s Development Council and served on the Board of the Georgia Department of Technical and Adult Education. He is a graduate of the Georgia Institute of Technology where he received a B.S. degree in Building Construction from the College of Architecture.

Richard W. Carpenter is one of our independent directors. He is also an independent director of Wells REIT I and a trustee of the Wells Family of Real Estate Funds. He served as General Vice President of Real Estate Finance of The Citizens and Southern National Bank from 1975 to 1979, during which time his duties included the establishment and supervision of the United Kingdom Pension Fund, U.K.-American Properties, Inc. that was established primarily for investment in commercial real estate within the United States.

Mr. Carpenter is a managing partner of Carpenter Properties, L.P., a real estate limited partnership and a Director and Chairman of the Audit Committee of MidCountry Financial Corporation. He retired as President and director of Commonwealth Oil Refining Company, Inc. and Realmark Holdings in 2001.

Mr. Carpenter previously served as Vice Chairman of the board of directors of both First Liberty Financial Corp. and Liberty Savings Bank, F.S.B. and Chairman of the Audit Committee of First Liberty Financial Corp. He has been a member of the National Association of Real Estate Investment Trusts and formerly served as President and Chairman of the Board of Southmark Properties, an Atlanta-based REIT which invested in commercial properties. Mr. Carpenter is a past Chairman of the American Bankers Association Housing and Real Estate Finance Division Executive Committee. Mr. Carpenter holds a Bachelor of Science degree from Florida State University, where he was named the outstanding alumnus of the School of Business in 1973.

Bud Carter is one of our independent directors. He is also an independent director of Wells REIT I and a trustee of the Wells Family of Real Estate Funds. He was an award-winning

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broadcast news director and anchorman for several radio and television stations in the Midwest for over 20 years. From 1975 to 1980, Mr. Carter served as General Manager of WTAZ-FM, a radio station in Peoria, Illinois and served as editor and publisher of The Peoria Press, a weekly business and political journal in Peoria, Illinois. From 1981 until 1989, Mr. Carter was also an owner and General Manager of Transitions, Inc., a corporate outplacement company in Atlanta, Georgia.

Mr. Carter currently serves as Senior Vice President for The Executive Committee, an international organization established to aid presidents and CEOs to share ideas on ways to improve the management and profitability of their respective companies. The Executive Committee operates in numerous large cities throughout the United States, Canada, Australia, France, Italy, Malaysia, Brazil, the United Kingdom and Japan. The Executive Committee has more than 7,000 presidents and CEOs who are members. In addition, Mr. Carter was the first Chairman of the organization recruited in Atlanta and still serves as Chairman of the first two groups formed in Atlanta, each comprised of 16 noncompeting CEOs and presidents. Mr. Carter serves on the board of directors of Creative Storage Systems, Inc., DiversiTech Corporation and Wavebase9. He is a graduate of the University of Missouri where he earned degrees in journalism and social psychology.

Donald S. Moss is one of our independent directors. He is also an independent director of Wells REIT I and a trustee of the Wells Family of Real Estate Funds. He was employed by Avon Products, Inc. from 1957 until his retirement in 1986. While at Avon, Mr. Moss served in a number of key positions, including Vice President and Controller from 1973 to 1976, Group Vice President of Operations-Worldwide from 1976 to 1979, Group Vice President of Sales-Worldwide from 1979 to 1980, Senior Vice President-International from 1980 to 1983 and Group Vice President-Human Resources and Administration from 1983 until his retirement in 1986. Mr. Moss was also a member of the board of directors of Avon Canada, Avon Japan, Avon Thailand, and Avon Malaysia from1980 to1983.

Mr. Moss is currently a director of The Atlanta Athletic Club. He formerly was the National Treasurer and a director of the Girls Clubs of America from 1973 to 1976. Mr. Moss graduated from the University of Illinois where he received a degree in business.

Jack M. Pinkerton is one of our independent directors. He served as President of The Pinkerton and Laws Company from 1955 to 1983. He resigned in 1983 as President and became Chairman of the Executive Committee for The Pinkerton & Laws Company until his retirement in 1988, at which time The Pinkerton and Laws Company was one of the 200 largest construction companies in the United States. Mr. Pinkerton s current activities include Co-Director of Construction for Piedmont Park Conservancy and Early Learning Property Management (construction and development of Early Learning Centers).

Mr. Pinkerton served as chairman of the board of Enterprise National Bank before it was sold to Regions Bank. Mr. Pinkerton has also served as chairman of the board of numerous non-profit organizations. He received his Civil Engineering degree from Vanderbilt University and a Master of Theology Studies degree from Emory University.

Walter W. Sessoms is one of our independent directors. He is also an independent director of Wells REIT I and a trustee of the Wells Family of Real Estate Funds. He was employed by Southern Bell and its successor company, BellSouth, from 1956 until his retirement in June 1997. While at BellSouth, Mr. Sessoms served in a number of key positions, including

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Vice President-Residence for the State of Georgia from June 1979 to July 1981, Vice President-Transitional Planning Officer from July 1981 to February 1982, Vice President-Georgia from February 1982 to June 1989, Senior Vice President-Regulatory and External Affairs from June 1989 to November 1991, and Group President-Services from December 1991 until his retirement on June 30, 1997. He also worked at AT&T Corporation in New York from 1969 to1971 when Southern Bell was a part of the Bell System. From September 1973 to September 1974, Mr. Sessoms participated in the President s Executive Interexchange Program in Washington, D.C.

Mr. Sessoms currently serves as a director of the Georgia Chamber of Commerce for which he is a past Chairman of the Board and the Salvation Army s Board of Visitors of the Southeast Region. Mr. Sessoms is also a past advisory council member for the University of Georgia College of Business Administration and past member of the executive committee of the Atlanta Chamber of Commerce. Mr. Sessoms is a graduate of Wofford College where he earned a degree in economics and business administration, and is currently a member of the Wofford College Board of Trustees. He is a past member of the Governor s Education Reform Commission. In addition, Mr. Sessoms is a member of the Board of Trustees of the Southern Center for International Studies and is past President of the Atlanta Rotary Club. He is also a Trustee for the Atlanta University Center.

Neil H. Strickland is one of our independent directors. He is also an independent director of Wells REIT I and a trustee of the Wells Family of Real Estate Funds. He was employed by Loyalty Group Insurance (which subsequently merged with America Fore Loyalty Group and is now known as The Continental Group) as an automobile insurance underwriter. From 1957 to 1961, Mr. Strickland served as Assistant Supervisor of the Casualty Large Lines Retrospective Rating Department. From 1961 to 1964, Mr. Strickland served as Branch Manager of Wolverine Insurance Company, a full service property and casualty service company, where he had full responsibility for underwriting of insurance and office administration in the State of Georgia. In 1964, Mr. Strickland and a non-active partner started Superior Insurance Service, Inc., a property and casualty wholesale general insurance agency. Mr. Strickland served as President and was responsible for the underwriting and all other operations of the agency. In 1967, Mr. Strickland sold his interest in Superior Insurance Service, Inc. and started Strickland General Agency, Inc., a property and casualty general insurance agency concentrating on commercial customers. Mr. Strickland is currently the Senior Operation Executive of Strickland General Agency, Inc. and devotes most of his time to long-term planning, policy development and senior administration.

Mr. Strickland is a past President of the Norcross Kiwanis Club and served as both Vice President and President of the Georgia Surplus Lines Association. He also served as President and a director of the National Association of Professional Surplus Lines Offices. Mr. Strickland currently serves as a director of First Capital Bank, a community bank located in the State of Georgia. Mr. Strickland attended Georgia State University where he majored in business administration. He received his L.L.B. degree from Atlanta Law School.

W. Wayne Woody is one of our independent directors. He is also an independent director of Wells REIT I and a trustee of the Wells Family of Real Estate Funds. He served as the Interim Chief Financial Officer for Legacy Investment Group, a boutique investment firm, from 2000 to 2001. From 1968 until his retirement in 1999, Mr. Woody was employed by KPMG LLP and its predecessor firms, Peat Marwick Mitchell & Co. and Peat Marwick Main. As a Senior Partner, he served in a number of key positions in the firm, including Securities and Exchange Commission Reviewing Partner and Partner-in-Charge of Professional Practice and Firm Risk Management for the southeastern United States and Puerto Rico. Mr. Woody was also a member

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of the Board of Directors of KPMG LLP from 1990 through 1994. Prior to joining KPMG, Mr. Woody was the Principal Budget Analyst for the State of Georgia Office of Planning and Budget where he reviewed, analyzed and presented the Governor s budget proposals to the state legislature.

Mr. Woody currently serves as Chairman of the Audit Committee for the City of Atlanta. He is also a director and the Chairman of the Audit Committee of the Metropolitan Atlanta Chapter of the American Red Cross. Mr. Woody is a member of the Board of Directors for the Metropolitan Atlanta Chapter of the American Heart Association. In addition, he is a trustee and the Chairman of the Finance Committee for the Georgia State University Foundation. Mr. Woody previously served a three-year term as Chairman of the Board of Trustees for the Georgia Center for the Visually Impaired.

Mr. Woody received a Bachelor of Science degree from Middle Tennessee State University and a Masters of Business Administration degree from Georgia State University. He is a Certified Public Accountant in the states of Georgia and North Carolina.

Randall D. Fretz is our Vice President and is a Senior Vice President of Wells Capital. He is also the Chief of Staff and a Vice President of Wells Real Estate Funds, Inc., a Vice President of Wells REIT I, and a director of Wells Investment Securities, Inc. Mr. Fretz is primarily responsible for corporate strategy and planning and advising and coordinating the executive officers of Wells Capital on corporate matters and special projects. Prior to joining Wells Capital in 2002, Mr. Fretz served for seven years as President of US & Canada operations for Larson-Juhl, a world leader in custom art and picture-framing home decor. Mr. Fretz was previously a Division Director at Bausch & Lomb, a manufacturer of optical equipment and products, and also held various senior positions at Tandem International and Lever Brothers. Mr. Fretz holds a bachelor degree in each of Sociology and Physical Education from McMaster University in Hamilton, Ontario. He also earned an MBA from the Ivey School of Business in London, Ontario.

Compensation of Directors

We intend to pay each of our independent directors an annual retainer of $12,000. In addition, we will pay directors for attending board and committee meetings as follows:

$2,500 per regular board meeting; we expect seven regular board meetings per year.

$2,500 per audit committee meeting to review our periodic reports; we expect four such meetings per year.

$250 per teleconference board meeting; we expect two such meetings per month.

$1,500 for all other committee meetings; we expect five such meetings per committee per year.

An additional $500 to a committee chair for each committee meeting attended in person.

However, when a committee meeting follows a board meeting, an additional fee will not always be paid for attending the committee meeting. For example, a conflicts committee meeting will

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generally be held immediately after every board meeting, but a separate fee will not be paid for attendance at the conflicts committee meeting.

In addition, we have reserved 100,000 shares of common stock for future issuance upon the exercise of stock options granted to the independent directors pursuant to our Independent Director Stock Option Plan. All directors will receive reimbursement of reasonable out-of-pocket expenses incurred in connection with attendance at meetings of the board of directors. If a director also is one of our officers, we will not pay separate compensation for services rendered as a director.

Independent Director Stock Option Plan

Our sole stockholder has approved an Independent Director Stock Option Plan. We expect to issue non-qualified stock options to purchase 2,500 shares to each independent director pursuant to this plan. In addition, we expect to issue options to purchase 1,000 shares to each independent director then in office on the date of each annual stockholders meeting. We may not grant options at any time when the issuance of the shares underlying the grant, when combined with those issuable upon exercise of outstanding options or warrants granted to our advisor, directors, officers or any of their affiliates, would exceed 10% of our outstanding shares.

The exercise price for the initial options for 2,500 shares will be $12.00 per share. The exercise price for the subsequent options will be the greater of (1) $12.00 per share or (2) the fair market value of the shares on the date they are granted. Fair market value is generally defined to mean (1) the closing sales price on the immediately preceding date on which sales were reported if the shares are listed on a securities exchange or are traded over the Nasdaq National Market or (2) the mean between the bid and offered prices as quoted by Nasdaq for such immediately preceding trading date if the shares are not listed on a securities exchange or traded over the Nasdaq National Market. However, if the conflicts committee determines that the fair market value of our shares is not properly reflected by such Nasdaq quotations, or if our shares are not quoted by Nasdaq, then the conflicts committee will determine fair market value in good faith.

We have authorized and reserved a total of 100,000 shares for issuance under the plan. If the number of outstanding shares is changed into a different number or kind of shares or securities through a reorganization or merger in which we are the surviving entity, or through a combination, recapitalization or otherwise, we will make an appropriate adjustment in the number and kind of shares that may be issued pursuant to exercise of the options. We will also make a corresponding adjustment to the exercise price of the options granted prior to any change. Any such adjustment, however, will not change the total payment, if any, applicable to the portion of the options not exercised but will change only the exercise price for each share. To date, we have not issued any director options under this Plan.

Options will lapse on the first to occur of (1) the tenth anniversary of the date we grant them, (2) the removal for cause of the independent director as a member of the board of directors, or (3) three months following the date the independent director ceases to be a director for any reason other than death or disability. Options may be exercised by payment of cash or through the delivery of common stock. Options are generally exercisable in the case of death or disability for a period of one year after death or the disabling event. No option issued may be exercised if such exercise would jeopardize our status as a REIT under the Internal Revenue Code. The independent directors may not sell, pledge, assign or transfer their options other than by will or the laws of descent or distribution.

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The term of the plan is 10 years. Upon our earlier dissolution or liquidation, upon our reorganization, merger or consolidation with one or more corporations as a result of which we are not the surviving corporation or upon sale of all or substantially all of our properties, the plan will terminate, and any outstanding options will terminate and be forfeited. The board of directors may provide in writing in connection with any such transaction for any or all of the following alternatives:

- for the assumption by the successor corporation of the options granted or the replacement of the options with options covering the stock of the successor corporation, or a parent or subsidiary of such corporation, with appropriate adjustments as to the number and kind of shares and exercise prices;

- for the continuance of the plan and the options by such successor corporation under the original terms; or

- for the payment in cash or shares of common stock in lieu of and in complete satisfaction of such options.

Stock Option Plan

Our sole stockholder has approved a Stock Option Plan, which is designed to enable Wells Capital and Wells Management to obtain or retain the services of employees considered essential to our long-range success and the success of Wells Capital and Wells Management by offering such employees an opportunity to participate in our growth through ownership of our common stock.

The conflicts committee of the board of directors shall conduct the general administration of the plan. The conflicts committee is authorized to grant non-qualified stock options to selected employees of Wells Capital and Wells Management based upon the recommendation of Wells Capital and subject to the absolute discretion of the conflicts committee and applicable limitations of the plan. The exercise price for the options shall be the greater of (1) $11.00 per share, or (2) the fair market value of the shares on the date the option is granted. Fair market value for this plan will be determined in the same fashion as the Independent Director Stock Option Plan. A total of 750,000 shares have been authorized and reserved for issuance under our Stock Option Plan. However, we may not grant options at any time when the issuance of the shares underlying the grant, when combined with those issuable upon exercise of outstanding options or warrants granted to our advisor, directors, officers or any of their affiliates, would exceed 10% of our outstanding shares. To date, we have not issued any stock options under this plan.

The conflicts committee shall set the term of the options in its discretion, although no option shall have a term greater than five years The conflicts committee shall set the period during which the right to exercise an option vests in the holder of the option. No option issued may be exercised, however, if such exercise would jeopardize our status as a REIT under the Internal Revenue Code. In addition, no option may be sold, pledged, assigned or transferred by an option holder in any manner other than by will or the laws of descent or distribution.

In the event that the conflicts committee determines that any dividend or other distribution, recapitalization, stock split, reorganization, merger, liquidation, dissolution, or sale, transfer, exchange or other disposition of all or substantially all of our assets, or other similar corporate transaction or event, affects the shares such that the conflicts committee determines an

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adjustment to be appropriate in order to prevent dilution or enlargement of the benefits or potential benefits intended to be made available under the plan or with respect to an option, then the conflicts committee shall, in such manner as it may deem equitable, adjust the number and kind of shares or the exercise price with respect to any option. The plan has a 10-year term and has the same provisions as the Independent Director Stock Option Plan with respect to dissolution, liquidation, reorganization, merger or other similar transactions.

Limited Liability and Indemnification of Directors, Officers, Employees and Other Agents

Our charter limits the liability of our directors and officers to us and our stockholders for monetary damages and requires us to indemnify our directors, officers, Wells Capital or its affiliates for losses they may incur by reason of their service in that capacity if all of the following conditions are met:

- our directors, Wells Capital or its affiliates have determined, in good faith, that the course of conduct that caused the loss or liability was in our best interests;
- our directors, Wells Capital or its affiliates were acting on our behalf or performing services for us;
- in the case of independent directors, the liability or loss was not the result of gross negligence or willful misconduct by the party seeking indemnification;
- in the case of the non-independent directors, Wells Capital or its affiliates, the liability or loss was not the result of negligence or misconduct by the party seeking indemnification; and
- the indemnification is recoverable only out of our net assets and not from the stockholders.

The SEC takes the position that indemnification against liabilities arising under the Securities Act of 1933 is against public policy and unenforceable. Furthermore, our charter prohibits our indemnification of our directors, Wells Capital or its affiliates or broker-dealers for liabilities arising from or out of a violation of state or federal securities laws, unless one or more of the following conditions are met:

- there has been a successful adjudication on the merits of each count involving alleged securities law violations;
- such claims have been dismissed with prejudice on the merits by a court of competent jurisdiction; or
- a court of competent jurisdiction approves a settlement of the claims against the indemnitee and finds that indemnification of the settlement and the related costs should be made, and the court considering the request for indemnification has been advised of the position of the SEC and of the published position of any state securities regulatory authority in which the securities were offered as to indemnification for violations of securities laws.

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The Advisor

Our advisor is Wells Capital. Wells Capital has contractual and fiduciary responsibilities to us and our stockholders. Some of our officers and directors are also officers and directors of Wells Capital.

The directors and executive officers of Wells Capital are as follows:

Name	*Age*	*Positions*
Leo F. Wells, III	59	President, Treasurer and sole director
Douglas P. Williams	52	Senior Vice President and Assistant Secretary
Ron D. Ford	42	Senior Vice President
Stephen G. Franklin	54	Senior Vice President
Randall D. Fretz	51	Senior Vice President
Donald A. Miller	41	Senior Vice President
David H. Steinwedell	42	Vice President

The backgrounds of Messrs. Wells, Williams and Fretz are described in the Management Executive Officers and Directors section of this prospectus. Below is a brief description of the other executive officers of Wells Capital.

Ron D. Ford, Ph.D. is a Senior Vice President of Wells Capital. Mr. Ford is responsible for all of the finance, risk management, accounting and reporting activities. Prior to joining Wells in 2003, Mr. Ford was Chief Executive Officer at Media Arts Group, Inc. during 2002. From 1998 to 2001 he was Chief Financial Officer and then President of OneCoast Network, Inc., a sales and marketing company in the wholesale gift segment of consumer goods. From 1995 to 1998, Mr. Ford was with Curtis 1000, a supplier of office business products, as Chief Financial Officer/Chief Information Officer. Mr. Ford has more than 20 years of experience in senior management. He has extensive experience in sales, operations, financial management, information technology and organizational development. Mr. Ford received his undergraduate degree in Business Administration with a magna cum laude from the University of Tennessee. He completed his MBA at Vanderbilt University and earned a doctorate in executive management from the Weatherhead School of Management at Case Western Reserve University. Mr. Ford is a certified public accountant.

Stephen G. Franklin, Ph.D. is a Senior Vice President of Wells Capital. Mr. Franklin is responsible for marketing, sales and coordination of broker-dealer relations. Mr. Franklin also serves as Vice President of Wells Real Estate Funds, Inc. Prior to joining Wells Capital in 1999, Mr. Franklin served as President of Global Access Learning, an international executive education and management development firm. From 1997 to 1999, Mr. Franklin served as President, Chief Academic Officer and Director of EduTrek International, a publicly traded provider of international post-secondary education that owns the American InterContinental University, with campuses in Atlanta, Ft. Lauderdale, Los Angeles, Washington, D.C., London and Dubai. While at EduTrek, he was instrumental in developing the Masters and Bachelors of Information Technology, International MBA and Adult Evening BBA programs. Prior to joining EduTrek, Mr. Franklin was Associate Dean of the Goizueta Business School at Emory University and a former tenured Associate Professor of Business Administration. He served on the founding Executive MBA faculty, and has taught graduate, undergraduate and executive courses in management and organizational behavior, human resources management and entrepreneurship. He is also co-founder and Director of the Center for Healthcare Leadership in the Emory

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University School of Medicine. Mr. Franklin was a frequent guest lecturer at universities throughout North America, Europe and South Africa.

In 1984, Mr. Franklin took a sabbatical from Emory University and became Executive Vice President and a principal stockholder of Financial Service Corporation, an independent financial planning broker-dealer. Mr. Franklin and the other stockholders of FSC later sold their interests in FSC to Mutual of New York Life Insurance Company.

Donald A. Miller is a Senior Vice President of Wells Capital. Mr. Miller is responsible for directing all aspects of the acquisitions, dispositions, property management, construction and leasing groups of our advisor and its affiliates. Prior to joining Wells in 2003, Mr. Miller headed Lend Lease s U.S. real estate operations including acquisitions, dispositions, financing and investment management. Prior to joining Lend Lease (The Yarmouth Group) in 1994, Mr. Miller was responsible for regional acquisitions for Prentiss Properties Realty Advisors, a predecessor entity to the publicly traded Prentiss REIT. Earlier in his career, Mr. Miller worked in the pension investment management department of Delta Air Lines, and was responsible for real estate and international equity investment programs. Mr. Miller is a Chartered Financial Analyst (CFA) and holds multiple broker/dealer and real estate licenses. He received a B.A. from Furman University in Greenville, South Carolina.

David H. Steinwedell is a Vice President of Wells Capital. He is primarily responsible for the acquisition of real estate properties. From 2000 to 2001, when he joined Wells Capital, Mr. Steinwedell served as a principal in Steinwedell and Associates, a capital markets advisory firm specializing in transactions and strategic planning for commercial real estate firms. From 1998 to 2000, he served as the Executive Vice President of Investment Banking at Jones Lang LaSalle and as Managing Director at Cushman Realty Corporation from 1994 to 1998. From 1982 to 1994, Mr. Steinwedell served as Managing Director for Real Estate Investments at Aetna Life and Casualty. He graduated from Hamilton College with a B.S. in Economics. Mr. Steinwedell is a licensed real estate broker in Georgia and is a member of the Urban Land Institute and the National Association of Industrial and Office Properties.

Wells Capital employs personnel, in addition to the directors and executive officers listed above, who have extensive experience in selecting and managing commercial properties similar to the properties we seek to acquire.

The Advisory Agreement

Under the terms of the advisory agreement, Wells Capital will use its reasonable efforts to present to us investment opportunities to provide a continuing and suitable investment program consistent with our investment policies and objectives as adopted by our board of directors. The advisory agreement calls for Wells Capital to provide for our day-to-day management and to retain property managers, subject to the authority of our board of directors, and to perform other duties including the following:

- find, present and recommend to us real estate investment opportunities consistent with our investment policies and objectives;

- structure the terms and conditions of our real estate acquisitions, sales or joint ventures;

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- acquire properties on our behalf in compliance with our investment objectives and policies;
- arrange for financing and refinancing of properties;
- enter into leases and service contracts for our properties;
- oversee the property managers performance;
- review and analyze the properties operating and capital budgets;
- generate an annual budget for us;
- review and analyze financial information for each property and the overall portfolio;
- formulate and oversee the implementation of strategies for the administration, promotion, management, operation, maintenance, improvement, financing and refinancing, marketing, leasing and disposition of properties;
- perform transfer agent functions; and
- engage our agents.

The fees payable to Wells Capital under the advisory agreement are described in detail at Management Compensation below. We also describe in that section our obligation to reimburse Wells Capital for organization and offering expenses, administrative and management services and payments made by Wells Capital to third parties in connection with potential acquisitions.

The term of the current advisory agreement ends after one year and may be renewed for an unlimited number of successive one-year periods upon mutual consent of Wells Capital and us. Additionally, either party may terminate without penalty the advisory agreement upon 60 days written notice.

Wells Capital and its affiliates expect to engage in other business ventures and, as a result, their resources will not be dedicated exclusively to our business. However, pursuant to the advisory agreement, Wells Capital must devote sufficient resources to our administration to discharge its obligations. Wells Capital may assign the advisory agreement to an affiliate upon our approval. We may assign or transfer the advisory agreement to a successor entity.

Initial Investment by Our Advisor

Wells Capital has purchased 20,000 limited partnership units of Wells OP II, our operating partnership, for $200,000 and 100 shares of our common stock for $1,000. The units constitute 100% of the minority limited partner units outstanding at this time. Wells Capital may not sell any of these units during the period it serves as our advisor. Although Wells Capital and its affiliates are not prohibited from acquiring additional shares of our common stock, Wells Capital currently has no options or warrants to acquire any shares. Wells Capital has agreed to abstain from voting any shares it acquires in any vote for the election of directors or any vote regarding the approval or termination of any contract with Wells Capital or any of its affiliates.

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Affiliated Companies

Property Manager

We may engage Wells Management Company, Inc. to manage and lease particular properties. Wells Management is a wholly owned subsidiary of Wells Real Estate Funds, Inc., and Mr. Wells is the sole director of Wells Management. The executive officers of Wells Management are as follows:

Name	*Age*	*Positions*
Leo F. Wells, III	59	President and Treasurer
M. Scott Meadows	39	Senior Vice President and Secretary

The background of Mr. Wells is described in the Management Executive Officers and Directors section of this prospectus. Below is a brief description of the other executive officer of Wells Management.

M. Scott Meadows is a Senior Vice President and Secretary of Wells Management. He is primarily responsible for the real estate operations for Wells Management. Prior to joining Wells Management in 1996, Mr. Meadows served as Senior Property Manager for The Griffin Company, a full-service commercial real estate firm in Atlanta, where he was responsible for managing a 500,000 square foot office and retail portfolio. Mr. Meadows previously managed real estate as a Property Manager for Sea Pines Plantation Company. He graduated from University of Georgia with a B.B.A. in management. Mr. Meadows is a Georgia real estate broker and holds a Real Property Administrator designation from the Building Owners and Managers Institute International and a Certified Property Manager designation from the Institute of Real Estate Management.

If we retain Wells Management to manage and lease any of our properties, we will pay a market-based fee as determined by our advisor. The advisor will make this determination based on a review of what other management companies charge for the type and location of properties subject to the property management and leasing agreement. In addition, we may reimburse Wells Management for costs and expenses Wells Management incurs in managing properties we own. If we manage joint ventures and retain Wells Management to manage the property held by those joint ventures, the joint ventures may also reimburse Wells Management for similar costs and expenses relating to the joint ventures properties. Reimbursable costs and expenses typically include wages and salaries and other employee-related expenses for employees engaged in operating, managing, maintaining, and leasing properties subject to a management agreement. Employee-related expenses include taxes, insurance, benefits, legal, travel, and other out-of-pocket expenses related to managing and leasing properties. The management fees we may pay to Wells Management would cover, without additional expense to us, Wells Management s general overhead costs, such as its expenses for rent and utilities.

We may also pay Wells Management a separate one-time fee for the initial leasing of newly constructed properties based on a market rate, which is typically an amount equal to one month s rent. In addition, Wells Management may receive a separate fee if a tenant engages Wells Management to oversee tenant improvements. Such fees typically do not exceed 5.0% of the cost of the tenant improvements.

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Wells Management will hire, direct and establish policies for employees who will have direct responsibility for each property s operations, including resident managers and assistant managers, as well as building and maintenance personnel. Some or all of the other employees may be employed on a part-time basis and may also be employed by one or more of the following:

- Wells Capital;
- Wells Management;
- partnerships organized by Wells Management or its affiliates; and
- other persons or entities owning properties managed by Wells Management.

The principal office of Wells Management is located at 6200 The Corners Parkway, Suite 250, Norcross, Georgia 30092.

Dealer Manager

Wells Investment Securities, Inc., our dealer manager, is a member firm of the NASD. Wells Investment Securities was organized in May 1984 for the purpose of participating in and facilitating the distribution of securities of Wells programs.

Wells Investment Securities will provide wholesaling, sales promotion and marketing assistance services to us in connection with the distribution of the shares offered pursuant to this prospectus. It may also sell shares at the retail level.

Wells Real Estate Funds, Inc. is the sole stockholder of Wells Investment Securities. In connection with the NASD enforcement action described below, Mr. Wells recently resigned as the President, Treasurer and sole director of Wells Investment Securities. The current directors and executive officers of Wells Investment Securities are:

Name	***Age***	***Positions***
Philip M. Taylor	60	President and Director
Douglas P. Williams	52	Vice President, CFO, Treasurer and Director
Randall D. Fretz	51	Director

The backgrounds of Messrs. Williams and Fretz are described in the Management Executive Officers and Directors section of this prospectus.

Philip M. Taylor is President and Director of Wells Investment Securities, Inc. Mr. Taylor joined Wells in March 2001 and directs the national sales effort. Prior the joining Wells, Mr. Taylor was Vice President, Sales and Project Operations, for Atlantech International, Inc. from 1991 to 2000. During a twenty-one year tenure with Ingersoll-Rand Company, Mr. Taylor held progressively more responsible positions in sales, marketing and management. He also served for five years as an officer of the U.S. Army. Mr. Taylor holds NASD series 7, 24 and 63 licenses. Mr. Taylor earned a bachelor degree in Industrial Management from East Tennessee State University and a Master of Business Administration in Finance/Management from the University of Oregon.

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NASD Action. On August 26, 2003, Wells Investment Securities and Mr. Wells entered into a Letter of Acceptance, Waiver and Consent (AWC) with the NASD relating to alleged rule violations. The AWC set forth the NASD s findings that Wells Investment Securities and Mr. Wells had violated conduct rules relating to the provision of non-cash compensation of more than $100 to associated persons of NASD member firms in connection with their attendance at the annual educational and due diligence conferences sponsored by Wells Investment Securities in 2001 and 2002.

Without admitting or denying the allegations and findings against them, WIS and Mr. Wells consented in the AWC to various findings by the NASD, which are summarized as follows:

In 2001 and 2002, WIS sponsored conferences attended by registered representatives who sold its real estate investment products. WIS also paid for certain expenses of guests of the registered representatives who attended the conferences. In 2001, WIS paid the costs of travel to the conference and meals for many of the guests, and paid the costs of playing golf for some of the registered representatives and their guests. WIS later invoiced registered representatives for the cost of golf and for travel expenses of guests, but was not fully reimbursed for such. In 2002, WIS paid for meals for registered representatives of a predetermined sales goal for WIS products. The conduct violated the prohibitions against payment and receipt of non-cash compensation in connection with the sales of these products contained in NASD s Conduct Rules 2710, 2810 and 3060. In addition, WIS and Wells failed to adhere to all of the terms of their written undertaking, made in March 2001, not to engage in the conduct described above, thereby failing to observe high standards of commercial honor and just and equitable principles of trade.

WIS consented to a censure and Mr. Wells consented to suspension from acting in a principal capacity with a member firm for one year. WIS and Mr. Wells also agreed to the imposition of a joint and several fine in the amount of $150,000. In conjunction with the entry of the AWC, Mr. Wells resigned as President, Treasurer and sole director of WIS; however, he will continue to engage in selling efforts on behalf of WIS.

Legal Proceeding. On October 9, 2003, Stephen L. Flood, the Controller of Luzerne County, Pennsylvania, and the Luzerne County Retirement Board (Luzerne Board) on behalf of the Luzerne County Employee Retirement System (Plan) filed a lawsuit in the U.S. District Court, Middle District of Pennsylvania against 26 separate defendants including Wells REIT I, Wells Investment Securities, and Wells Real Estate Funds, Inc., the parent company of our advisor and of our dealer manager (Wells Defendants).

The complaint alleges, among other things, that (1) certain former members of the Luzerne Board named as defendants invested $10 million in Wells REIT I on behalf of the Plan, (2) such former members of the Luzerne Board breached their fiduciary duties to the Plan by, among other things, permitting the investment of the Plan s funds in investments not suitable for the Plan because they were long-term illiquid investments, permitting the Plan to pay excessive fees and commissions to co-defendants and accepting political contributions in exchange for awarding advisory and management agreements, (3) the Wells Defendants and others knew or

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should have known that the investment, and the fees and commissions associated with the investment, were not proper for the Plan because the investment was a long-term illiquid investment, (4) the Wells Defendants and others knew or should have known that certain Luzerne Board members and certain investment advisers and managers were breaching their fiduciary duties to the Plan, (5) the defendants engaged in and conspired to engage in an improper scheme to intentionally defraud the Plan, and (6) the investment was not approved by a majority of the Luzerne Board at a public meeting, and consequently, the investment was an inappropriate and void action.

The Plan is seeking damages of not less than $25 million, treble damages and punitive damages from all defendants on a joint and several liability basis. Our promoters believe that this lawsuit is without merit with respect to the Wells Defendants, and the Wells Defendants intend to vigorously defend this lawsuit.

IRA Custodian

Wells Advisors, Inc. was organized in 1991 for the purpose of acting as a passive, non-bank custodian for IRAs investing in the securities of Wells real estate programs. Wells Advisors currently charges no fees for such services. Wells Advisors was approved by the Internal Revenue Service to act as a qualified passive non-bank custodian for IRAs on March 20, 1992. In circumstances where Wells Advisors acts as an IRA custodian, the authority of Wells Advisors is limited to holding limited partnership units or REIT shares on behalf of the beneficiary of the IRA and making distributions or reinvestments in such units or shares solely at the direction of the beneficiary of the IRA. Well Advisors is not authorized to vote any of such units or shares held in any IRA except in accordance with the written instructions of the beneficiary of the IRA. Mr. Wells is the President and sole director and owns 50% of the common stock and all of the preferred stock of Wells Advisors. As of September 30, 2003, Wells Advisors was acting as the IRA custodian for in excess of $1,030,000,000 in Wells real estate program investments.

Management Decisions

The primary responsibility for the management decisions of Wells Capital and its affiliates, including the selection of investment properties to be recommended to our board of directors, the negotiation for these investments and asset-management decisions, will reside in Leo F. Wells, III, Douglas P. Williams, Ron D. Ford, Randall D. Fretz, Donald A. Miller and David H. Steinwedell. We expect that proposed transactions will often be discussed by the board of directors in advance of a final board vote. During these discussions, independent directors can offer ideas for ways in which deals can be changed to make them acceptable. The conflicts committee is empowered to approve or reject all acquisitions of real estate. We expect that the conflicts committee will condition our acquisition of any property on the committee s prior approval.

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MANAGEMENT COMPENSATION

We have no paid employees. Wells Capital, our advisor, and its affiliates will manage our day-to-day affairs. The following table summarizes all of the compensation and fees we will pay to Wells Capital and its affiliates, including amounts to reimburse their costs in providing services. The selling commissions and dealer manager fee may vary for different categories of purchasers. See Plan of Distribution. This table assumes the shares are sold through distribution channels associated with the highest possible selling commissions and dealer manager fees.

Form of Compensation and Entity Receiving	*Determination of Amount*	*Estimated Amount for Maximum Offering* [(1)]
	Organizational and Offering Stage	
Selling Commissions Wells Investment Securities [(2)]	7.0% of gross offering proceeds (5.0% for sales of shares under the dividend reinvestment plan) before reallowance of commissions earned by participating broker-dealers. Wells Investment Securities, our dealer manager, will reallow 100% of commissions earned to participating broker-dealers.	$ 508,337,500
Dealer Manager Fee Wells Investment Securities [(2)]	2.5% of gross offering proceeds before reallowance to participating broker-dealers, except that no dealer manager fee is payable on shares sold under our dividend reinvestment plan. Wells Investment Securities will reallow a portion of its dealer manager fee to participating broker-dealers. See Plan of Distribution.	$ 150,000,000
Reimbursement of Organization and Offering Expenses Wells Capital [(3)]	Up to 2.0% of gross offering proceeds. Wells Capital will incur or pay our organization and offering expenses (excluding selling commissions and the dealer manager fee). We will then reimburse Wells Capital for these amounts up to 2.0% of aggregate gross offering proceeds.	$ 34,778,830
	Acquisition and Development Stage	
Acquisition Fees Wells Capital [(4)]	2.0% of gross offering proceeds for services in connection with the selection, purchase, development or construction of real property.	$ 155,335,000

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Form of Compensation and Entity Receiving	*Determination of Amount*	*Estimated Amount for Maximum Offering* (1)
Asset Management Fee Wells Capital (5)	Monthly fee equal to one-twelfth of 0.75% of the cost of (1) the occupied properties we own and (2) our investments in joint ventures. These fees are limited to 1.0% of the net asset value of the properties included in the above calculation, calculated on a quarterly basis. For purposes of this calculation, net asset value means the excess of the cost of the investments described above over aggregate outstanding debt used to acquire or refinance properties. Additionally, we will reimburse Wells Capital for all costs and expenses it incurs in fulfilling its duties as our asset portfolio manager. These costs and expenses may include wages and salaries and other employee-related expenses of Wells Capital s employees engaged in the management, administration, operations, and marketing functions. Employee-related expenses include taxes, insurance and benefits relating to such employees, and legal, travel and other out-of-pocket expenses that are directly related to their services provided to us.	Actual amounts are dependent upon total equity and debt capital we raise and results of operations and therefore cannot be determined at the present time.
Property Management Wells Management (5)(6)	If we retain Wells Management to manage and lease any of our properties, we will pay Wells Management a fee equal to what other management companies generally charge for the management of similar properties, which may include reimbursement for the costs and expenses Wells Management incurs in managing the properties. Reimbursable costs and expenses include wages and salaries and other expenses of employees engaged in operating, managing, maintaining and leasing properties. In addition, we may pay Wells Management a separate one-time fee for the initial leasing of newly constructed properties at a market rate, typically equal to one month s rent.	Actual amounts are dependent upon results of operations and therefore cannot be determined at the present time.
Other Operating Expenses (5)	We will reimburse the expenses incurred by Wells Capital in connection with its provision of administrative services, including related personnel costs. We will not reimburse for personnel costs in connection with services for which Wells Capital receives acquisition fees or real estate commissions.	Actual amounts are dependent upon operations and therefore cannot be determined at the present time.
	Liquidation/Listing Stage	
Real Estate Commissions - Wells Capital or its Affiliates (7)	For substantial assistance in connection with the sale of properties, we will pay Wells Capital or its affiliates an amount equal to 3.0% of the contract price of each property sold; provided, however, in no event may the real estate commissions paid to Wells Capital, its affiliates and unaffiliated third parties exceed 6% of the contract sales price.	Actual amounts are dependent upon results of operations and therefore cannot be determined at the present time.

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Form of Compensation and Entity Receiving	*Determination of Amount*	*Estimated Amount for Maximum Offering* (1)
Subordinated Participation in Net Sale Proceeds Wells Capital (8)	After investors in our offerings have received a return of their net capital contributions and an 8.0% per year cumulative, noncompounded return, then Wells Capital is entitled to receive 10.0% of remaining net sale proceeds.	Actual amounts are dependent upon results of operations and therefore cannot be determined at the present time.
Subordinated Incentive Listing Fee Wells Capital (8)(9)	Upon listing of our common stock on a national securities exchange or the Nasdaq National Market, a fee equal to 10.0% of the amount by which (1) the market value of our outstanding stock plus distributions paid by us prior to listing, exceeds (2) the sum of the total amount of capital raised from investors and the amount of cash flow necessary to generate an 8.0% per year cumulative, noncompounded return to investors.	Actual amounts are dependent upon results of operations and therefore cannot be determined at the present time.

(1) The estimated maximum dollar amounts are based on the sale of the maximum of 785,000,000 shares to the public, including 185,000,000 shares through the dividend reinvestment plan.

(2) The selling commissions and, in some cases, the dealer manager fee will not be charged with regard to shares sold to or for the account of certain categories of purchasers. See Plan of Distribution.

(3) These organization and offering expenses include all expenses (other than selling commissions and the dealer manager fee) to be paid by us in connection with the offering, including our legal, accounting, printing, mailing and filing fees, charges of our escrow holder, due diligence expense reimbursements to participating broker-dealers and amounts to reimburse Wells Capital for the salaries of its employees and other costs in connection with preparing supplemental sales materials, holding educational conferences and attending retail seminars conducted by broker-dealers. Under our charter, the portion of these organization and offering expenses for which we (as opposed to Wells Capital) would be responsible could not be increased above 2.0% of our gross offering proceeds without the approval of a majority of our independent directors.

(4) We will pay Wells Capital the acquisition fee amount upon receipt of the offering proceeds rather than at the time a property is acquired. However, if either party terminates or fails to renew the advisory agreement, Wells Capital must return acquisition fees not yet allocated to one of our investments. In addition, we will reimburse Wells Capital for amounts it pays to third parties in connection with the selection, acquisition or development of a property, whether or not acquired. Under our charter, a majority of our independent directors would have to approve any increase in the acquisition fees payable to our advisor above 2.0% of gross offering proceeds. Our charter also limits our ability to purchase property if the total of all acquisition fees and expenses relating to the purchase exceeds 6% of the contract purchase price.

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(5) Wells Capital must reimburse us the amount by which our aggregate annual total operating expenses exceed the greater of 2% of our average invested assets or 25% of our net income unless the conflicts committee has determined that such excess expenses were justified based on unusual and non-recurring factors. Average invested assets means the average monthly book value of our assets during the 12-month period before deducting depreciation, bad debts or other non-cash reserves. Total operating expenses means all expenses paid or incurred by us, as determined under GAAP, that are in any way related to our operation, including advisory fees, but excluding (a) the expenses of raising capital such as organization and offering expenses, legal, audit, accounting, underwriting, brokerage, listing, registration and other fees, printing and other such expenses and taxes incurred in connection with the issuance, distribution, transfer, registration and stock exchange listing of our stock; (b) interest payments; (c) taxes; (d) non-cash expenditures such as depreciation, amortization and bad debt reserves; (e) reasonable incentive fees based on the gain in the sale of our assets; and (f) acquisition fees, acquisition expenses (including expenses relating to potential acquisitions that we do not close), real estate commissions on the resale of property and other expenses connected with the acquisition, disposition, management and ownership of real estate interests, mortgage loans or other property (including the costs of foreclosure, insurance premiums, legal services, maintenance, repair and improvement of property).

(6) Our organizational documents do not impose a specific cap on property management fees. However, if we retain Wells Management to manage some of our properties, our charter requires that the management fee be no less favorable to us than a fee we could obtain from a third-party property manager. Additionally, all property management fees, including both those paid to Wells Management and third parties, are subject to the limit on total operating expenses as described in footnote (5).

(7) Although we are most likely to pay real estate commissions to Wells Capital or an affiliate in the event of our liquidation, these fees may also be earned during our operational stage.

(8) Upon termination of the Advisory Agreement, Wells Capital may be entitled to a similar fee if Wells Capital would have been entitled to a subordinated participation in net sale proceeds had the portfolio been liquidated (based on an independent appraised value of the portfolio) on the date of termination. Under our charter, we could not increase these success-based fees without the approval of a majority of our independent directors, and any increase in the subordinated participation in net sale proceeds would have to be reasonable. Our charter provides that such incentive fee is presumptively reasonable if it does not exceed 15% of the balance of such net proceeds remaining after investors have received a return of their net capital contributions and a 6% per year cumulative, noncompounded return.

Wells Capital cannot earn both the subordinated participation in net sale proceeds and the subordinated incentive listing fee. Any portion of the subordinated participation in net sale proceeds that Wells Capital receives prior to our listing will offset the amount otherwise due pursuant to the subordinated incentive listing fee.

(9) If at any time the shares become listed on a national securities exchange or on the Nasdaq National Market, we will negotiate in good faith with Wells Capital a fee structure appropriate for an entity with a perpetual life. The conflicts committee of our board of directors must approve the new fee structure negotiated with Wells Capital. In

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negotiating a new fee structure, the conflicts committee must consider all of the factors its members deem relevant, including but not limited to:

- the size of the advisory fee in relation to the size, composition and profitability of our portfolio;
- the success of Wells Capital in generating opportunities that meet our investment objectives;
- the rates charged to other REITs and to investors other than REITs by advisors performing similar services;
- additional revenues realized by Wells Capital through their relationship with us;
- the quality and extent of service and advice furnished by Wells Capital;
- the performance of our investment portfolio, including income, conservation or appreciation of capital, frequency of problem investments and competence in dealing with distress situations; and
- the quality of our portfolio in relationship to the investments generated by Wells Capital for the account of other clients.

The market value of our outstanding stock will be calculated based on the average market value of the shares issued and outstanding at listing over the 30 trading days beginning 180 days after the shares are first listed on a stock exchange. We have the option to pay the subordinated incentive listing fee in the form of stock, cash, a promissory note or any combination thereof. In the event the subordinated incentive listing fee is earned by Wells Capital as a result of the listing of the shares, any previous payments of the subordinated participation in net sale proceeds will offset the amounts due pursuant to the subordinated incentive listing fee, and we will not be required to pay Wells Capital any further subordinated participation in net sale proceeds.

Since Wells Capital and its affiliates are entitled to differing levels of compensation for undertaking different transactions on our behalf, such as the subordinated participation in net sale proceeds, Wells Capital has the ability to affect the nature of the compensation it receives by recommending different transactions. However, as our fiduciary, Wells Capital is obligated to exercise good faith in all its dealings with respect to our affairs. (See Management The Advisory Agreement.)

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STOCK OWNERSHIP

The following table sets forth the beneficial ownership of our common stock as of the date of this prospectus for each person or group that holds more than 5% of our common stock, for each director and executive officer and for our directors and executive officers as a group. To our knowledge, each person that beneficially owns our shares has sole voting and dispositive power with regard to such shares.

Name of Beneficial Owner (1)	Number of Shares Beneficially Owned (2)	Percent of All Shares
Wells Capital, Inc.	100	100.0%
Leo F. Wells, III, President and Director	100	100.0%
Douglas P. Williams, Executive Vice President and Director		
Charles R. Brown, Director		
Richard W. Carpenter, Director		
Bud Carter, Director		
Donald S. Moss, Director		
Jack M. Pinkerton, Director		
Walter W. Sessoms, Director		
Neil H. Strickland, Director		
W. Wayne Woody, Director		
Randall D. Fretz, Vice President		
All directors and executive officers as a group	100	100.0%

(1) Address of each beneficial owner listed is 6200 The Corners Parkway, Suite 250, Norcross, Georgia 30092.

(2) Consists of shares held by Wells Capital, Inc. Mr. Wells indirectly owns all of the shares of Wells Capital. Excludes Wells OP II limited partner interests.

CONFLICTS OF INTEREST

We are subject to various conflicts of interest arising out of our relationship with Wells Capital and its affiliates, some of whom serve as our officers and directors. We discuss these conflicts below and conclude this section with a discussion of the corporate governance measures we adopted to ameliorate some of the risks posed by these conflicts.

Our Advisor s Interests in Other Wells Real Estate Programs

General

Wells Capital and its affiliates are general partners and advisors of other Wells programs, including programs that have investment objectives similar to ours, and we expect that they will organize other such partnerships and programs in the future. Wells Capital and such affiliates have legal and financial obligations with respect to these programs that are similar to their obligations to us.

As described in the Prior Performance Summary, Wells Capital and its affiliates have sponsored the following 16 public real estate programs with substantially identical investment objectives as ours:

1. Wells Real Estate Fund I (Wells Fund I),
2. Wells Real Estate Fund II (Wells Fund II),
3. Wells Real Estate Fund II-OW (Wells Fund II-OW),
4. Wells Real Estate Fund III, L.P. (Wells Fund III),
5. Wells Real Estate Fund IV, L.P. (Wells Fund IV),
6. Wells Real Estate Fund V, L.P. (Wells Fund V),
7. Wells Real Estate Fund VI, L.P. (Wells Fund VI),
8. Wells Real Estate Fund VII, L.P. (Wells Fund VII),
9. Wells Real Estate Fund VIII, L.P. (Wells Fund VIII),
10. Wells Real Estate Fund IX, L.P. (Wells Fund IX),

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11. Wells Real Estate Fund X, L.P. (Wells Fund X),

12. Wells Real Estate Fund XI, L.P. (Wells Fund XI),

13. Wells Real Estate Fund XII, L.P. (Wells Fund XII),

14. Wells Real Estate Fund XIII, L.P. (Wells Fund XIII),

15. Wells Real Estate Fund XIV, L.P. (Wells Fund XIV), and

16. Wells Real Estate Investment Trust, Inc. (Wells REIT I).

Two Wells-sponsored programs are currently also conducting public offerings. Wells REIT I commenced its fourth public offering on July 26, 2002 of up to 300 million shares of common stock at a price of $10.00 per share. Wells Fund XIV commenced a public offering of up to 4.5 million units of limited partnership interest at a price of $10.00 per unit on May 14, 2003.

A 17th program, Wells Real Estate Investment Trust III, Inc. (Wells REIT III), is a newly formed entity with no assets or operating history. Wells REIT III has filed a registration statement covering the issuance of 500,000 shares of common stock and 100,000,000 shares of preferred stock. Our promoters will likely withdraw the Wells REIT III registration statement or delay its effectiveness or amend it to either decrease the size of its offering or to change the investment objectives of Wells REIT III. In other words, our promoters do not intend to launch two large initial public offerings of REITs with similar investment objectives that would likely be raising capital at the same time. All of our officers and some of our directors are also officers and directors of Wells REIT I and Wells REIT III.

Allocation of Investment Opportunities

We rely on our advisor to identify suitable investment opportunities. Other Wells-sponsored programs, especially those that are currently raising offering proceeds, also rely on Wells Capital for investment opportunities. Many investment opportunities would be suitable for us as well as other Wells programs. If Wells Capital directs an investment opportunity to a Wells-sponsored program, it will offer the investment opportunity to the program for which the opportunity, in the discretion of Wells Capital, is most suitable. As a result, Wells Capital could direct attractive investment opportunities to other entities or even purchase them for its own account. Our charter disclaims any interest in an investment opportunity known to Wells Capital that Wells Capital has not recommended to us. See Certain Conflict Resolution Procedures.

Joint Ventures with Affiliates of Wells Capital

We are likely to enter into joint venture agreements with other Wells programs for the acquisition, development or improvement of properties. See Investment Objectives and Criteria Joint Venture Investments. Wells Capital and its affiliates may have conflicts of interest in determining which Wells program should enter into any particular joint venture agreement. The co-venturer may have economic or business interests or goals that are or may become inconsistent with our business interests or goals. In addition, should any such joint venture be consummated, Wells

Capital may face a conflict in structuring the terms of the relationship between our interests and the interests of the affiliated co-venturer and in managing the joint venture. Since Wells Capital and its affiliates will control both the affiliated co-venturer and, to a certain extent, us, agreements and transactions between the co-venturers with respect to any such joint venture will not have the benefit of arm s-length negotiation of the type normally conducted between unrelated co-venturers. See Risk Factors Investment Risks.

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Competition for Tenants and Others

Conflicts of interest will exist to the extent that we may acquire properties in the same geographic areas where other Wells programs own properties. In such a case, a conflict could arise in the leasing of properties in the event that we and another Wells program were to compete for the same tenants in negotiating leases, or a conflict could arise in connection with the resale of properties in the event that we and another Wells program were to attempt to sell similar properties at the same time. See Risk Factors Investment Risks. Conflicts of interest may also exist at such time as we or any of our affiliates managing property on our behalf seek to employ developers, contractors, building managers or other third parties. Wells Capital will seek to reduce conflicts that may arise with respect to properties available for sale or rent by making prospective purchasers or tenants aware of all such properties. Wells Capital will also seek to reduce conflicts relating to the employment of developers, contractors or building managers by making prospective employees aware of all properties in need of their services. However, Wells Capital and its affiliates cannot fully avoid these conflicts because it may establish differing terms for resales or leasing of the various properties or differing compensation arrangements for employees at different properties.

Allocation of Advisor s Time

We rely on Wells Capital and its affiliates for the day-to-day operation of our business. As a result of its interests in other Wells programs and the fact that it has also engaged and will continue to engage in other business activities, Wells Capital and its affiliates will have conflicts of interest in allocating their time between us and other Wells programs and activities in which they are involved. However, Wells Capital believes that it and its affiliates have sufficient personnel to discharge fully their responsibilities to all of the Wells programs and ventures in which they are involved.

Receipt of Fees and Other Compensation by Wells Capital and its Affiliates

Wells Capital and its affiliates will receive substantial fees from us. These compensation arrangements could influence our advisor s advice to us, as well as the judgment of the affiliates of Wells Capital who serve as our officers or directors. Among other matters, the compensation arrangements could affect their judgment with respect to:

- the continuation, renewal or enforcement of our agreements with Wells Capital and its affiliates, including the advisory agreement and the dealer manager agreement;
- public offerings of equity by us, which entitle Wells Investment Securities to dealer manager fees and entitle Wells Capital to increased acquisition and asset-management fees;
- property sales, which entitle Wells Capital to real estate commissions and possible success-based sale fees;
- property acquisitions from other Wells-sponsored programs, which might entitle Wells Capital to real estate commissions and possible success-based sale fees in connection with its services for the seller;

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property acquisitions from third parties, which utilize proceeds from our public offerings, thereby increasing the likelihood of continued equity offerings and related fee income for Wells Investment Securities and Wells Capital;

whether and when we seek to list our common shares on a national securities exchange or the Nasdaq National Market, which listing could entitle Wells Capital to a success-based listing fee but could also adversely affect its sales efforts for other programs depending on the price at which the shares trade; and

whether and when we seek to sell the company or its assets, which sale could entitle Wells Capital to a success-based fee but could also adversely affect its sales efforts for other programs depending upon the sales price for the company or its assets.

The advisory fees paid to Wells Capital and any management and leasing fees we may pay to Wells Management Company if we retain them to manage some of our properties will be paid irrespective of the quality of their acquisition or property management services during the term of the related agreement. See Certain Conflict Resolution Procedures.

Our Board s Loyalties to Wells REIT I and Possibly to Future Wells-sponsored Programs

Eight of our ten directors are also directors of Wells REIT I. The loyalties of those eight directors to Wells REIT I may influence the judgment of our board when considering issues for us that may affect Wells REIT I, such as the following:

The conflicts committee of the board of directors must evaluate the performance of Wells Capital with respect to whether Wells Capital is presenting to us our fair share of investment opportunities. If our advisor is not presenting a sufficient number of investment opportunities to us because it is presenting many opportunities to Wells REIT I, or if our advisor is giving preferential treatment to Wells REIT I in this regard, our conflicts committee may not be well suited to enforce our rights under the terms of the advisory agreement or to seek a new advisor.

The conflicts committee may have to make a similar evaluation with respect to the performance of Wells Management if we retain Wells Management to manage and lease some of our properties. If Wells Management is not performing well as a property manager because of its services for Wells REIT I, the divided loyalties of the members of our conflicts committee could adversely affect their willingness to insist on improvement of the performance of the property manager.

The conflicts committee will likely decide whether we purchase a property. This decision could be influenced by the hope that Wells Capital would present the opportunity to Wells REIT I if we did not pursue it.

We could enter into transactions with Wells REIT I, such as property sales or acquisitions, joint ventures or financing arrangements. Decisions of the board or the conflicts committee regarding the terms of those transactions may be influenced by its loyalties to Wells REIT I.

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A decision of the board or the conflicts committee regarding the timing of a debt or equity offering could be influenced by concerns that the offering would compete with an offering of Wells REIT I.

A decision of the board or the conflicts committee regarding the timing of property sales could be influenced by concerns that the sales would compete with those of Wells REIT I.

We could also face similar conflicts if our promoters sponsor additional REITs, such as Wells REIT III. See Our Advisor s Interest in Other Wells Real Estate Programs General.

Fiduciary Duties Owed by Some of Our Affiliates to Our Advisor and Our Advisor s Affiliates

Our executive officers and some of our directors are also officers and directors of:

Wells Capital, our advisor and the general partner of the various real estate programs sponsored by Wells Capital described above;

Wells Management, one of our possible property managers; and

Wells Investment Securities, our dealer manager.

As a result, they owe fiduciary duties to these various entities and their stockholders and limited partners, which fiduciary duties may from time to time conflict with the fiduciary duties they owe to us.

Affiliated Dealer Manager

Since Wells Investment Securities, our dealer manager, is an affiliate of Wells Capital, you will not have the benefit of an independent due diligence review and investigation of the type normally performed by an independent underwriter in connection with the offering of securities. See Plan of Distribution.

Affiliated Property Manager

Some properties we acquire may be managed and leased by Wells Management. To the extent we retain Wells Management, we will not have the benefit of independent property management. See Management Affiliated Companies.

Lack of Separate Representation

Alston & Bird LLP is counsel both to us and to Wells Capital and its affiliates, including Wells Investment Services, Wells Management and Wells Development Corporation. There is a possibility that in the future the interests of the various parties may conflict. If we do not obtain separate counsel when our interests conflict with those of Wells Capital and its affiliates, our counsel s loyalties to Wells Capital and its affiliates could interfere with its independent professional judgment in considering alternatives that we should pursue. The conflicts committee of our board of directors is authorized to engage separate counsel for advice when considering matters where the interests of Wells Capital and its affiliates could conflict with our interests.

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Certain Conflict Resolution Procedures

Conflicts Committee

In order to reduce or eliminate certain potential conflicts of interest, our charter creates a conflicts committee of our board or directors comprised of all of our independent directors. Serving on the board of, or owning an interest in, another Wells-sponsored program will not, by itself, preclude a director from serving on the conflicts committee. The conflicts committee, which is authorized to retain its own legal and financial advisors, is empowered to act on any matter permitted under Maryland law provided that it first determines that the matter at issue is such that the exercise of independent judgment by Wells Capital affiliates could reasonably be compromised. Those conflict of interest matters that we cannot delegate to a committee under Maryland law must be acted upon by both the board of directors and the conflicts committee. Among the matters we expect the conflicts committee to act upon are:

- the continuation, renewal or enforcement of our agreements with Wells Capital and its affiliates, including the advisory agreement and the dealer manager agreement;
- public offerings of securities;
- property sales;
- property acquisitions;
- transactions with affiliates;
- compensation of our officers and directors who are affiliated with our advisor;
- whether and when we seek to list our common shares on a national securities exchange or the Nasdaq National Market; and
- whether and when we seek to sell the company or its assets.

Conflicts Subcommittee

To address conflicts involving us and another Wells-sponsored program, the conflicts committee has created a subcommittee of the conflicts committee comprised of all directors on the conflicts committee that are unaffiliated with another Wells-sponsored program, e.g., Wells REIT I. The conflicts subcommittee is empowered to act on any matter permitted by Maryland law if (1) the conflicts committee delegates the matter to the conflicts subcommittee or (2) the conflicts subcommittee disagrees with the conflicts committee s handling of a matter and its minutes reflect that it determined that the matter at issue was such that the exercise of independent judgment by both the affiliates of Wells Capital and the affiliates of another Wells-sponsored program could reasonably have been compromised. Two directors currently serve on the conflicts subcommittee.

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Other Charter Provisions Relating to Conflicts of Interest

In addition to the creation of the conflicts committee, our charter contains many other restrictions relating to conflicts of interest including the following:

Advisor Compensation. The conflicts committee will evaluate at least annually whether the compensation that we contract to pay to Wells Capital and its affiliates is reasonable in relation to the nature and quality of services performed and that such compensation is within the limits prescribed by the charter. The conflicts committee will supervise the performance of Wells Capital and its affiliates and the compensation we pay to them to determine that the provisions of our compensation arrangements are being carried out. This evaluation will be based on the factors set forth below as well as any other factors deemed relevant by the conflicts committee:

- the amount of the fees paid to Wells Capital and its affiliates in relation to the size, composition and performance of our investments;
- the success of Wells Capital in generating appropriate investment opportunities;
- the rates charged to other REITs and others by advisors performing similar services;
- additional revenues realized by Wells Capital and its affiliates through their relationship with us, including whether we pay them or they are paid by others with whom we do business;
- the quality and extent of service and advice furnished by Wells Capital and its affiliates;
- the performance of our investment portfolio; and
- the quality of our portfolio relative to the investments generated by Wells Capital for its own account and for its other clients.

We can only pay Wells Capital a real estate commission in connection with the sale of a property if it provides a substantial amount of the services in the effort to sell the property and the commission does not exceed 3% of the sales price of the property. Moreover, the commission, when added to all other real estate commissions paid to unaffiliated parties in connection with the sale, may not exceed the lesser of a competitive real estate commission or 6% of the sales price of the property.

Term of Advisory Agreement. Each contract for the services of our advisor may not exceed one year, although there is no limit on the number of times that a particular advisor may be retained. The conflicts committee or our advisor may terminate our advisory agreement with Wells Capital without cause or penalty on 60 days written notice.

Our Acquisitions. We will not purchase or lease properties in which Wells Capital, our directors or officers or any of their affiliates has an interest without a determination by a majority of the conflicts committee, that such transaction is fair and reasonable to us and at a price to us no greater than the cost of the property to the affiliated seller or lessor unless there is substantial justification for the excess amount. In no event will we acquire any such property at an amount in excess of its current appraised value as determined by an independent expert selected by our independent directors not otherwise interested in the transaction.

Mortgage Loans Involving Affiliates. Our charter prohibits us from investing in or making mortgage loans in which the transaction is with Wells Capital or our directors or officers or any of their affiliates unless an independent expert appraises the underlying property. We must keep the appraisal for at least five years and make it available for inspection and duplication by

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any of our stockholders. In addition, we must obtain a mortgagee s or owner s title insurance policy or commitment as to the priority of the mortgage or the condition of the title. Our charter prohibits us from making or investing in any mortgage loans that are subordinate to any mortgage or equity interest of Wells Capital, our directors or officers or any of their affiliates.

Other Transactions Involving Affiliates. A majority of the conflicts committee must conclude that all other transactions, including joint ventures, between us and Wells Capital, our officers or directors or any of their affiliates are fair and reasonable to us and on terms and conditions not less favorable to us than those available from unaffiliated third parties.

Limitation on Operating Expenses. Wells Capital must reimburse us the amount by which our aggregate annual total operating expenses exceed the greater of 2% of our average invested assets or 25% of our net income unless the conflicts committee has determined that such excess expenses were justified based on unusual and non-recurring factors. Average invested assets means the average monthly book value of our assets during the 12-month period before deducting depreciation, bad debts or other non-cash reserves. Total operating expenses means all expenses paid or incurred by us, as determined under generally accepted accounting principles, that are in any way related to our operation, including advisory fees, but excluding (a) the expenses of raising capital such as organization and offering expenses, legal, audit, accounting, underwriting, brokerage, listing, registration and other fees, printing and other such expenses and taxes incurred in connection with the issuance, distribution, transfer, registration and stock exchange listing of our stock; (b) interest payments; (c) taxes; (d) non-cash expenditures such as depreciation, amortization and bad debt reserves; (e) reasonable incentive fees based on the gain in the sale of our assets; and (f) acquisition fees, acquisition expenses, real estate commissions on the resale of property and other expenses connected with the acquisition, disposition, management and ownership of real estate interests, mortgage loans or other property (including the costs of foreclosure, insurance premiums, legal services, maintenance, repair and improvement of property).

Issuance of Options and Warrants to Certain Affiliates. Our charter prohibits the issuance of options or warrants to purchase our capital stock to Wells Capital, our directors or officers or any of their affiliates (i) on terms more favorable than we offer such options or warrants to the general public or (ii) in excess of an amount equal to 10% of our outstanding capital stock on the date of grant.

Repurchase of Our Shares. Our charter prohibits us from paying a fee to Wells Capital or our directors or officers or any of their affiliates in connection with our repurchase of our capital stock.

Loans. We will not make any loans to Wells Capital or to our directors or officers or any of their affiliates. In addition, we will not borrow from these affiliates unless a majority of the conflicts committee approves the transaction as being fair, competitive and commercially reasonable, and no less favorable to us than comparable loans between unaffiliated parties. These restrictions on loans will only apply to advances of cash that are commonly viewed as loans, as determined by the board of directors. By way of example only, the prohibition on loans would not restrict advances of cash for legal expenses or other costs incurred as a result of any legal action for which indemnification is being sought, nor would the prohibition limit our ability to advance reimbursable expenses incurred by directors or officers or Wells Capital or its affiliates.

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Reports to Stockholders. Our charter requires that we prepare an annual report and deliver it to our stockholders within 120 days after the end of each fiscal year. Among the matters that must be included in the annual report are:

- the ratio of the costs of raising capital during the year to the capital raised;
- the aggregate amount of advisory fees and the aggregate amount of other fees paid to Wells Capital and any affiliate of Wells Capital by us or third parties doing business with us during the year;
- our total operating expenses for the year, stated as a percentage of our average invested assets and as a percentage of our net income;
- a report from the conflicts committee that our policies are in the best interests of our common stockholders and the basis for such determination; and
- separately stated, full disclosure of all material terms, factors and circumstances surrounding any and all transactions involving us and our advisor, a director or any affiliate thereof during the year; and the conflicts committee is specifically charged with a duty to examine and comment in the report on the fairness of the transactions.

Voting of Shares Owned by Affiliates. Before becoming a stockholder, Wells Capital or a director or officer or any of their affiliates must agree not to vote their shares regarding (i) the removal of any of these affiliates or (ii) any transaction between them and us.

Ratification of Charter Provisions. Our board of directors and the conflicts committee have reviewed and ratified our charter by the vote of a majority of their respective members, as required by our charter.

Allocation of Investment Opportunities

When Wells Capital presents an investment opportunity to a Wells-sponsored program, it will offer the opportunity to the program for which the investment opportunity is most suitable. This determination is made by Wells Capital. However, our advisory agreement with Wells Capital requires that Wells Capital make this determination in a manner that is fair without favoring any other Wells-sponsored program. In determining the Wells-sponsored program for which an investment opportunity would be most suitable, Wells Capital will consider the following factors:

- the investment objectives and criteria of each program;
- the cash requirements of each program;
- the effect of the acquisition both on diversification of each program s investments by type of commercial property and geographic area and on diversification of the tenants of its properties;

the policy of each program relating to leverage of properties;

the anticipated cash flow of each program;

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- the income tax effects of the purchase on each program;
- the size of the investment; and
- the amount of funds available to each program and the length of time such funds have been available for investment.

In the event that an investment opportunity becomes available that is equally suitable for us and one or more other Wells programs, then Wells Capital will offer the investment opportunity to the entity that has had the longest period of time elapse since it was offered an investment opportunity. If a subsequent event or development, such as a delay in the closing of a property or a delay in the construction of a property, causes any such investment, in the opinion of Wells Capital, to be more appropriate for another Wells program, Wells Capital may offer the investment to another Wells program.

Our advisory agreement with Wells Capital requires that Wells Capital periodically inform the conflicts committee of the investment opportunities it has offered to other Wells programs so that the conflicts committee can evaluate whether we are receiving our fair share of opportunities. Wells Capital is to inform the conflicts committee of such investment opportunities quarterly. Wells Capital s success in generating investment opportunities for us and its fair allocation of opportunities among Wells programs are important criteria in the conflicts committee s determination to continue or renew our arrangements with Wells Capital and its affiliates. The conflicts committee has a duty to ensure that Wells Capital fairly applies its method for allocating investment opportunities among the Wells-sponsored programs.

INVESTMENT OBJECTIVES AND CRITERIA

General

We intend to invest in commercial real estate properties. Our primary investment objectives are:

- to provide current income for you through the payment of cash dividends; and
- to preserve and return your capital contributions.

We also seek capital gain from our investments.

We may return all or a portion of your capital contribution in connection with a sale of the company or the properties we will acquire. Alternatively, you may be able to obtain a return on all or a portion of your capital contribution in connection with the sale of your shares.

We will seek to list our shares of common stock when our independent directors believe listing would be in the best interest of our stockholders. If we do not list our shares of common stock on a national securities exchange or on the Nasdaq National Market by October 2015, our charter requires that we either:

- seek stockholder approval of an extension or amendment of this listing deadline; or

- seek stockholder approval of the liquidation of the corporation.

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If we sought and did not obtain stockholder approval of an extension or amendment to the listing deadline, we would then be required to seek stockholder approval of our liquidation. If we sought and failed to obtain stockholder approval of our liquidation, our charter would not require us to list or liquidate, and we could continue to operate as before. If we sought and obtained stockholder approval of our liquidation, we would begin an orderly sale of our properties and distribute our net proceeds to you.

Our board may revise our investment policies, which we describe in more detail below, without the concurrence of our stockholders. Our conflicts committee will review our investment policies, which we discuss in detail below, at least annually to determine that our policies are in the best interest of our stockholders. Our charter requires that the conflicts committee include the basis for its determination in its minutes and in an annual report delivered to our stockholders.

Acquisition and Investment Policies

Primary Investment Focus

We intend to invest primarily in high quality, income-generating office and industrial properties, leased or preleased to creditworthy companies and governmental entities. We will invest in properties at all stages of development, from those under construction to those with established operating histories. As of September 30, 2003, our advisor had sponsored or advised public real estate programs that had acquired more than 22 million square feet of office and industrial buildings.

Wells Capital has developed specific standards for determining the creditworthiness of potential tenants of our properties. While authorized to enter into leases with any type of tenant, we anticipate that a majority of our tenants will be large corporations or other entities that have a net worth in excess of $100,000,000 or whose lease obligations are guaranteed by another corporation or entity with a net worth in excess of $100,000,000. In an attempt to limit or avoid speculative purchases, Wells Capital generally will seek to secure, on our behalf, leases with tenants at or prior to the closing of our acquisitions of properties.

Although we are not limited as to the geographic area where we may conduct our operations, we currently intend to invest in properties located in the United States. Generally, we will hold fee title or a long-term leasehold estate in the properties we acquire.

Other Possible Investments

Although we expect that most of our property acquisitions will be of the type described above, we may make other investments. For example, we may purchase warehouse and distribution facilities, shopping centers, business and industrial parks, manufacturing facilities, undeveloped land or options to purchase a particular property. We may also purchase mortgage loans. In fact, we can invest in whatever types of interests in real estate that we believe are in our best interests. Moreover, we are not limited in the number or size of properties we may acquire or on the percentage of net proceeds of this offering that we may invest in a single property.

Although we can purchase any type of interest in real estate, our charter does limit certain types of investments. Unless our charter is amended, we will not:

- invest more than 10% of our total assets in unimproved property or mortgage loans on unimproved property, which we define as property not acquired for the purpose of producing rental or other operating income or on which there is no development or construction in progress or planned to commence within one year;

make or invest in mortgage loans unless an appraisal is obtained concerning the underlying property, except for those mortgage loans insured or guaranteed by a government or government agency;

make or invest in mortgage loans, including construction loans, on any one property if the aggregate amount of all mortgage loans on such property would exceed an amount equal to 85% of the appraised value of such property as determined by appraisal unless substantial justification exists for exceeding such limit because of the presence of other underwriting criteria;

invest in commodities or commodity futures contracts, except for futures contracts when used solely for the purpose of hedging in connection with our ordinary business of investing in real estate assets and mortgages;

invest in real estate contracts of sale, otherwise known as land sale contracts, unless the contract is in recordable form and is appropriately recorded in the chain of title; or

invest in equity securities unless a majority of the conflicts committee approves such investment as being fair, competitive and commercially reasonable.

We do not intend to make loans to other persons (other than mortgage loans described below), to underwrite securities of other issuers or to engage in the purchase and sale of any types of investments other than interests in real estate.

Mortgage Loans

Although our charter permits us to make mortgage loans or to invest in mortgages within the limits described above, we generally do not intend to do so. We do not have a goal of investing any percentage of our assets in mortgages. Even if we have offering proceeds that cannot be invested in office properties immediately, we do not intend to invest those proceeds in mortgages. The circumstances in which we believe we may invest in mortgages or make mortgage loans are limited to the following:

the making of a mortgage loan required by a property owner as a condition to our purchase of a property;

the indirect acquisition of a mortgage by purchasing an entity, such as a REIT or other real estate company, that also owns a mortgage; and

the acquisition of a mortgage with the view of acquiring the underlying property through foreclosure.

Investment Decisions

Wells Capital will have substantial discretion with respect to the selection of specific investments and the purchase and sale of our properties, subject to the approval of our conflicts

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committee. Our conflicts committee will review our investment policies at least annually to determine whether these policies continue to be in the best interests of our stockholders.

In pursuing our investment objectives and making investment decisions for us, Wells Capital will consider relevant real estate property and financial factors, including the creditworthiness of major tenants, the location of the property, its suitability for any development contemplated or in progress, its income-producing capacity, the prospects for long-range appreciation, liquidity and tax considerations. Moreover, to the extent feasible, Wells Capital will strive to invest in a diversified portfolio of properties for us based on geography, type of property and industry group of tenants, although the number and mix of properties we acquire will largely depend upon real estate and market conditions and other circumstances existing at the time we are acquiring our properties and the amount of proceeds we raise in this offering.

To find properties that best meet our selection criteria for investment, Wells Capital s property acquisition team will study regional demographics and market conditions and interview local brokers to gain the practical knowledge that these studies sometimes lack. An experienced commercial construction engineer will inspect the structural soundness and the operating systems of each building, and an environmental firm will investigate all environmental issues to ensure each property meets our quality specifications.

Conditions to Closing Our Acquisitions

Generally, we will condition our obligation to close the purchase of any investment on the delivery and verification of certain documents from the seller or developer, including, where appropriate:

- plans and specifications;
- surveys;
- evidence of marketable title, subject to such liens and encumbrances as are acceptable to Wells Capital;
- title and liability insurance policies; and
- financial statements covering recent operations of properties having operating histories.

Moreover, we will not close the purchase of any property unless and until we obtain an environmental assessment (Phase I review at a minimum) for each property purchased and are generally satisfied with the environmental status of the property.

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Development and Construction of Properties

We may invest substantially all of the proceeds available for investment in properties on which improvements are to be constructed or completed. Because development of real estate properties is subject to risks relating to a builder s ability to control construction costs or to build in conformity with plans, specifications and timetables, we may help ensure performance by the builders of properties that are under construction at the price contracted by obtaining either an adequate completion bond or performance bond. As an alternative to a completion bond or performance bond, we may rely upon the substantial net worth of the contractor or developer or a personal guarantee, accompanied by financial statements showing a substantial net worth, provided by an affiliate of the person entering into the construction or development contract.

Moreover, we may directly employ one or more project managers to plan, supervise and implement the development of any unimproved properties that we may acquire. In such event, such persons would be compensated directly by us.

Tenant Improvements

We anticipate that tenant improvements required at the time of our acquisition of a property will be funded from our offering proceeds. However, at such time as a tenant of one of our properties does not renew its lease or otherwise vacates its space in one of our buildings, it is likely that, in order to attract new tenants, we will be required to expend substantial funds for tenant improvements and tenant refurbishments to the vacated space. Since we do not anticipate maintaining permanent working capital reserves, we may not have access to funds required in the future for tenant improvements and tenant refurbishments in order to attract new tenants to lease vacated space.

Terms of Leases

The terms and conditions of any lease we enter into with our tenants may vary substantially from those we describe in this prospectus. However, we expect that a majority of our leases will be what we refer to as economically net leases. An economically net lease provides that in addition to making its lease payments, the tenant will be required to pay or reimburse us for all real estate taxes, sales and use taxes, special assessments, utilities, insurance and building repairs, and other building operation and management costs. We will probably be responsible for the replacement of specific structural components of a property such as the roof of the building or the parking lot. We expect that our leases will generally have terms of five or more years, some of which may have renewal options.

We may purchase properties and lease them back to the sellers of such properties. Such sale-leaseback transactions carry certain risks, as discussed more fully under Risk Factors Federal Income Tax Risks Recharacterization of sale-leaseback transactions may cause us to lose our REIT status.

We may also enter into arrangements with the seller or developer of a property whereby the seller or developer agrees that if, during a stated period, the property does not generate a specified cash flow, the seller or developer will pay in cash to us a sum necessary to reach the specified cash flow level, subject in some cases to negotiated dollar limitations.

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Joint Venture Investments

In order to diversify our portfolio of assets, we are likely to enter into joint ventures for the acquisition, development or improvement of properties, including joint ventures with other Wells programs. We may also enter into joint ventures, partnerships, co-tenancies and other co-ownership arrangements or participations with real estate developers, owners and other affiliated third parties for the purpose of developing, owning and operating real properties. In determining whether to invest in a particular joint venture, Wells Capital will evaluate the real property that such joint venture owns or is being formed to own under the same criteria described elsewhere in this prospectus for the selection of our real estate property investments.

Our policy is to invest in joint ventures only when we will have a right of first refusal to purchase the co-venturer s interest in the joint venture if the co-venturer elects to sell such interest. In the event that the co-venturer elects to sell property held in any such joint venture, however, we may not have sufficient funds to exercise our right of first refusal to buy the other co-venturer s interest in the property held by the joint venture. In the event that any joint venture with an affiliated entity holds interests in more than one property, the interest in each such property may be specially allocated based upon the respective proportion of funds invested by each co-venturer in each such property.

We may only enter into joint ventures with other Wells programs if our conflicts committee approves the transaction as being fair and reasonable to us. At such time as Wells Capital enters into a material joint venture with another Wells program, we will supplement this prospectus to disclose the terms of such investment transaction.

Section 1031 Exchange Program

Persons selling real estate held for investment often seek to reinvest the proceeds of that sale in another real estate investment in an effort to obtain favorable tax treatment under Section 1031 of the Internal Revenue Code. Wells Development Corporation (Wells Development), an affiliate of Wells Capital, our advisor, has developed a program (the Section 1031 Exchange Program) to facilitate these transactions, referred to as like-kind exchanges. For each such transaction (a Section 1031 Program Transaction), Wells Development or another Wells affiliate will create a single member limited liability company (each of which we refer to as a Wells Exchange LLC). A Wells Exchange LLC will acquire real estate to be owned in co-tenancy arrangements with persons wishing to engage in like-kind exchanges (1031 Participants). A Wells Exchange LLC will acquire the subject property and prepare and market a private placement memorandum for the sale of co-tenancy interests in that property. When a 1031 Participant wishes to acquire a co-tenancy interest, the Wells Exchange LLC will deed an undivided co-tenancy interest in the subject property to a newly formed single-member limited liability company and then sell that entity to the 1031 Participant.

Wells Development anticipates that properties acquired in connection with the Section 1031 Exchange Program initially will be financed entirely with debt. The Wells Exchange LLC acquiring the property will obtain a first mortgage secured by the property acquired for a portion of the purchase price. In order to finance the remainder of the purchase price, the Wells Exchange LLC will obtain a short-term loan from an institutional lender. Following its acquisition of a property, a Wells Exchange LLC will attempt to sell co-tenancy interests in the property to 1031 Participants in the manner described above. The Wells Exchange LLC will use the proceeds of these sales to pay off the short-term acquisition loan. When a Wells Exchange LLC initially acquires a property, Wells OP II, our operating partnership, may enter into a

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contract with the Wells Exchange LLC. The contract would provide that, if the Wells Exchange LLC cannot sell all of the co-tenancy interests in that particular property to 1031 Participants, Wells OP II will purchase any remaining unsold co-tenancy interests. The purchase price generally would equal the Wells Exchange LLC s cost of those interests (i.e., the amount of the remaining short-term acquisition loan). Wells OP II may execute an agreement providing for the potential purchase of the unsold co-tenancy interests from a Wells Exchange LLC only if our conflicts committee approves of the transaction as being fair, competitive and commercially reasonable to Wells OP II. The price to Wells OP II may be no greater than the cost of the co-tenancy interests to the Wells Exchange LLC unless the conflicts committee finds substantial justification for such excess and that such excess is reasonable. In addition, a fair market value appraisal for each property must be obtained from an independent expert selected by our conflicts committee, and in no event may Wells OP II purchase co-tenancy interests from an affiliate at a price that exceeds the current appraised value for the property interests. Moreover, Wells OP II may enter into one or more additional contractual arrangements obligating it to purchase co-tenancy interests in a particular property directly from the 1031 Participants. In consideration for such obligations, the Wells Exchange LLC would pay Wells OP II a fee in an amount currently anticipated to range between 1.0% and 1.5% of the amount of the short-term loan being obtained by the Wells Exchange LLC. These fees could be characterized by the Internal Revenue Service as non-qualifying income for purposes of satisfying the income tests required for REIT qualification. If this fee income were, in fact, treated as non-qualifying, and if the aggregate of such fee income and any other non-qualifying income in any taxable year ever exceeded 5.0% of our gross revenues for such year, we could lose our REIT status for that taxable year and the four ensuing taxable years. Our failure to qualify as a REIT would adversely affect your return on your investment. While we will monitor these fees and any other non-qualifying income, we could fail to satisfy this test.

In the event that Wells OP II has any obligation to acquire any interest in a property pursuant to the Section 1031 Exchange Program, our conflicts committee will be required to approve each acquisition. Accordingly, Wells Development intends that each Wells Exchange LLC will purchase only real estate properties that otherwise meet our investment objectives.

All purchasers of co-tenancy interests, including Wells OP II if it purchases co-tenancy interests, will be required to execute a tenants-in-common agreement with the other purchasers of co-tenancy interests in that particular property. They will also be required to execute a property management and leasing agreement with Wells Management, which would provide for the payment of property management and leasing fees to Wells Management. If Wells OP II is required to purchase co-tenancy interests pursuant to one or more of these contractual arrangements, we will be subject to various risks associated with co-tenancy arrangements which are not otherwise present in real estate investments, such as the risk that the interests of the 1031 Participants will become adverse to our interests.

Borrowing Policies

Our charter limits our borrowings to 50% of our cost (before deducting depreciation or other non-cash reserves) of all our assets unless any excess borrowing is approved by a majority of the conflicts committee and is disclosed to our stockholders in our next quarterly report with an explanation from the conflicts committee of the justification for the excess borrowing. There is no limitation on the amount we may borrow for the purchase of any single property. We do not intend to exceed this leverage limit except in the early stages of our development, when the costs of properties are most likely to exceed our net offering proceeds. See Plan of Operation

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Liquidity and Capital Resources   for a discussion of proposed bridge financing facilities that would enable us to borrow up to 100% of the cost of a property.

By operating on a leveraged basis, we would have more funds available for investment in properties, which would allow us to acquire a more diversified portfolio. Although our liability for the repayment of indebtedness is expected to be limited to the value of the property securing the liability and the rents or profits derived from the property, our use of leveraging increases the risk of default on the mortgage payments and a resulting foreclosure of a particular property. To the extent that we do not obtain mortgage loans on our properties, our ability to acquire additional properties will be restricted. When interest rates on mortgage loans are high or financing is otherwise unavailable on a timely basis, we may purchase certain properties for cash with the intention of obtaining a mortgage loan for a portion of the purchase price at a later time. Wells Capital will seek to obtain financing on our behalf on the most favorable terms available. Lenders may have recourse to assets not securing the repayment of the indebtedness.

Wells Capital will refinance properties during the term of a loan only in limited circumstances, such as when a decline in interest rates makes it beneficial to prepay an existing mortgage, when an existing mortgage matures or if an attractive investment becomes available and the proceeds from the refinancing can be used to purchase such investment. The benefits of the refinancing may include an increased cash flow resulting from reduced debt service requirements, an increase in dividend distributions from proceeds of the refinancing, if any, and/or an increase in property ownership if some refinancing proceeds are reinvested in real estate.

Disposition Policies

We intend to hold each property we acquire for an extended period. However, circumstances might arise that could result in the early sale of some properties. We may sell a property before the end of the expected holding period if we believe the sale of the property would be in the best interests of our stockholders.

The determination of whether a particular property should be sold or otherwise disposed of will be made after consideration of relevant factors, including prevailing economic conditions and current tenant creditworthiness, with a view to achieving maximum capital appreciation. We cannot assure you that this objective will be realized. The selling price of a property that is net leased will be determined in large part by the amount of rent payable under the lease. If a tenant has a repurchase option at a formula price, we may be limited in realizing any appreciation. In connection with our sales of properties we may lend the purchaser all or a portion of the purchase price. In these instances, our taxable income may exceed the cash received in the sale. The terms of payment will be affected by custom in the area in which the property being sold is located and the then-prevailing economic conditions.

Investment Limitations

Our charter places numerous limitations on us with respect to the manner in which we may invest our funds or issue securities. These limitations cannot be changed unless our charter is amended, which requires approval of our stockholders. Unless our charter is amended, we will not:

borrow in excess of 50% of our aggregate cost (before deducting depreciation or other non-cash reserves) of all assets owned by us, unless approved by a majority of the conflicts committee;

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make investments in unimproved property or mortgage loans on unimproved property in excess of 10% of our total assets;

make or invest in mortgage loans unless an appraisal is obtained concerning the underlying property, except for those mortgage loans insured or guaranteed by a government or government agency;

make or invest in mortgage loans, including construction loans, on any one property if the aggregate amount of all mortgage loans on such property would exceed an amount equal to 85% of the appraised value of such property as determined by appraisal unless substantial justification exists for exceeding such limit because of the presence of other underwriting criteria;

make an investment in a property or mortgage loan if the related acquisition fees and acquisition expenses are not reasonable or exceed 6% of the purchase price of the property or, in the case of a mortgage loan, 6% of the funds advanced; provided that the investment may be made if a majority of the conflicts committee determines that the transaction is commercially competitive, fair and reasonable to us.

invest in equity securities unless a majority of the conflicts committee approves such investment as being fair, competitive and commercially reasonable;

invest in real estate contracts of sale, otherwise known as land sale contracts, unless the contract is in recordable form and is appropriately recorded in the chain of title;

invest in commodities or commodity futures contracts, except for futures contracts when used solely for the purpose of hedging in connection with our ordinary business of investing in real estate assets and mortgages;

issue equity securities on a deferred payment basis or other similar arrangement;

issue debt securities in the absence of adequate cash flow to cover debt service;

issue equity securities that are assessable after we have received the consideration for which our board of directors authorized their issuance; or

issue equity securities redeemable solely at the option of the holder, which restriction has no effect on our proposed share redemption program or the ability of our operating partnership to issue redeemable partnership interests.

In addition, our charter includes many other investment limitations in connection with conflict-of-interest transactions, which limitations are described above under Conflicts of Interest. Our charter also includes restrictions on roll-up transactions, which are described under Description of Shares below.

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PLAN OF OPERATION

General

As of the date of this prospectus, we have not commenced operations. After the minimum subscription of 250,000 shares at $10 per share is achieved, subscription proceeds will be released to us (except for subscriptions from Pennsylvania investors see Plan of Distribution Special Notice to Pennsylvania Investors) and applied to investments in properties and other assets and the payment or reimbursement of selling commissions and other organization and offering expenses. See Estimated Use of Proceeds. We will experience a relative increase in liquidity as additional subscriptions for shares are received and a relative decrease in liquidity as net offering proceeds are expended in connection with the acquisition, development and operation of properties.

We have not entered into any arrangements to acquire any specific properties with the net proceeds from this offering. The number of properties we may acquire will depend upon the number of shares sold and the resulting amount of the net proceeds available for investment in properties.

We are not aware of any material trends or uncertainties, favorable or unfavorable, other than national economic conditions affecting real estate generally, that may be reasonably anticipated to have a material impact on either capital resources or the revenues or income to be derived from the acquisition and operation of real estate properties, other than those referred to in this prospectus.

Our advisor also may, but is not required to, establish reserves from gross offering proceeds, out of cash flow generated by operating properties or out of non-liquidating net sale proceeds from the sale of our properties. Working capital reserves are typically utilized for non-operating expenses such as tenant improvements, leasing commissions and major capital expenditures. Alternatively, a lender may require its own formula for escrow of working capital reserves.

The net proceeds of this offering will provide funds to enable us to purchase properties. We may acquire properties free and clear of permanent mortgage indebtedness by paying the entire purchase price of each property in cash or for equity securities, or a combination thereof, and we may selectively encumber all or certain properties, if favorable financing terms are available, following acquisition. The proceeds from such loans will be used to acquire additional properties or increase cash flow. In addition, we intend to borrow funds to purchase properties. In the event that this offering is not fully sold, our ability to diversify our investments may be diminished.

We intend to make an election under Section 856(c) of the Internal Revenue Code to be taxed as a REIT under the Internal Revenue Code, beginning with the taxable year ended December 31, 2003. If we qualify as a REIT for federal income tax purposes, we generally will not be subject to federal income tax on income that we distribute to our stockholders. If we fail to qualify as a REIT in any taxable year, we will be subject to federal income tax on our taxable income at regular corporate rates and will not be permitted to qualify for treatment as a REIT for federal income tax purposes for four years following the year in which our qualification is denied. Such an event could materially and adversely affect our net income. However, we believe that we are organized and operate in a manner that will enable us to qualify for treatment as a REIT for

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federal income tax purposes during the year ended December 31, 2003, and we intend to continue to operate so as to remain qualified as a REIT for federal income tax purposes.

We will monitor the various qualification tests that we must meet to maintain our status as a REIT. Ownership of our shares will be monitored to ensure that no more than 50% in value of our outstanding shares is owned, directly or indirectly, by five or fewer individuals at any time after the first taxable year for which we make an election to be taxed as a REIT. We will also determine, on a quarterly basis, that the gross income, asset and distribution tests as described in the section of this prospectus entitled Federal Income Tax Considerations Requirements for Qualification are met.

Liquidity and Capital Resources

Our principal demands for funds will be for property acquisitions, either directly or through investment interests, for the payment of operating expenses and dividends, and for the payment of interest on our outstanding indebtedness. Generally, cash needs for items other than property acquisitions will be met from operations, and cash needs for property acquisitions will be funded by public offerings of our shares and debt. However, there may be a delay between the sale of our shares and our purchase of properties, which could result in a delay in the benefits to our stockholders, if any, of returns generated from our investment operations. In an attempt to avoid this delay, we have been in discussions with a lender to arrange bridge financing facilities. The discussions have envisioned two tranches of financing. The first financing facility under discussion would be a $175 million, 90-day secured credit facility, the proceeds of which we would use to acquire properties that are at least 85% leased and occupied. Advances under this facility would initially be available to finance 100% of the acquisition cost of properties. The facility would require us to use equity raised subsequent to entering the facility to repay it. Within 45 days, we must reduce our leverage so that the advances represent no more than 85% of our debt and equity capital. We must further decrease our leverage to 70% by the facility s maturity. Interest would accrue depending on our leverage and would range from LIBOR plus 500 basis points for leverage in excess of 85% down to LIBOR plus 225 basis points for leverage of 70% or less. This facility would be secured by property acquisitions up to $175 million during the facility term.

When we reduce our leverage to 70%, we will be eligible to replace this facility with the second financing tranche. For the second tranche, we are currently discussing a $350 million revolving facility, the proceeds of which would be used to acquire properties meeting similar lender requirements, including that each property be 85% occupied and 100% owned in fee simple by Wells OP II. Advances under the facility would be generally limited to 60% to 70% of the property s acquisition cost. We could choose to pay an interest rate of either LIBOR plus 225 basis points or the base rate of the facility s administrative agent plus 50 basis points. In addition to monthly payments of interest, we would have to repay outstanding principal and accrued interest within 180 days of entering into the facility unless we sought a 180-day extension and met the conditions to extend the maturity date. We would also be expected to pay down the facility with proceeds from this offering to the extent they were not needed to meet our budgeted costs. We would execute mortgage instruments and deliver them to the facility s administrative agent at the time of advances under the facility; however, the mortgage instruments would not be recorded unless we defaulted under the facility. The lender arranging the bridge facilities has not committed to making the facilities available to us; the proposal is subject to negotiation as well as the agent s internal credit approval and completion of due diligence.

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Our advisor will evaluate potential additional property acquisitions and engage in negotiations with sellers and lenders on our behalf. After a purchase contract is executed that contains specific terms, the property will not be purchased until the successful completion of due diligence, which includes review of the title insurance commitment, an appraisal and an environmental analysis. In some instances, the proposed acquisition will require the negotiation of final binding agreements, which may include financing documents. During this period, we may decide to temporarily invest any unused proceeds from the offering in certain investments that could yield lower returns than the properties. These lower returns may affect our ability to make distributions.

Potential future sources of capital include proceeds from secured or unsecured financings from banks or other lenders, proceeds from the sale of properties and undistributed funds from operations. If necessary, we may use financings or other sources of capital in the event of unforeseen significant capital expenditures. Other than the proposed bridge facility described above, we have not identified sources of such financing currently.

Results of Operations

As of the date of this prospectus, we have commenced no significant operations because we are in our organizational and development stage. No operations will commence until we have sold at least 250,000 shares of our common stock to the public at $10 per share in this offering. Our management is not aware of any material trends or uncertainties, other than national economic conditions affecting real estate generally, that may reasonably be expected to have a material impact, favorable or unfavorable, on revenues or income from the acquisition and operations of real properties, other than those referred to in this prospectus.

Inflation

The real estate market has not been affected significantly by inflation in the past three years due to the relatively low inflation rate. However, we expect that there will be provisions in the majority of our tenant leases which would protect us from the impact of inflation. These provisions include reimbursement billings for operating expense pass-through charges, real estate tax and insurance reimbursements on a per square foot basis, or in some cases, annual reimbursement of operating expenses above a certain per square foot allowance. However, due to the long-term nature of the leases, the leases may not re-set frequently enough to cover inflation.

Critical Accounting Policies

Our accounting policies have been established to conform with GAAP. The preparation of financial statements in conformity with GAAP requires management to use judgment in the application of accounting policies, including making estimates and assumptions. These judgments affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. If management s judgment or interpretation of the facts and circumstances relating to various transactions had been different, it is possible that different accounting policies would have been applied or different amounts of assets, liabilities, revenues and expenses would have been recorded, thus resulting in a different presentation of the financial statements or different amounts reported in the financial statements. Additionally, other companies may utilize different estimates that may impact comparability of our results of operations to those of companies in similar businesses.

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Below is a discussion of the accounting policies that management considers to be critical once we commence operations in that they may require complex judgment in their application or require estimates about matters that are inherently uncertain.

Investment in Real Estate Assets

We will be required to make subjective assessments as to the useful lives of our depreciable assets. We consider the period of future benefit of the asset to determine the appropriate useful lives. These assessments have a direct impact on net income. We anticipate the estimated useful lives of our assets by class to be as follows:

Building	25 years
Building improvements	10-25 years
Land improvements	20-25 years
Tenant Improvements	Lease term

In the event that inappropriate useful lives or methods are used for depreciation, our net income would be misstated.

Valuation of Real Estate Assets

We will continually monitor events and changes in circumstances that could indicate that the carrying amounts of our real estate assets, including those held through joint ventures, may not be recoverable. When indicators of potential impairment are present which indicate that the carrying amounts of real estate assets may not be recoverable, we will assess the recoverability of the real estate assets by determining whether the carrying value of the real estate assets will be recovered through the undiscounted future operating cash flows expected from the use of the asset and its eventual disposition. In the event that such expected undiscounted future cash flows do not exceed the carrying value, we will adjust the real estate assets to the fair value and recognize an impairment loss.

Projections of expected future cash flows require us to estimate future market rental income amounts subsequent to the expiration of current lease agreements, property operating expenses, discount rates, the number of months it takes to re-lease the property and the number of years the property is held for investment. The use of inappropriate assumptions in the future cash flows analysis would result in an incorrect assessment of the property s future cash flows and fair value and could result in the overstatement of the carrying value of our real estate assets and net income.

Allocation of Purchase Price of Acquired Assets

Upon the acquisition of real properties, it will be our policy to allocate the purchase price of properties to acquired tangible assets, consisting of land and building, and identified intangible assets and liabilities, consisting of the value of above-market and below-market leases, and the value of in-place leases, based in each case on their fair values.

The fair values of the tangible assets of an acquired property (which includes land and building) will be determined by valuing the property as if it were vacant, and the as-if-vacant value will then be allocated to land and building based on our determination of the relative fair value of these assets. We will determine the as-if vacant fair value of a property using methods similar to those used by independent appraisers. Factors we consider in performing these

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analyses will include an estimate of carrying costs during the expected lease-up periods considering current market conditions and costs to execute similar leases. In estimating carrying costs, we will include real estate taxes, insurance, and other operating expenses during the expected lease-up periods based on current market demand. We will estimate costs to execute similar leases, including leasing commissions and other related costs.

The fair values of above-market and below-market in-place leases will be recorded based on the present value (using an interest rate that reflects the risks associated with the leases acquired) of the difference between (i) the contractual amounts to be paid pursuant to the in-place leases and (ii) our estimate of fair market lease rates for the corresponding in-place leases, measured over a period equal to the remaining terms of the leases. The capitalized above-market and below-market lease values will be amortized as an adjustment to rental income over the remaining terms of the respective leases. The fair values of in-place leases will include direct costs associated with obtaining a new tenant, opportunity costs associated with lost rentals, which are avoided by acquiring an in-place lease, and tenant relationships. Direct costs associated with obtaining a new tenant will include commissions, tenant improvements and other direct costs and will be estimated based on our consideration of current market costs to execute a similar lease. We will include these direct costs in deferred leasing costs in our consolidated balance sheet and will amortize such costs to expense over the remaining terms of the respective leases. The value of opportunity costs will be calculated using the contractual amounts to be paid pursuant to the in-place leases over market absorption periods for similar leases. We will value customer relationships based on expected renewal of a lease or the likelihood of obtaining a particular tenant for other locations. We will include these lease intangibles in intangible lease assets in our consolidated balance sheet and amortize these assets to rental income over the remaining terms of the respective leases.

Estimates of the fair values of the tangible and intangible assets will require us to estimate market lease rates, property operating expenses, carrying costs during lease-up periods, discount rates, market absorption periods and the number of years the property is held for investment. The use of inappropriate estimates would result in an incorrect assessment of our purchase price allocations, which could impact the amount of our reported net income.

Distributions

The amount of dividends to be distributed to our stockholders will be determined by our board of directors and is dependent on a number of factors, including funds available from our operations, capital expenditure requirements and annual distribution requirements needed to maintain our status as a REIT under the Internal Revenue Code.

PRIOR PERFORMANCE SUMMARY

The information presented in this section represents the historical experience of real estate programs managed by Wells Capital, our advisor, and its affiliates in the last 10 years. Investors should not assume that they will experience returns, if any, comparable to those experienced by investors in such prior Wells real estate programs.

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Our advisor, Wells Capital, has served as a general partner of a total of 14 completed publicly offered real estate limited partnerships, eight of which completed their public offerings in the last 10 years. These eight limited partnerships and the year in which each of their offerings was completed are:

1. Wells Real Estate Fund VI, L.P. (1994),
2. Wells Real Estate Fund VII, L.P. (1995),
3. Wells Real Estate Fund VIII, L.P. (1996),
4. Wells Real Estate Fund IX, L.P. (1996),
5. Wells Real Estate Fund X, L.P. (1997),
6. Wells Real Estate Fund XI, L.P. (1998),
7. Wells Real Estate Fund XII, L.P. (2001), and
8. Wells Real Estate Fund XIII, L.P. (2003).

The Prior Performance Tables in this prospectus set forth information as of the dates indicated regarding certain of these Wells public programs as to: (1) experience in raising and investing funds (Table I); (2) compensation to sponsor (Table II); (3) annual operating results of prior programs (Table III); and (4) sales or disposals of properties (Table V).

In addition to the foregoing real estate limited partnerships, Wells Capital and its affiliates have sponsored four public offerings of shares of common stock of Wells Real Estate Investment Trust, Inc., which we refer to as Wells REIT I. Wells REIT I s initial public offering commenced on January 30, 1998 and terminated on December 19, 1999. Wells REIT I received gross proceeds of $132,181,919 from the sale of 13,218,192 shares from its initial public offering. Wells REIT I s second public offering commenced on December 20, 1999 and terminated on December 19, 2000. Wells REIT I received gross proceeds of $175,229,193 from the sale of 17,522,919 shares from the second public offering. Wells REIT I s third public offering commenced on December 19, 2000 and terminated on July 26, 2002. Wells REIT I received gross proceeds of $1,282,976,865 from the sale of 128,297,687 shares from the third public offering. Wells REIT I commenced its fourth public offering on July 26, 2002. As of September 30, 2003, Wells REIT I had received gross proceeds of $2,369,976,324 from the sale of 236,997,632 shares from its fourth public offering. Accordingly, as of September 30, 2003, Wells REIT I had received aggregate gross offering proceeds of $3,960,364,301,116 from the sale of 396,036,430 shares of its common stock to 100,599 investors.

Wells Capital and its affiliates are also currently sponsoring a public offering of 4,500,000 units on behalf of Wells Real Estate Fund XIV, L.P. (Wells Fund XIV), a public limited partnership. Wells Fund XIV began its offering on May 14, 2003. As of September 30, 2003, Wells Fund XIV had raised a total of $9,594,649 in offering proceeds from the sale of 959,465 units to 97 investors.

In addition to the public real estate programs sponsored by our advisor and its affiliates discussed above, Wells Development intends to form a series of limited liability companies (each of which we refer to as a Wells Exchange LLC) pursuant to the Section 1031 Exchange Program. See Investment Objectives and Criteria Acquisition and Investment Policies Section 1031 Exchange Program for a description of this program. To date, there have been only two such offerings that have closed. In the most recent offering, a Wells Exchange LLC raised $16,670,000 in proceeds from a total of 24 investors, the proceeds of which were used to acquire co-tenancy interests in an office building located in Birmingham, Alabama. These offerings are the only private programs sponsored by Wells Capital or its affiliates within the last 10 years.

Since December 31, 1999, the Wells public programs previously sponsored by our advisor and its affiliates have acquired 55 properties located in 21 states. Of these properties acquired, approximately 70.9% of these properties were single-tenant office or industrial buildings and 29.1% were multi-tenant office or industrial buildings. In addition, approximately 21.8% of these properties were new properties, 72.7% were existing properties and 5.5% were properties under construction. All of the properties purchased in which a Wells public partnership

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owned any interest were purchased without borrowing any additional funds. Table VI contained in Part II of the registration statement, which is not part of this prospectus, gives additional information relating to properties acquired by the Wells public programs, including applicable mortgage financing on properties purchased by Wells REIT I.

In addition to the real estate programs sponsored by our advisor discussed above, our advisor is also sponsoring an index mutual fund that invests in various REIT stocks and is known as the Wells S&P REIT Index Fund. The Wells S&P REIT Index Fund is a mutual fund that seeks to provide investment results corresponding to the performance of the S&P REIT Index by investing in the REIT stocks included in the S&P REIT Index. The Wells S&P REIT Index Fund began its offering on January 12, 1998, and as of December 31, 2002, the fund had raised offering proceeds net of redemptions of $131,774,458 from 7,726 investors.

Publicly Offered Unspecified Real Estate Programs

General

Wells Capital and its affiliates have previously sponsored the above-listed eight publicly offered real estate limited partnerships and are currently sponsoring Wells Fund XIV and Wells REIT I on an unspecified property or blind pool basis. As of December 31, 2002, the total amount of funds raised from investors in these eight completed offerings and the ongoing Wells REIT I offering (Wells Fund XIV did not commence its initial offering until May 14, 2003) was approximately $2.4 billion and the total number of investors in such programs was approximately 80,000.

The investment objectives of each of these Wells programs are substantially identical to our investment objectives. Substantially all of the proceeds of the offerings of these programs that are available for investment in real properties have been so invested. As of December 31, 2002, approximately 87% of the aggregate gross rental income of the properties purchased by Wells public programs since January 1, 1994 was derived from corporate tenants that at the time of lease execution, had a net worth of at least $100,000,000 or whose lease obligations were guaranteed by another entity having a net worth of at least $100,000,000.

Wells-sponsored programs have occasionally been adversely affected by the cyclical nature of the real estate market. Some Wells programs invested funds in properties at the high end of a real estate cycle, resulting in sales of such properties for less than their purchase price. In addition, some Wells public programs have owned properties that have experienced long periods of time when no tenants were paying rent. Such occurrences have been sporadic, however.

From the inception of the first Wells public program through December 31, 2002, the Wells public programs had sold four properties and one outparcel of land. No assurance can be made that any of the Wells public programs will ultimately be successful in meeting their investment objectives.

The aggregate dollar amount of the acquisition and development costs of the 91 properties purchased by the nine sponsored Wells public programs in the last 10 years (other than Wells Fund XIV), as of December 31, 2002, was approximately $2.4 billion of which approximately $36.5 million (or approximately 1.5%) had not yet been expended on the development of certain of the projects which are still under construction. Of the aggregate amount, approximately 98.34% was or will be spent on acquiring or developing office or industrial buildings, and approximately 1.66% was or will be spent on acquiring or developing shopping centers. Of the aggregate amount, approximately 23.11% was or will be spent on new

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properties, 68.63% on existing properties and 8.26% on properties under construction. Following is a table showing a breakdown of the aggregate amount of the acquisition and development costs of the properties purchased by these nine Wells public programs as of December 31, 2002:

Type of Property	*New*	*Existing*	*Construction*
Office and Industrial Buildings	22.82%	68.21%	7.31%
Shopping Centers	0.29%	0.42%	0.95%

Summary of the Wells Public Programs

Wells Fund VI terminated its offering on April 4, 1994, and received gross proceeds of $25,000,000 representing subscriptions from 1,793 limited partners ($19,332,176 of the gross proceeds were attributable to sales of Class A Units, and $5,667,824 of the gross proceeds were attributable to sales of Class B Units). Limited partners in Wells Fund VI are entitled to change the status of their units from Class A to Class B and vice versa. After taking into effect conversion elections made by limited partners subsequent to their subscription for units, as of December 31, 2002, $22,687,161 of units of Wells Fund VI were treated as Class A Units, and $2,313,227 of units were treated as Class B Units. As of December 31, 2002, Wells Fund VI owned interests in the following properties:

Property Name	*Location*	*Property Type*	*Major Tenant(s)*
Hartford	Hartford, CT	four-story office building	Hartford Fire Insurance Company
Stockbridge Village II	Stockbridge, GA	restaurant properties	multiple tenants
Stockbridge Village I Expansion	Stockbridge, GA	restaurant and retail building	multiple tenants
Stockbridge Village III	Stockbridge, GA	shopping center	multiple tenants
Marathon	Appleton, WI	three-story office building	Jaakko Poyry Fluor Daniel
Holcomb Bridge	Roswell, GA	retail center and office development	multiple tenants
BellSouth	Jacksonville, FL	four-story office building	BellSouth Advertising and Publishing Corporation and American Express Travel Related Services, Inc.
Tanglewood Commons	Clemmons, NC	shopping center	Harris Teeter, Inc.

Holcomb Bridge was 40% vacant as of December 31, 2002. The general partners of Wells Fund VI are actively attempting to find new tenants for this space.

As of December 31, 2002, Wells Fund VI had sold its interest in the following properties from its portfolio:

Date of Sale	*Property Name*	*Purchase Price*	*Net Sale Price*	*Wells Fund VI % Ownership*	*Wells Fund VI Net Sale Proceeds*	*Wells Fund VI Taxable Gain*

Oct. 1, 2001	Cherokee Commons	$ 10,650,750	$ 8,434,089	11%	$ 927,750	$ 21,867
Oct. 7, 2002	Tanglewood Commons (outparcel only)	$ 506,326	$ 524,398	34%	$ 178,295	$ 6,144

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The net sale proceeds generated from the above sale of Cherokee Commons and the outparcel of Tanglewood Commons are anticipated to be utilized by the general partners of Wells Fund VI to fund anticipated tenant improvements and other leasing costs associated with re-leasing Holcomb Bridge and are being retained to fund expansion costs, tenant improvements and leasing costs associated with a contemplated expansion of the Tanglewood Commons property.

Wells Fund VII terminated its offering on January 5, 1995, and received gross proceeds of $24,180,174 representing subscriptions from 1,910 limited partners ($16,788,095 of the gross proceeds were attributable to sales of Class A Units, and $7,392,079 of the gross proceeds were attributable to sales of Class B Units). Limited partners in Wells Fund VII are entitled to change the status of their units from Class A to Class B and vice versa. After taking into effect conversion elections made by limited partners subsequent to their subscriptions for units, as of December 31, 2002, $20,925,476 of units in Wells Fund VII were treated as Class A Units, and $3,254,699 of units were treated as Class B Units.

As of December 31, 2002, Wells Fund VII owned interests in the following properties:

Property Name	*Location*	*Property Type*	*Major Tenant(s)*
Marathon	Appleton, WI	three-story office building	Jaakko Poyry Fluor Daniel
Stockbridge Village I Expansion	Stockbridge, GA	restaurant and retail building	multiple tenants
Stockbridge Village III	Stockbridge, GA	shopping center	multiple tenants
Holcomb Bridge	Roswell, GA	retail center and office development	multiple tenants
CH2M Hill	Gainesville, FL	two-story office building	CH2M Hill and Affiliated Engineers
BellSouth	Jacksonville, FL	four-story office building	BellSouth Advertising and Publishing Corporation and American Express Travel Related Services, Inc.
Tanglewood Commons	Clemmons, NC	shopping center	Harris Teeter, Inc.
Hannover Center	Stockbridge, GA	retail development	multiple tenants

Holcomb Bridge was 40% vacant as of December 31, 2002. The general partners of Wells Fund VII are actively attempting to find new tenants for this space.

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As of December 31, 2002, Wells Fund VII had sold its interest in the following properties from its portfolio:

Date of Sale	*Property Name*	*Purchase Price*	*Net Sale Price*	*Wells Fund VII % Ownership*	*Wells Fund VII Net Sale Proceeds*	*Wells Fund VII Taxable Gain*
Oct. 1, 2001	Cherokee Commons	$ 10,650,750	$ 8,434,089	11%	$ 927,750	$ 21,867
Oct. 7, 2002	Tanglewood Commons (outparcel only)	$ 506,326	$ 524,398	34%	$ 178,295	$ 6,144

The net sale proceeds generated from the above sale of Cherokee Commons and the outparcel of Tanglewood Commons are anticipated to be utilized by the general partners of Wells Fund VII to fund anticipated tenant improvements and other leasing costs associated with re-leasing Holcomb Bridge and are being retained to fund expansion costs, tenant improvements and leasing costs associated with a contemplated expansion of the Tanglewood Commons property.

Wells Fund VIII terminated its offering on January 4, 1996, and received gross proceeds of $32,042,689 representing subscriptions from 2,241 limited partners ($26,135,339 of the gross proceeds were attributable to sales of Class A Units, and $5,907,350 were attributable to sales of Class B Units). Limited partners in Wells Fund VIII are entitled to change the status of their units from Class A to Class B and vice versa. After taking into effect conversion elections made by limited partners subsequent to their subscriptions for units and certain repurchases made by Wells Fund VIII, as of December 31, 2002, $28,623,653 of units in Wells Fund VIII were treated as Class A Units, and $3,409,036 of units were treated as Class B Units. As of December 31, 2002, Wells Fund VIII owned interests in the following properties:

Property Name	*Location*	*Property Type*	*Major Tenant(s)*
CH2M Hill	Gainesville, FL	two-story office building	CH2M Hill and Affiliated Engineers
BellSouth	Jacksonville, FL	four-story office building	BellSouth Advertising and Publishing Corporation and American Express Travel Related Services, Inc.
Tanglewood Commons	Clemmons, NC	shopping center	Harris Teeter, Inc.
Hannover Center	Stockbridge, GA	retail development	multiple tenants
US Cellular	Madison, WI	four-story office building	US Cellular, a subsidiary of BellSouth Corporation
AT&T Texas	Farmers Branch, TX	one-story office building	TCI Central, Inc.
Quest	Irvine, CA	two-story office building	Quest Software, Inc.
Cirrus Logic	Broomfield, CO	two-story office building	Cirrus Logic, Inc.

As of December 31, 2002, Wells Fund VIII had sold its interest in the following property from its portfolio:

Date of Sale	*Property Name*	*Purchase Price*	*Net Sale Price*	*Wells Fund VIII % Ownership*	*Wells Fund VIII*	*Wells Fund VIII*

					Net Sale Proceeds	***Taxable Gain***
Oct. 7, 2002	Tanglewood Commons (outparcel only)	$ 506,326	$ 524,398	32%	$ 167,808	$ 5,784

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The net sale proceeds generated from the above sale of the outparcel of Tanglewood Commons are anticipated to be utilized by the general partners of Wells Fund VIII to fund expansion costs, tenant improvements and leasing costs associated with a contemplated expansion of the Tanglewood Commons property.

Wells Fund IX terminated its offering on December 30, 1996, and received gross proceeds of $35,000,000 representing subscriptions from 2,098 limited partners. $29,359,310 of the gross proceeds were attributable to sales of Class A Units, and $5,640,690 were attributable to sales of Class B Units. Limited Partners in Wells Fund IX are entitled to change the status of their units from Class A to Class B and vice versa. After taking into effect conversion elections made by limited partners subsequent to their subscriptions for units, as of December 31, 2002, $31,655,826 of units in Wells Fund IX were treated as Class A Units, and $3,344,174 of units were treated as Class B Units. As of December 31, 2002, Wells Fund IX owned interests in the following properties:

Property Name	*Location*	*Property Type*	*Major Tenant(s)*
US Cellular	Madison, WI	four-story office building	US Cellular, a subsidiary of BellSouth Corporation
AT&T Texas	Farmers Branch, TX	one-story office building	TCI Central, Inc.
Quest	Irvine, CA	two-story office building	Quest Software, Inc.
Cirrus Logic	Broomfield, CO	two-story office building	Cirrus Logic, Inc.
Ohmeda	Louisville, CO	two-story office building	Ohmeda, Inc.
Alstom Power Knoxville	Knoxville, TN	three-story office building	Alstom Power, Inc.
Iomega	Ogden, UT	one-story office and warehouse building	Iomega Corporation
Interlocken	Broomfield, CO	three-story office building	GAIAM, Inc. and ODS Technologies, L.P.
Avaya	Oklahoma City, OK	one-story office building	Avaya, Inc.

Wells Fund X terminated its offering on December 30, 1997, and received gross proceeds of $27,128,912 representing subscriptions from 1,806 limited partners. $21,160,992 of the gross proceeds were attributable to sales of Class A Units, and $5,967,920 were attributable to sales of Class B Units. Limited Partners in Wells Fund X are entitled to change the status of their units from Class A to Class B and vice versa. After taking into effect conversion elections made by limited partners subsequent to their subscriptions for units, as of December 31, 2002, $23,280,145 of units in Wells Fund X were treated as Class A Units and $3,848,767 of units were treated as Class B Units. As of December 31, 2002, Wells Fund X owned interests in the following properties:

Property Name	*Location*	*Property Type*	*Major Tenant(s)*
Ohmeda	Louisville, CO	two-story office building	Ohmeda, Inc.
Alstom Power Knoxville	Knoxville, TN	three-story office building	Alstom Power, Inc.
Iomega	Ogden, UT	one-story office and warehouse building	Iomega Corporation
Interlocken	Broomfield, CO	three-story office building	GAIAM, Inc. and ODS Technologies, L.P.
Avaya	Oklahoma City, OK	one-story office building	Avaya, Inc.
Cort Furniture	Fountain Valley, CA	one-story office and warehouse building	Cort Furniture Rental Corporation
Fairchild	Fremont, CA	two-story office and manufacturing building	Fairchild Technologies U.S.A., Inc.

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Wells Fund XI terminated its offering on December 30, 1998, and received gross proceeds of $16,532,802 representing subscriptions from 1,345 limited partners. $13,029,424 of the gross proceeds were attributable to sales of Class A Units and $3,503,378 were attributable to sales of Class B Units. Limited Partners in Wells Fund XI are entitled to change the status of their units from Class A to Class B and vice versa. After taking into effect conversion elections made by limited partners subsequent to their subscriptions for units, as of December 31, 2002, $13,716,060 of units in Wells Fund XI were treated as Class A Units and $2,816,742 of units were treated as Class B Units. As of December 31, 2002, Wells Fund XI owned interests in the following properties:

Property Name	*Location*	*Property Type*	*Major Tenant(s)*
Ohmeda	Louisville, CO	two-story office building	Ohmeda, Inc.
Alstom Power Knoxville	Knoxville, TN	three-story office building	Alstom Power, Inc.
Iomega	Ogden, UT	one-story office and warehouse building	Iomega Corporation
Interlocken	Broomfield, CO	three-story office building	GAIAM, Inc. and ODS Technologies, L.P.
Avaya	Oklahoma City, OK	one-story office building	Avaya, Inc.
Cort Furniture	Fountain Valley, CA	one-story office and warehouse building	Cort Furniture Rental Corporation
Fairchild	Fremont, CA	two-story office and manufacturing building	Fairchild Technologies U.S.A., Inc.
EYBL CarTex	Fountain Inn, SC	two-story manufacturing and office building	EYBL CarTex, Inc.
Sprint	Leawood, KS	three-story office building	Sprint Communications Company L.P.
Johnson Matthey	Wayne, PA	two-story research and development office and warehouse building	Johnson Matthey, Inc.
Gartner	Fort Myers, FL	two-story office building	Gartner Group, Inc.

Wells Fund XII terminated its offering on March 21, 2001, and received gross proceeds of $35,611,191 representing subscriptions from 1,333 limited partners. $26,888,608 of the gross proceeds were attributable to sales of cash-preferred units and $8,722,583 were attributable to sales of tax-preferred units. Limited Partners in Wells Fund XII are entitled to change the status of their units from cash-preferred to tax-preferred and vice versa. After taking into effect conversion elections made by limited partners subsequent to their subscriptions for units, as of

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December 31, 2002, $28,563,961 of units in Wells Fund XII were treated as cash-preferred units and $7,047,229 of units were treated as tax-preferred units. As of December 31, 2002, Wells Fund XII owned interests in the following properties:

Property Name	***Location***	***Property Type***	***Major Tenant(s)***
EYBL CarTex	Fountain Inn, SC	two-story manufacturing and office building	EYBL CarTex, Inc.
Sprint	Leawood, KS	three-story office building	Sprint Communications Company L.P.
Johnson Matthey	Wayne, PA	two-story research and development office and warehouse building	Johnson Matthey, Inc.
Gartner	Fort Myers, FL	two-story office building	Gartner Group, Inc.
Siemens	Troy, MI	three-story office building	Siemens Automotive Corporation
AT&T Oklahoma	Oklahoma City, OK	one-story office building and a two-story office building	AT&T Corp.
Comdata	Brentwood, TN	three-story office building	Comdata Network, Inc.

Wells Fund XIII began its offering on March 29, 2001. As of December 31, 2002, Wells Fund XIII had received gross proceeds of $27,232,886 representing subscriptions from 1,170 limited partners. Limited partners in Wells Fund XIII are entitled to change the status of their units from cash preferred to tax preferred and vice versa. After taking into effect conversion elections made by limited partners subsequent to their subscription for units, as of December 31, 2002, $19,215,466 of units in Wells Fund XIII were treated as cash-preferred units, and $4,252,654 of units were treated as tax-preferred units. As of December 31, 2002, $22,018,166 of the gross proceeds were attributable to sales of cash-preferred units and $5,214,720 were attributable to sales of tax-preferred units. As of December 31, 2002, Wells Fund XIII owned interests in the following properties:

Property Name	***Location***	***Property Type***	***Major Tenant(s)***
AmeriCredit	Orange Park, FL	two-story office building	AmeriCredit Financial Services Corporation
ADIC	Parker, CO	two connected one-story office and assembly buildings	Advanced Digital Information Corporation
John Wiley Indianapolis	Fishers, Indiana	four-story office building	John Wiley & Sons, Inc.

Wells REIT I terminated its first offering on December 19, 1999, and received gross proceeds of $132,181,919. Wells REIT I terminated its second offering on December 19, 2000, and received gross proceeds of $175,229,193. Wells REIT I terminated its third offering on July 26, 2002, and received gross proceeds of $1,282,976,865. Wells REIT I commenced its fourth public offering of shares of common stock on July 26, 2002. As of December 31, 2002, Wells REIT I had received gross proceeds of $587,134,594. Accordingly, as of December 31, 2002,

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Wells REIT I had received aggregate gross offering proceeds of $2,156,998,116 from the sale of 215,699,812 shares of its common stock to 58,136 investors. As of December 31, 2002, Wells REIT I owned interests in the following properties:

Property Name	*Location*	*Property Type*	*Major Tenant(s)*
Alstom Power Knoxville	Knoxville, TN	three-story office building	Alstom Power, Inc.
Ohmeda	Louisville, CO	two-story office building	Ohmeda, Inc.
Interlocken	Broomfield, CO	three-story office building	GAIAM, Inc. and ODS Technologies, L.P.
Iomega	Ogden, UT	one-story office and warehouse building	Iomega Corporation
Avaya	Oklahoma City, OK	one-story office building	Avaya, Inc.
Fairchild	Fremont, CA	one-story office and warehouse building	Fairchild Technologies U.S.A., Inc.
Cort Furniture	Fountain Valley, CA	two-story office and manufacturing building	Cort Furniture Rental Corporation
Eisenhower Blvd Tampa	Tampa, FL	four-story office building	IBM
AT&T Pennsylvania	Harrisburg, PA	four-story office building	Pennsylvania Cellular Telephone Corp.
Matsushita	Lake Forest, CA	two-story office building	Matsushita Avionics Systems Corporation
EYBL CarTex	Fountain Inn, SC	two-story manufacturing and office building	EYBL CarTex, Inc.
Sprint	Leawood, KS	three-story office building	Sprint Communications Company, L.P.
Alstom Power Richmond	Midlothian, VA	four-story office building	Alstom Power, Inc.
Johnson Matthey	Wayne, PA	research and development, office and warehouse building	Johnson Matthey, Inc.
Videojet Technologies Chicago	Wood Dale, IL	two-story office, assembly and manufacturing building	Videojet Technologies, Inc.
Gartner	Ft. Myers, FL	two-story office building	The Gartner Group, Inc.
Cinemark	Plano, TX	five-story office building	Cinemark USA, Inc. The Coca-Cola Company
Metris Tulsa	Tulsa, OK	three-story office building	Metris Direct, Inc.
Dial	Scottsdale, AZ	two-story office building	Dial Corporation

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Property Name	*Location*	*Property Type*	*Major Tenant(s)*
ASML	Tempe, AZ	two-story office building	ASM Lithography, Inc.
Motorola Tempe	Tempe, AZ	two-story office building	Motorola, Inc.
Siemens	Troy, MI	three-story office building	Siemens Automotive Corp.
Avnet	Tempe, AZ	two-story office building	Avnet, Inc.
Delphi	Troy, MI	three-story office building	Delphi Automotive Systems, LLC
Quest	Irvine, CA	two-story office building	Quest Software, Inc.
Motorola Plainfield	S. Plainfield, NJ	three-story office building	Motorola, Inc.
Stone & Webster	Houston, TX	six-story office building	Stone & Webster, Inc. SYSCO Corporation
Metris Minnesota	Minnetonka, MN	nine-story office building	Metris Direct, Inc.
AT&T Oklahoma	Oklahoma City, OK	one-story office building and a two-story office building	AT&T Corp.
			Jordan Associates, Inc.
Comdata	Brentwood, TN	three-story office building	Comdata Network, Inc.
AmeriCredit	Orange Park, FL	two-story office building	AmeriCredit Financial Services Corporation
State Street	Quincy, MA	seven-story office building	SSB Realty, LLC
IKON	Houston, TX	two one-story office buildings	IKON Office Solutions, Inc.
Nissan	Irving, TX	three-story office building	Nissan Motor Acceptance Corporation
Ingram Micro	Millington, TN	one-story office and warehouse building	Ingram Micro, L.P.
Lucent	Cary, NC	four-story office building	Lucent Technologies, Inc.
ADIC	Parker, CO	two one-story office and assembly buildings	Advanced Digital Information Corporation
Convergys	Tamarac, FL	two-story office building	Convergys Customer Management Group, Inc.
Windy Point I	Schaumburg, IL	seven-story office building	TCI Great Lakes, Inc. The Apollo Group, Inc. Global Knowledge Network Various other tenants
Windy Point II	Schaumburg, IL	eleven-story office building	Zurich American Insurance Company, Inc.

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Property Name	*Location*	*Property Type*	*Major Tenant(s)*
Vertex Sarasota	Sarasota, FL	three-story office building	Vertex Tax Technology Enterprises LLC
Transocean Houston	Houston, TX	six-story office building	Transocean Deepwater Offshore Drilling, Inc.
			Newpark Drilling Fluids, Inc.
Novartis Atlanta	Duluth, GA	four-story office building	Novartis Opthalmics, Inc.
Dana Kalamazoo	Kalamazoo, MI	two-story office and industrial building	Dana Corporation
Dana Detroit	Farmington Hills, MI	three-story office and research and development building	Dana Corporation
Travelers Express Denver	Lakewood, CO	two one-story office buildings	Travelers Express Company, Inc.
Agilent Atlanta	Alpharetta, GA	two-story office building	Agilent Technologies, Inc. Koninklijke Philips Electronics N.V.
BellSouth Ft. Lauderdale	Ft. Lauderdale, FL	one-story office building	BellSouth Advertising and Publishing Corporation
Experian/TRW	Allen, TX	two two-story office buildings	Experian Information Solutions, Inc.
Agilent Boston	Boxborough, MA	three-story office building	Agilent Technologies, Inc.
TRW Denver	Aurora, CO	three-story office building	TRW, Inc.
MFS Phoenix	Phoenix, AZ	three-story office building	Massachusetts Financial Services Company
ISS Atlanta	Atlanta, GA	two five-story office buildings	Internet Security Systems, Inc.
PacifiCare San Antonio	San Antonio, TX	two-story office building	PacifiCare Health Systems, Inc.
Kerr-McGee	Houston, TX	four-story office building	Kerr-McGee Oil & Gas Corporation
BMG Greenville	Greenville, SC	two one-story distribution facilities	BMG Marketing, Inc. and BMG Music
Kraft Atlanta	Suwanee, GA	one-story office building	Kraft Foods North America, Inc. and PerkinElmer Instruments, LLC
Nokia Dallas	Irving, TX	three office buildings	Nokia, Inc.

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Property Name	*Location*	*Property Type*	*Major Tenant(s)*
Harcourt Austin	Austin, TX	seven-story office building	Harcourt, Inc.
IRS Long Island	Holtsville, NY	two-story office building and one-story daycare facility	U.S. Internal Revenue Service
AmeriCredit Phoenix	Chandler, AZ	three-story office building	AmeriCredit Financial Services, Inc.
KeyBank Parsippany	Parsippany, NJ	four-story office building	KeyBank U.S.A., N.A. and Gemini Technology Services
Allstate Indianapolis	Indianapolis, IN	one-story office building	Allstate Insurance Company
Federal Express Colorado Springs	Colorado Springs, CO	three-story office building	Federal Express Corporation
EDS Des Moines	Des Moines, IA	one-story office and distribution building	EDS Information Services, L.L.C.
Intuit Dallas	Plano, TX	two-story office building	Intuit, Inc.
Daimler Chrysler Dallas	Westlake, TX	two-story office building	Daimler Chrysler Services North America LLC
NASA	Washington, DC	two nine-story office buildings	NASA and The Office of the Comptroller of the Currency
Capital One Richmond	Glen Allen, VA	three three-story office buildings	Capital One Services, Inc.
Caterpillar Nashville	Nashville, TN	11-story office building	Caterpillar Financial Services Corporation
John Wiley Indianapolis	Fishers, IN	four-story office building	John Wiley & Sons, Inc.
Nestle	Glendale, CA	20-story office building	Nestle USA, Inc.

Selected financial information for Wells REIT I is summarized below:

	2002	2001	2000	1999	1998
Gross Revenues	$ 139,969,246	$ 49,308,802	$ 23,373,206	$ 6,495,395	$ 395,178
Net Income	$ 60,866,964	$ 21,723,967	$ 8,552,967	$ 3,884,649	$ 334,034
Dividends per $1,000 Invested	$ 75	$ 76	$ 73	$ 70	$ 31

The information set forth above should not be considered in any way indicative of results to be expected from us. All of the properties acquired by the above Wells public programs, except for those acquired solely by Wells REIT I, were purchased and developed on an all cash basis.

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Potential investors are encouraged to examine the Prior Performance Tables in this prospectus for more detailed information regarding the prior experience of Wells Capital and its affiliates. In addition, upon request, prospective investors may obtain from Wells Capital without charge copies of offering materials and any reports prepared in connection with any of the Wells public programs, including a copy of the most recent Annual Report on Form 10-K filed with the SEC. For a reasonable fee, we will also furnish upon request copies of the exhibits to any such Form 10-K. Any such request should be directed to Wells Capital. Additionally, Table VI contained in Part II of the registration statement, which is not part of this prospectus, gives certain additional information relating to properties acquired by the Wells public programs. We will furnish, without charge, copies of such table upon request.

FEDERAL INCOME TAX CONSIDERATIONS

The following summary describes the material federal income tax considerations to us and our stockholders relating to this registration statement and the treatment of us as a REIT. The summary is not intended to represent a detailed description of the federal income tax consequences applicable to a particular stockholder in view of such stockholders particular circumstances, nor is it intended to represent a detailed description of the federal income tax consequences applicable to certain types of stockholders subject to special treatment under the federal income tax laws (such as insurance companies, financial institutions, broker-dealers, and, except to the extent discussed below, tax-exempt organizations and non-U.S. persons). This summary does not address state, local or non-U.S. tax considerations. Also, this summary deals only with our stockholders that hold common stock as capital assets within the meaning of Section 1221 of the Internal Revenue Code (the Code).

We base the information in this section on the current Code, current, temporary and proposed Treasury regulations, the legislative history of the Code and current administrative interpretations of the Internal Revenue Service (the IRS), including its practices and policies as endorsed in private letter rulings, which are not binding on the IRS, and existing court decisions. Future legislation, regulations, administrative interpretations and court decisions could change current law or adversely affect existing interpretations of current law. Any change could apply retroactively. We have not obtained any rulings from the IRS concerning the tax treatment of the matters discussed below. Thus, it is possible that the IRS could challenge the statements in this discussion, which do not bind the IRS or the courts, and that a court could agree with the IRS.

Each investor is advised to consult his or her own tax advisor regarding the tax consequences to him or her of the purchase, ownership and sale of the offered stock, including the federal, state, local, foreign and other tax consequences of such purchase, ownership, or sale and of potential changes in applicable tax laws.

Federal Income Taxation of the Company

Beginning with our taxable year that will end December 31, 2003, we intend to elect to be taxed as a REIT under Sections 856 through 860 of the Code. We believe that beginning with that taxable year we have been organized and have operated in a manner to qualify for taxation as a REIT under the Code, and we intend to continue to operate in such a manner. We can provide no assurance, however, that we have operated or will operate in a manner so as to qualify or remain qualified as a REIT.

The sections of the Code relating to qualification and operation as a REIT are highly technical and complex. The following discussion sets forth the material aspects of the Code

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sections that govern the federal income tax treatment of a REIT and its stockholders. This summary is qualified in its entirety by the applicable Code provisions, relevant rules and regulations and administrative and judicial interpretations of Code provisions and regulations. We have not requested a ruling from the IRS with respect to any issues relating to our qualification as a REIT. Therefore, we can provide no assurance that the IRS will not challenge our REIT status.

Alston & Bird LLP has acted as tax counsel to us in connection with this offering. Alston & Bird LLP is of the opinion that based on our proposed method of operation, we are in a position to qualify for taxation as a REIT for the taxable year that will end December 31, 2003. Alston & Bird s opinion is based solely on our representations with respect to factual matters concerning our business operations and our properties. Alston & Bird LLP has not independently verified these facts. In addition, our qualification as a REIT depends, among other things, upon our meeting the requirements of Sections 856 through 860 of the Code throughout each year. Accordingly, because our satisfaction of such requirements will depend upon future events, including the final determination of financial and operational results, no assurance can be given that we will satisfy the REIT requirements during the taxable year that will end December 31, 2003, or in any future year.

If we qualify as a REIT, we generally will not be subject to federal income tax on the taxable income that we distribute to our stockholders each year. The benefit of that tax treatment is that it avoids the double taxation, or taxation at both the corporate and stockholder levels, that generally results from owning stock in a corporation. However, we will be subject to federal tax in the following circumstances:

First, we will be taxed at regular corporate rates on our undistributed REIT taxable income, including undistributed net capital gains.

Second, we may be subject to the alternative minimum tax on our items of tax preference.

Third, if we have net income from foreclosure property held primarily for sale to customers in the ordinary course of business, including income from the sale or other disposition of such property, we will be subject to tax at the highest corporate rate on such income to the extent that it does not constitute qualifying income for purposes of the 75% income test (discussed below).

Fourth, if we have net income from prohibited transactions (which are, in general, certain sales or other dispositions of property that is held primarily for sale to customers in the ordinary course of business but that is not foreclosure property), we will be subject to a 100% tax on such income.

Fifth, if we fail to satisfy either the 75% or 95% gross income test (discussed below) but have nonetheless maintained our qualification as a REIT because certain other safe harbor requirements have been met, we will be subject to a 100% tax on the net income attributable to (1) the greater of (a) the amount by which we fail the 75% income test or (b) the amount by which 90% of our gross income exceeds the amount of income qualifying for the 95% income test, multiplied by (2) a fraction intended to reflect our profitability.

Sixth, if we fail to distribute each year at least the sum of:

(1) 85% of our ordinary income for such year;

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(2) 95% of our capital gain net income for such year; and

(3) any undistributed taxable income from prior periods,

then we will be subject to a 4% excise tax on the excess of the required distribution over the sum of (a) the amounts actually distributed and (b) retained amounts on which income tax is paid at the corporate level.

Seventh, if we acquire any asset from a corporation generally subject to full corporate-level tax in a carryover-basis transaction and we subsequently recognize gain on the disposition of such asset during the 10-year period beginning on the date on which we acquired the asset, then we generally will be subject to tax at the highest regular corporate rate on the lesser of the amount of gain that we recognize at the time of the sale or disposition and the amount of gain that we would have recognized if we had sold the asset at the time we acquired the asset, pursuant to guidelines issued by the IRS (the Built-In Gain Rules).

Eighth, subject to certain exceptions, we will be subject to a 100% tax if our transactions with our taxable REIT subsidiaries are not at arm s length, i.e. transactions in good faith by parties with independent interests under no compulsion to act.

Requirements for Qualification

To qualify as a REIT, we must elect to be treated as a REIT and must meet the requirements, discussed below, relating to our organization, sources of income and nature of assets.

Organizational Requirements

The Code defines a REIT as a corporation, trust or association that:

(1) is managed by one or more trustees or directors;

(2) uses transferable shares or transferable certificates to evidence beneficial ownership;

(3) would be taxable as a domestic corporation but for Sections 856 through 860 of the Code;

(4) is neither a financial institution nor an insurance company within the meaning of the applicable provisions of the Code;

(5) has at least 100 persons as beneficial owners;

(6) during the last half of each taxable year, is not closely held, i.e., not more than 50% of the value of the outstanding stock is owned, directly or indirectly, by five or fewer individuals, as defined in the Code to include certain entities;

(7) files an election or continues such election to be taxed as a REIT on its return for each taxable year; and

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(8) meets other tests described below, including with respect to the nature of its assets and income.

The Code provides that conditions (1) through (4) must be met during the entire taxable year and that condition (5) must be met during at least 335 days of a taxable year of 12 months or during a proportionate part of a taxable year of less than 12 months. Conditions (5) and (6) will not apply until after the first taxable year for which we make an election to be taxed as a REIT. For purposes of condition (6), an individual generally includes a supplemental unemployment compensation benefit plan, a private foundation, or a portion of a trust permanently set aside or used exclusively for charitable purposes, but does not include a qualified pension plan or profit sharing trust. Our beneficial ownership is evidenced by transferable shares. However, our charter currently includes certain restrictions regarding transfer of our common stock, which are intended (among other things) to assist us in continuing to satisfy conditions (5) and (6) noted above. We do not believe these restrictions cause our shares to be nontransferable within the meaning of Section 856(a)(2).

To monitor compliance with the share ownership requirements, the federal tax laws require us to maintain records regarding the actual ownership of our shares. To do so, we must require written statements each year from the record holders of significant percentages of our stock in which the record holders are to disclose the actual owners of the shares, i.e., the persons required to include the dividends we pay in their gross income. A list of those persons failing or refusing to comply with this requirement must be maintained as part of our records. Failure by us to comply with these record-keeping requirements could subject us to monetary penalties. A stockholder that fails or refuses to comply with the demand is required by Treasury regulations to submit a statement with its tax return disclosing the actual ownership of the shares and other information. If we satisfy these requirements and have no reason to know that condition (6) is not satisfied, we will be deemed to have satisfied such condition.

As a REIT, we are subject to other recordkeeping and reporting requirements, including, for example, information relating to activities performed by independent contractors and distributions.

In addition, a corporation generally may not elect to become a REIT unless its taxable year is the calendar year. We satisfy this requirement.

If a REIT owns a corporate subsidiary that is a qualified REIT subsidiary, the separate existence of that subsidiary will be disregarded for federal income tax purposes. Generally, a qualified REIT subsidiary is a corporation, other than a taxable REIT subsidiary, all of the capital stock of which is owned by the REIT. All assets, liabilities and items of income, deduction and credit of the qualified REIT subsidiary will be treated as assets, liabilities and items of income, deduction and credit of the REIT itself. A qualified REIT subsidiary of ours will not be subject to federal corporate income taxation, although it may be subject to state and local income taxation in some states. Other entities that are wholly owned by a REIT, including single member limited liability companies, are also generally disregarded as a separate entities for federal income tax purposes, including for purposes of the REIT income and asset tests.

A taxable REIT subsidiary of ours is a corporation in which we directly or indirectly own stock and that elects, together with us, to be treated as a taxable REIT subsidiary of ours. In addition, if a taxable REIT subsidiary of ours owns, directly or indirectly, securities representing 35% or more of the vote or value of a subsidiary corporation, that subsidiary will automatically be treated as a taxable REIT subsidiary of ours. A taxable REIT subsidiary is subject to federal income tax, and state and local income tax where applicable, as a regular C corporation.

Generally, a taxable REIT subsidiary can perform some impermissible tenant services without causing us to receive impermissible tenant services income under the REIT income tests. However, several provisions regarding the arrangements between a REIT and its taxable REIT subsidiaries ensure that a taxable REIT subsidiary will be subject to an appropriate level of federal income taxation. For example, the Code limits the ability of a taxable REIT subsidiary to deduct interest payments in excess of a certain amount made to us. In addition, we must pay a 100% tax on some payments that we receive or on certain expenses deducted by the taxable REIT subsidiary if the economic arrangements between us, our tenants and the taxable REIT subsidiary are not comparable to similar arrangements among unrelated parties. We cannot assure you that our taxable REIT subsidiary will not be limited in its ability to deduct interest payments (if any) made to us. In addition, we cannot assure you that the IRS might not seek to impose the 100% tax on services performed by our taxable REIT subsidiary for tenants of ours, or on a portion of the payments received by us from, or expenses deducted by, our taxable REIT subsidiaries. Moreover, all of our taxable REIT subsidiaries cannot total more than 20% of the total value of our assets.

In the case of a REIT that is a partner in a partnership, Treasury Regulations provide that the REIT will be deemed to own its proportionate share of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. In addition, the character of the assets and gross income of the partnership retain the same character in the hands of the REIT. Thus, our proportionate share of the assets, liabilities and items of income of Wells OP II will be treated as our assets, liabilities and items of income for purposes of applying and meeting the various REIT requirements. In addition, Wells OP II s proportionate share of the assets, liabilities and items of income with respect to any partnership (including any limited liability company treated as a partnership) in which it holds an interest would be considered assets, liabilities and items of income of Wells OP II for purposes of applying and meeting the various REIT requirements.

Income Tests

To maintain qualification as a REIT, we must meet two gross income requirements annually. First, we must derive directly or indirectly at least 75% of our gross income (excluding gross income from prohibited transactions) from investments relating to real property, including investments in other REITs or mortgages on real property (including rents from real property and, in certain circumstances, interest). Second, we must derive at least 95% of our gross income (excluding gross income from prohibited transactions) from the real property investments described in the preceding sentence as well as from dividends, interest, or gain from the sale or disposition of stock or securities (or from any combination of the foregoing).

Prior to the making of investments in properties, we may satisfy the 75% gross income test and the 95% income test by investing in liquid assets such as government securities or certificates of deposit, but earnings from those types of assets are qualifying income under the 75% gross income test only for one year from the receipt of proceeds. Accordingly, to the extent that offering proceeds have not been invested in properties prior to the expiration of this one-year period, in order to satisfy the 75% gross income test, we may invest the offering proceeds in less liquid investments approved by our board of directors such as mortgage-backed securities or shares in other REITs. We intend to trace offering proceeds received for purposes of determining the one-year period for new capital investments. No rulings or regulations have been issued

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under the provisions of the Code governing new capital investments, however, so that there can be no assurance that the IRS will agree with this method of calculation.

Rents we receive or that we are deemed to receive will qualify as rents from real property in satisfying the gross income requirements for a REIT described above only if several conditions are met. First, the amount of rent must not be based in whole or in part on the income or profits of any person but can be based on a fixed percentage of gross receipts or gross sales. Second, rents from real property excludes any amount received directly or indirectly from any corporation in which we own 10% or more of the total combined voting power of all classes of voting stock or 10% or more of the total number of shares of all classes of stock and from any other person in which we own an interest of 10% or more in the assets or net profits of such person. Third, rent attributable to personal property is generally excluded from rents from real property, except where such personal property is leased in connection with such real property and the rent attributable to such personal property is less than or equal to 15% of the total rent received under the lease. Finally, amounts that are attributable to services furnished or rendered in connection with the rental of real property, whether or not separately stated, will not constitute rents from real property unless such services are customarily provided in the geographic area. Customary services that are not provided to a particular tenant (e.g., furnishing heat and light, the cleaning of public entrances and the collection of trash) can be provided directly by the REIT. Where, however, such services are provided primarily for the convenience of the tenants or are provided to such tenants, such services must be provided by an independent contractor or a taxable REIT subsidiary. In the event that an independent contractor provides such services, the REIT must adequately compensate any such independent contractor, the REIT must not derive any income from the independent contractor and neither the independent contractor nor certain of its stockholders may, directly or indirectly, own more than 35% of the REIT, taking into consideration the applicable attributed ownership. Our rental income should not cease to qualify as rents from real property merely because we perform a de minimis amount of services to tenants of a property that are not usually and customarily provided and are considered rendered to the occupant. The income from these services will be considered de minimis if the value of such services (valued at not less than 150% of our direct cost of performing such services) is less than 1% of the total income derived from such property.

We do not anticipate deriving rent attributable to personal property leased in connection with real property that exceeds 15% of the total rent attributable to such lease or receiving rent from related party tenants.

Wells OP II may provide certain services with respect to our properties. We believe that these services will be of the type that are usually or customarily rendered in connection with the rental of space for occupancy only and that are not otherwise rendered to the tenants. Therefore, we believe that the provision of such customary services will not cause rents received with respect to our properties to fail to qualify as rents from real property. Noncustomary services and services rendered primarily for the tenants convenience will be provided by an independent contractor or a taxable REIT subsidiary to avoid jeopardizing the qualification of rent as rents from real property.

Fees to perform property management services for properties that we do not own will not qualify under the 75% or the 95% gross income tests. Either we or Wells OP II also may receive certain other types of income with respect to our properties that will not qualify for either of these tests. We, however, believe that the aggregate amount of such fees and other non-qualifying income in any taxable year will not cause us to exceed the limits for non-qualifying income under the 75% and 95% gross income tests.

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Except for amounts received with respect to certain investments of cash reserves, we anticipate that substantially all of our gross income will be derived from sources that will allow us to satisfy the income tests described above; however, we can make no assurance in this regard.

If we fail one or both of the 75% or 95% gross income tests for any taxable year, we may nevertheless qualify as a REIT for that year if we are eligible for relief under a certain provision of the Code. This relief provision generally will be available if: (1) our failure to meet such gross income tests is due to reasonable cause and not due to willful neglect; (2) we attach a schedule of the nature and amount of each item of income to our federal income tax return; and (3) the inclusion of any incorrect information on such schedule is not due to fraud with the intent to evade tax. We, however, cannot state whether in all circumstances we would be entitled to the benefit of this relief provision. For example, if we fail to satisfy the gross income tests because non-qualifying income that we intentionally receive exceeds the limits on such income, the IRS could conclude that our failure to satisfy the tests was not due to reasonable cause. As discussed above in Federal Income Taxation of the Company, even if this relief provision applies, a 100% tax would be imposed with respect to the part of our taxable income that fails the 75% or 95% tests.

Asset Tests

At the close of each quarter of our taxable year, we also must satisfy four tests relating to the nature and diversification of our assets. First, at least 75% of the value of our total assets must be represented by real estate assets, cash and cash items (including receivables) and government securities. Second, not more than 25% of the value of our total assets may consist of securities (other than those securities includible in the 75% asset test). Third, except for equity investments in REITs, qualified REIT subsidiaries or taxable REIT subsidiaries or other securities that qualify as real estate assets for purposes of the 75% asset test: (1) the value of any one issuer s securities owned by us may not exceed 5% of the value of our total assets; (2) we may not own more than 10% of any one issuer s outstanding voting securities; and (3) we may not own more than 10% of the value of the outstanding securities of any one issuer. Fourth, no more than 20% of the value of our total assets may be represented by securities of one or more taxable REIT subsidiaries.

Securities for purposes of the asset tests may include debt securities. However, debt of an issuer will not count as a security for purposes of the 10% value test if the debt securities are straight debt as defined in Section 1361 of the Code and one of the following conditions is met:

- the issuer is an individual;
- the only securities of the issuer that we hold are straight debt; or
- the issuer is a partnership and we hold at least a 20% profits interest in the partnership.

With respect to each issuer in which we currently own an interest that does not qualify as a REIT, a qualified REIT subsidiary or a taxable REIT subsidiary, we believe that our pro rata share of the value of the securities, including debt, of any such issuer does not exceed 5% of the total value of our assets and that we comply with the 10% voting securities limitation and 10% value limitation with respect to each such issuer. In this regard, however, we cannot provide any assurance that the IRS might not disagree with our determinations.

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After initially meeting the asset tests at the close of any quarter, we will not lose our status as a REIT for failure to satisfy the asset tests at the end of a later quarter solely by reason of changes in asset values. If the failure to satisfy the asset tests results from an acquisition of securities or other property during a quarter, we can cure the failure by disposing of a sufficient amount of non-qualifying assets within 30 days after the close of that quarter. We intend to maintain adequate records of the value of its assets to ensure compliance with the asset tests and to take such other actions within 30 days after the close of any quarter as necessary to cure any noncompliance.

Annual Distribution Requirements

To qualify for taxation as a REIT, we must meet the following annual distribution requirements.

First, we must make distributions (other than capital gain distributions) to our stockholders in an amount at least equal to (a) the sum of

(1) 90% of our REIT taxable income (computed without regard to the dividends paid deduction and by excluding our net capital gain), and

(2) 90% of the net income, if any, from foreclosure property in excess of the excise tax on income from foreclosure property, minus (b) the sum of certain items of non-cash income.

We must pay these distributions in the taxable year to which they relate. Dividends paid in the subsequent year, however, will be treated as if paid in the prior year for purposes of such prior year s 90% distribution requirement if one of the following two sets of criteria are satisfied: (1) the dividends were declared in October, November, or December, the dividends were payable to stockholders of record on a specified date in such a month, and the dividends were actually paid during January of the subsequent year; or (2) the dividends were declared before we timely file our federal income tax return for such year, the dividends were distributed in the 12-month period following the close of the prior year and not later than the first regular dividend payment after such declaration, and we elected on our tax return for the prior year to have a specified amount of the subsequent dividend treated as if paid in the prior year. Even if we satisfy this annual distribution requirement, we will be subject to tax at regular corporate tax rates to the extent that we do not distribute all of our net capital gain or REIT taxable income as adjusted.

Second, we must distribute during each calendar year at least the sum of

(1) 85% of our ordinary income for that year,

(2) 95% of our capital gain net income for that year, and

(3) any undistributed taxable income from prior periods.

In the event that we do not satisfy this distribution requirement, we will be subject to a 4% excise tax on the excess of such required distribution over the amounts actually distributed.

Third, if we dispose of any asset, which is subject to the Built-In Gain Rules, during the 10-year period beginning on the date on which we acquired the asset, we will be required to

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distribute at least 90% of the Built-In Gain (after tax), if any, recognized on the disposition of the asset.

We intend to make timely distributions sufficient to satisfy the annual distribution requirements. In this regard, the Wells OP II partnership agreement will authorize us, as general partner, to take such steps as may be necessary to cause Wells OP II to distribute to its partners an amount sufficient to permit us to meet these distribution requirements. In addition, we intend to distribute dividends pro rata to our stockholders that will not result in any dividend being treated as preferential within the meaning of Section 562(c) of the Code.

We expect that our REIT taxable income will be less than our cash flow due to the allowance of depreciation and other non-cash charges in computing REIT taxable income. Accordingly, we anticipate that we generally will have sufficient cash or liquid assets to enable us to satisfy the 90% distribution requirement. It is possible, however, that we may not have sufficient cash or other liquid assets to meet the 90% distribution requirement or to distribute such greater amount as may be necessary to avoid income and excise taxation. In such event, we may find it necessary to borrow funds to pay the required distribution or, if possible, pay taxable stock dividends in order to meet the distribution requirement.

In computing our REIT taxable income, we will use the accrual method of accounting. We are required to file an annual federal income tax return, which, like other corporate returns, is subject to examination by the IRS. Because the tax law requires us to make many judgments regarding the proper treatment of a transaction or an item of income or deduction, it is possible that the IRS will challenge positions we take in computing our REIT taxable income and our distributions. Issues could arise, for example, with respect to the allocation of the purchase price of properties between depreciable or amortizable assets and nondepreciable or non-amortizable assets such as land and the current deductibility of fees paid to Wells Capital or its affiliates. In the event that we are subject to an adjustment to our REIT taxable income (as defined in Section 860(d)(2) of the Code) resulting from an adverse determination by either a final court decision, a closing agreement between us and the IRS under Section 7121 of the Code, or any agreement as to tax liability between us and an IRS district director, we may be able to correct any resulting failure to meet the 90% annual distribution requirement by paying deficiency dividends to our stockholders that relate to the adjusted year but that are paid in the subsequent year. To qualify as a deficiency dividend, the distribution must be made within 90 days of the adverse determination and we also must satisfy certain other procedural requirements. If the statutory requirements of Section 860 of the Code are satisfied, a deduction is allowed for any deficiency dividend subsequently paid by us to offset an increase in our REIT taxable income resulting from the adverse determination. We, however, will be required to pay statutory interest on the amount of any deduction taken for deficiency dividends to compensate for the deferral of the tax liability.

Earnings and Profits

Throughout the remainder of this discussion, we frequently will refer to earnings and profits. Earnings and profits is a concept used extensively throughout corporate tax law, but it is undefined in the Code. Each corporation maintains an earnings and profits account that helps to measure whether a distribution originates from corporate earnings or from other sources. Distributions generally decrease the earnings and profits while income generally increases earnings and profits. If a corporation has positive earnings and profits, the distributions generally will be considered to come from corporate earnings. If a corporation has no earnings and profits, distributions generally will be considered a return of capital and then capital gain. In addition, a

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REIT cannot have, at the close of any taxable year, accumulated earnings and profits attributable to any non-REIT year and remain qualified as a REIT.

Failure to Qualify

If we fail to qualify as a REIT in any year and the relief provisions do not apply, we will be subject to tax (including any applicable alternative minimum tax) on our taxable income at regular corporate rates. Distributions to stockholders in any year in which we fail to qualify will not be deductible by us nor will they be required to be made. In such event, to the extent of positive current or accumulated earnings and profits, all distributions to stockholders will be dividends, taxable to individuals at preferential rates under the Jobs and Growth Relief Reconciliation Act of 2003 (the 2003 Act). Subject to certain limitations of the Code, corporate distributees may be eligible for the dividends-received deduction. Unless we are entitled to relief under specific statutory provisions, we also will be disqualified from taxation as a REIT for the four taxable years following the year during which qualification was lost. It is not possible to state whether in all circumstances we would be entitled to such statutory relief.

Sale-Leaseback Transactions

Some of our investments may be in the form of sale-leaseback transactions. In most instances, depending on the economic terms of the transaction, we will be treated for federal income tax purposes as either the owner of the property or the holder of a debt secured by the property. We do not expect to request an opinion of counsel concerning the status of any leases of properties as true leases for federal income tax purposes.

The IRS may take the position that a specific sale-leaseback transaction, which we treat as a true lease, is not a true lease for federal income tax purposes but is, instead, a financing arrangement or loan. In this event, for purposes of the asset tests and the 75% gross income test, each such loan likely would be viewed as secured by real property to the extent of the fair market value of the underlying property. We expect that, for this purpose, the fair market value of the underlying property would be determined without taking into account our lease. If a sale-leaseback transaction were so recharacterized, we might fail to satisfy the asset tests or the income tests and, consequently, lose our REIT status effective with the year of recharacterization. Alternatively, the amount of our REIT taxable income could be recalculated which might also cause us to fail to meet the distribution requirement for a taxable year.

Taxation of U.S. Stockholders

When we use the term U.S. Stockholder, we mean a holder of common stock that, for federal income tax purposes:

(1) is a citizen or resident of the United States;

(2)

is a corporation or partnership (including an entity treated as a corporation or partnership for United States federal income tax purposes) created or organized in or under the laws of the United States or of any of its political subdivisions;

(3) is an estate the income of which is subject to federal income taxation regardless of its source, or

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(4) is a trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more United States persons have the authority to control all substantial decisions of the trust.

For any taxable year for which we qualify for taxation as a REIT, amounts distributed to taxable U.S. Stockholders will be taxed as discussed below.

Distributions Generally

Distributions to U.S. Stockholders, other than capital gain dividends discussed below, will constitute taxable dividends up to the amount of our positive current or accumulated earnings and profits. Dividends received from REITs are generally not eligible to be taxed at the preferential qualified dividend income rates applicable to individuals who receive dividends from taxable C corporations pursuant to the 2003 Act. An exception applies, however, and individual stockholders are taxed at such rates on dividends designated by and received from REITs, to the extent that the dividends are attributable to (i) income that the REIT previously retained in the prior year, and on which it was subject to corporate level tax, (ii) dividends received by the REIT from taxable corporations, or (iii) income from sales of appreciated property acquired from C corporations in carryover basis transactions. Because a REIT is not subject to tax on income distributed to its stockholders, the distributions made to corporate stockholders are not eligible for the dividends-received deduction. To the extent that we make a distribution in excess of our positive current or accumulated earnings and profits, the distribution will be treated first as a tax-free return of capital, reducing the tax basis in the U.S. Stockholder s shares of common stock and then the distribution in excess of the tax basis will be taxable as gain realized from the sale of the common stock. Dividends we declare in October, November, or December of any year payable to a stockholder of record on a specified date in any such month shall be treated as both paid by us and received by the stockholders on December 31 of the year, provided that we actually pay the dividends during January of the following calendar year. Stockholders are not allowed to include on their own federal income tax returns any of our tax losses.

We will be treated as having sufficient earnings and profits to treat as a dividend any distribution we make up to the amount required to be distributed in order to avoid imposition of the 4% excise tax discussed in Federal Income Taxation of the Company above.

Capital Gain Distributions

Distributions to U.S. Stockholders that we properly designated as capital gain distributions will be treated as long-term capital gains (to the extent they do not exceed our actual net capital gain) for the taxable year without regard to the period for which the stockholder has held the stock. However, corporate stockholders may be required to treat up to 20% of certain capital gain dividends as ordinary income. Capital gain dividends are not eligible for the dividends-received deduction for corporations. Long-term capital gains are generally taxable at maximum federal rates of 15% (through 2008) in the case of stockholders who are individuals, and 35% for corporations. Capital gains attributable to the sale of depreciable real property held for more than 12 months are subject to a 25% maximum federal income tax rate for taxpayers who are individuals, to the extent of previously claimed depreciation deductions.

We may elect to retain and pay income tax on any net long-term capital gain. In this instance, U.S. Stockholders will include in their income their proportionate share of the undistributed long-term capital gain. The U.S. Stockholders also will be deemed to have paid their proportionate share of tax on such long-term capital gain and, therefore, will receive a credit

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or refund for the amount of such tax. In addition, the basis of the U.S. Stockholders shares will be increased in an amount equal to the excess of the amount of capital gain included in its income over the amount of tax it is deemed to have paid.

Certain Dispositions of Shares

In general, you will realize capital gain or loss on the disposition of common stock equal to the difference between (1) the amount of cash and the fair market value of any property received on such disposition, and (2) your adjusted basis of such common stock. Losses incurred on the sale or exchange of our common stock that you held for less than six months (after applying certain holding company rules) will be treated as a long-term capital loss to the extent of any capital gain dividend you received with respect to those shares.

The applicable tax rate will depend on the stockholder s holding period in the asset (generally, if the stockholder has held the asset for more than one year, it will produce long-term capital gain) and the stockholder s tax bracket. The IRS has the authority to prescribe, but has not yet prescribed, regulations that would apply a capital gain tax rate of 25% (which is generally higher than the long-term capital gain tax rates for non-corporate stockholders) to a portion of capital gain realized by a non-corporate stockholder on the sale of common stock that would correspond to our unrecaptured Section 1250 gain. Stockholders should consult with their own tax advisors with respect to their capital gain tax liability. In general, any loss recognized by a U.S. Stockholder upon the sale or other disposition of common stock that the stockholder has held for six months or less, after applying the holding period rules, will be treated as long-term capital loss, to the extent of distributions received by the U.S. Stockholder from us that were required to be treated as long-term capital gains.

Passive Activity Loss and Investment Interest Limitations

You may not treat distributions we make to you or any gain from disposing of our common stock as passive activity income. Therefore, you will not be able to apply any passive losses against such income. Dividends we pay (to the extent they do not constitute a return of capital) generally will be treated as investment income for purposes of the investment interest limitation. Net capital gain from the disposition of our common stock (or capital gain dividends) generally will be excluded from investment income unless you elect to have such gain taxed at ordinary income rates.

Treatment of Tax-Exempt Stockholders

Distributions we make to a tax-exempt employee pension trust or other domestic tax-exempt stockholder generally will not constitute unrelated business taxable income (UBTI) unless the tax-exempt stockholder has borrowed to acquire or carry our shares of common stock. Qualified trusts that hold more than 10% (by value) of the shares of pension-held REITs may be required to treat a certain percentage of such REIT s distributions as UBTI. We will attempt to monitor the concentration of ownership of employee pension benefit trusts in our shares, and we do not expect our shares to be deemed to be predominately held by qualified employee pension benefit trusts, as defined in the Code, to the extent required to trigger the treatment of our income as UBTI to such trusts.

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Special Tax Considerations for Non-U.S. Stockholders

The rules governing United States income taxation of non-U.S. Stockholders are complex. We intend the following discussion to be only a summary of these rules. Prospective non-U.S. Stockholders should consult with their own tax advisors to determine the impact of federal, state, local and foreign tax laws on an investment in our common stock, including any reporting requirements.

In general, non-U.S. Stockholders will be subject to regular federal income tax with respect to their investment in us if the income from the investment is effectively connected with the non-U.S. Stockholder s conduct of a trade or business in the United States. A corporate non-U.S. Stockholder that receives income that is (or is treated as) effectively connected with a U.S. trade or business also may be subject to the branch profits tax under Section 884 of the Code, which is imposed in addition to regular federal income tax at the rate of 30%, subject to reduction under a tax treaty, if applicable. Effectively connected income must meet various certification requirements to be exempt from withholding. The following discussion will apply to non-U.S. Stockholders whose income from their investments in us is not so effectively connected (except to the extent that the FIRPTA rules discussed below treat such income as effectively connected income).

A distribution payable out of our current or accumulated earnings and profits that is not attributable to gain from the sale or exchange by us of a United States real property interest and that we do not designate as a capital gain distribution will be subject to a federal income tax, required to be withheld by us, equal to 30% of the gross amount of the dividend, unless an applicable tax treaty reduces this tax. Such a distribution in excess of our earnings and profits will be treated first as a return of capital that will reduce a non-U.S. Stockholder s basis in its common stock (but not below zero) and then as gain from the disposition of such stock, the tax treatment of which is described under the rules discussed below with respect to dispositions of common stock.

Distributions by us that are attributable to gain from the sale or exchange of a United States real property interest will be taxed to a non-U.S. Stockholder under the Foreign Investment in Real Property Tax Act of 1980, or FIRPTA. Such distributions are taxed to a non-U.S. Stockholder as if the distributions were gains effectively connected with a United States trade or business. Accordingly, a non-U.S. Stockholder will be taxed at the normal capital gain rates applicable to a U.S. Stockholder (subject to any applicable alternative minimum tax and a special alternative minimum tax in the case of nonresident alien individuals). Such distributions also may be subject to a 30% branch profits tax when made to a foreign corporation that is not entitled to an exemption or reduced branch profits tax rate under a tax treaty.

Although the law is not clear on this matter, it appears that amounts designated by us as undistributed capital gains in respect of the common stock generally should be treated with respect to non-U.S. Stockholders in the same manner as actual distributions by us of capital gain dividends. Under that approach, the non-U.S. Stockholder would be able to offset as a credit against its resulting federal income tax liability an amount equal to its proportionate share of the tax paid by us on the undistributed capital gains and to receive from the IRS a refund to the extent its proportionate share of this tax paid by us were to exceed its actual federal income tax liability.

Although tax treaties may reduce our withholding obligations, we generally will be required to withhold from distributions to non-U.S. Stockholders, and remit to the IRS, 35% of designated capital gain dividends (or, if greater, 35% of the amount of any distributions that could

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be designated as capital gain dividends) and 30% of ordinary dividends paid out of earnings and profits. In addition, if we designate prior distributions as capital gain dividends, subsequent distributions, up to the amount of such prior distributions that we designated as capital gain dividends, will be treated as capital gain dividends for purposes of withholding. In addition, we may be required to withhold 10% of distributions in excess of our current and accumulated earnings and profits. If the amount of tax withheld by us with respect to a distribution to a non-U.S. Stockholder exceeds the stockholder s United States tax liability, the non-U.S. Stockholder may file for a refund of such excess from the IRS.

We expect to withhold federal income tax at the rate of 30% on all distributions (including distributions that later may be determined to have been in excess of current and accumulated earnings and profits) made to a non-U.S. Stockholder unless:

- a lower treaty rate applies and the non-U.S. Stockholder files with us an IRS Form W-8BEN evidencing eligibility for that reduced treaty rate;

- the non-U.S. Stockholder files with us an IRS Form W-8ECI claiming that the distribution is income effectively connected with the non-U.S. Stockholder s trade or business so that no withholding tax is required; or

- the distributions are treated for FIRPTA withholding tax purposes as attributable to a sale of a U.S. real property interest, in which case tax will be withheld at a 35% rate.

Unless our common stock constitutes a U.S. real property interest within the meaning of FIRPTA, a sale of common stock by a non-U.S. Stockholder generally will not be subject to federal income taxation. Our common stock will not constitute a U.S. real property interest if we are a domestically-controlled REIT. A domestically-controlled REIT is a REIT in which at all times during a specified testing period less than 50% in value of its shares is held directly or indirectly by non-U.S. Stockholders. We currently anticipate that we will be a domestically-controlled REIT and, therefore, that the sale of common stock will not be subject to taxation under FIRPTA. However, because the common stock will be publicly traded, we cannot assure you that we will be a domestically-controlled REIT. If we were not a domestically-controlled REIT, a non-U.S. Stockholder s sale of common stock would be subject to tax under FIRPTA as a sale of a U.S. real property interest unless the common stock were regularly traded on an established securities market and the selling stockholder owned no more than 5% of the common stock throughout the applicable testing period. If the gain on the sale of common stock were subject to taxation under FIRPTA, the non-U.S. Stockholder would be subject to the same treatment as a U.S. Stockholder with respect to the gain (subject to applicable alternative minimum tax and a special alternative minimum tax in the case of nonresident alien individuals). However, even if our common stock is not a U.S. real property interest, a nonresident alien individual s gains from the sale of common stock will be taxable if the nonresident alien individual is present in the United States for 183 days or more during the taxable year and certain other conditions apply, in which case the nonresident alien individual will be subject to a 30% tax on his or her U.S. source capital gains.

A purchaser of common stock from a non-U.S. Stockholder will not be required to withhold under FIRPTA on the purchase price if the purchased common stock is regularly traded on an established securities market or if we are a domestically-controlled REIT. Otherwise, the purchaser of common stock from a non-U.S. Stockholder may be required to withhold 10% of the purchase price and remit this amount to the IRS. Our shares of common stock will not be regularly traded on an established securities market.

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Upon the death of a nonresident alien individual, that individual s common stock will be treated as part of his or her U.S. estate for purposes of the U.S. estate tax, except as may be otherwise provided in an applicable estate tax treaty.

Information Reporting Requirements and Backup Withholding Tax

U.S. Stockholders

In general, information reporting requirements will apply to payments of distributions on our common stock and payments of the proceeds of the sale of our common stock, unless an exception applies. Further, under certain circumstances, U.S. Stockholders may be subject to backup withholding at a rate of 28% for 2003 on payments made with respect to, or cash proceeds of a sale or exchange of, our common stock. Backup withholding will apply only if:

(1) the payee fails to furnish his or her taxpayer identification number (which, for an individual, would be his or her Social Security Number) to the payor as required;

(2) the IRS notifies the payor that the taxpayer identification number furnished by the payee is incorrect;

(3) the IRS has notified the payee that such payee has failed to properly include reportable interest and dividends in the payee s return or has failed to file the appropriate return and the IRS has assessed a deficiency with respect to such underreporting; or

(4) the payee has failed to certify to the payor, under penalties of perjury, that the payee is not subject to withholding. In addition, backup withholding will not apply with respect to payments made to certain exempt recipients, such as corporations and tax-exempt organizations. U.S. Stockholders should consult their own tax advisors regarding their qualifications for exemption from backup withholding and the procedure for obtaining such an exemption.

Backup withholding is not an additional tax. Rather, the amount of any backup withholding with respect to a payment to a U.S. Stockholder will be allowed as a credit against the U.S. Stockholder s federal income tax liability and may entitle the stockholder to a refund, provided that the stockholder furnishes the required information to the IRS.

Non-U.S. Stockholders

Generally information reporting will apply to payments of distributions on our common stock, and backup withholding at a rate of 28% may apply, unless the payee certifies that it is not a U.S. person or otherwise establishes an exemption.

The payment of the proceeds from the disposition of our common stock to or through the U.S. office of a U.S. or foreign broker will be subject to information reporting and, possibly backup withholding unless the non-U.S. Stockholder certifies as to its non-U.S. status or otherwise establishes an exemption, provided that the broker does not have actual knowledge that the stockholder is a U.S. person or that the conditions of any other exemption are not, in fact, satisfied. The proceeds of the disposition by a non-U.S. Stockholder of our common stock to or through a foreign office of a broker generally will not be subject to information reporting or backup withholding. However, if the broker is a U.S. person, a controlled foreign corporation for

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U.S. tax purposes or a foreign person 50% or more whose gross income from all sources for specified periods is from activities that are effectively connected with a U.S. trade or business, information reporting generally will apply unless the broker has documentary evidence as to the non-U.S. Stockholder s foreign status and has no actual knowledge to the contrary.

Applicable Treasury regulations provide presumptions regarding the status of stockholders when payments to the stockholders cannot be reliably associated with appropriate documentation provided to the payer. Under these Treasury regulations, some stockholders are required to have provided new certifications with respect to payments made after December 31, 2000. Because the application of these Treasury regulations varies depending on the stockholder s particular circumstances, non-U.S. Stockholders should consult their tax advisors with regards to U.S. information reporting and backup withholding.

Tax Aspects of Wells OP II

General

We expect that substantially all of our investments will be held through Wells OP II. In general, partnerships are pass-through entities that are not subject to federal income tax. Rather, partners are allocated their proportionate share of the items of income, gain, loss, deduction and credit of a partnership and are potentially subject to tax thereon, without regard to whether the partners receive a distribution from the partnership. We will include in our income our proportionate share of Wells OP II s income, gain, loss, deduction and credit for purposes of the various REIT income tests and in the computation of our REIT taxable income. In addition, we will include our proportionate share of assets held by Wells OP II in the REIT asset tests.

Tax Allocations with Respect to our Properties

When property is contributed to a partnership in exchange for an interest in the partnership, the partnership generally takes a carryover basis in that property for tax purposes. That carryover basis is equal to the contributing partner s adjusted basis in the property rather than the fair market value of the property at the time of contribution. Pursuant to Section 704(c) of the Code, income, gain, loss and deduction attributable to such contributed property must be allocated in a manner such that the contributing partner is charged with or benefits from the unrealized gain or unrealized loss associated with the property at the time of the contribution. The amount of such unrealized gain or unrealized loss generally is equal to the difference between the fair market value of the contributed property at the time of contribution and the adjusted tax basis of such property at the time of contribution (a Book-Tax difference). Such allocations are solely for federal income tax purposes and do not affect the book capital accounts or other economic or legal arrangements among the partners.

Wells OP II may be formed by way of contributions of appreciated property, and future contributions to Wells OP II may also take the form of appreciated property. Consequently, Wells OP II agreement will require tax allocations to be made in a manner consistent with Section 704(c) of the Code.

In general, the partners who have contributed their interests in properties to Wells OP II (the Contributing Partners) will be allocated lower amounts of depreciation deductions for tax purposes than such deductions would be if determined on a pro rata basis. In addition, in the event of the disposition of any of the contributed assets that have a Book-Tax Difference, all taxable income attributable to such Book-Tax Difference generally will be allocated to the

Contributing Partners and the Company generally will be allocated only its share of capital gains attributable to appreciation, if any, occurring after the closing of the acquisition of such properties. This will tend to eliminate the Book-Tax Difference over the life of Wells OP II. However, the special allocation rules of Section 704(c) of the Code do not always entirely eliminate the Book-Tax Difference on an annual basis or with respect to a specific taxable transaction such as a sale. Thus, the carryover basis of the contributed assets in the hands of Wells OP II may cause us to be allocated lower depreciation and other deductions and cause Contributing Partners to be allocated less taxable income. As a result, we could recognize taxable income in excess of distributed amounts, which might adversely affect our ability to comply with the REIT distribution requirements and Contributing Partners may realize income on the distribution of cash because their basis has not been increased sufficiently from income allocations. See Annual Distribution Requirements.

With respect to any property purchased by Wells OP II, such property initially will have a tax basis equal to its fair market value and Section 704(c) of the Code will not apply.

Basis in Operating Partnership Interest

Our adjusted tax basis in our interest in Wells OP II generally

(1) will be equal to the amount of cash and the basis of any other property that we contributed to Wells OP II,

(2) will be increased by (a) our allocable share of Wells OP II s income and (b) our allocable share of indebtedness of Wells OP II and

(3) will be reduced, but not below zero, by our allocable share of (a) losses suffered by Wells OP II, (b) the amount of cash distributed to us, and (c) constructive distributions resulting from a reduction in our share of indebtedness of Wells OP II.

If the allocation of our distributive share of Wells OP II s loss exceeds the adjusted tax basis of its partnership interest in Wells OP II, the recognition of such excess loss will be deferred until such time and to the extent that it has an adjusted tax basis in our partnership interest. To the extent that Wells OP II s distributions, or any decrease in our share of the indebtedness of Wells OP II (such decreases being considered a cash distribution to the partners) exceed our adjusted tax basis, such excess distributions (including such constructive distributions) constitute taxable income to us. Such taxable income normally will be characterized as a capital gain if the interest in Wells OP II has been held for longer than one year, subject to reduced tax rates described above (See Taxation of U.S. Stockholders Capital Gain Distributions). Under current law, capital gains and ordinary income of corporations generally are taxed at the same marginal rates.

Sale of the Properties

Our share of gain realized by Wells OP II on the sale of any property held by Wells OP II as inventory or other property held primarily for sale to customers in the ordinary course of Wells OP II s trade or business will be treated as income from a prohibited transaction that is subject to a 100% penalty tax. See Requirements for Qualification Income Tests. Such prohibited transaction income also may have an adverse effect upon its ability to satisfy the income tests for qualification as a REIT. Under existing law, whether property is held as inventory or primarily

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for sale to customers in the ordinary course of Wells OP II s trade or business is a question of fact that depends on all the facts and circumstances with respect to the particular transaction. We, however, do not presently intend to acquire or hold or allow Wells OP II to acquire or hold any property that represents inventory or other property held primarily for sale to customers in the ordinary course of our or Wells OP II s trade or business.

State and Local Tax

We may be subject to state and local tax in various states and localities. Our stockholders also may be subject to state and local tax in various states and localities. The tax treatment to us and to our stockholders in such jurisdictions may differ from the federal income tax treatment described above. Consequently, before you buy our common stock, you should consult your own tax advisor regarding the effect of state and local tax laws on an investment in our common stock.

ERISA CONSIDERATIONS

The following is a summary of some considerations associated with an investment in our shares by a qualified employee pension benefit plan or an individual retirement account (IRA). This summary is based on provisions of the Employee Retirement Income Security Act of 1974 (ERISA), and the Internal Revenue Code, each as amended through the date of this prospectus, and relevant regulations and opinions and other authority issued by the Department of Labor and the Internal Revenue Service. We cannot assure you that there will not be adverse tax or labor decisions or legislative, regulatory or administrative changes which would significantly modify the statements expressed herein. Any such changes may or may not apply to transactions entered into prior to the date of their enactment.

Each fiduciary of an employee pension benefit plan subject to ERISA, such as a profit sharing, section 401(k) or pension plan, or of any other retirement plan or account subject to Section 4975 of the Internal Revenue Code, such as an IRA, seeking to invest plan assets in our shares must, taking into account the facts and circumstances of each such plan or IRA (Benefit Plan), consider, among other matters:

- whether the investment is consistent with the applicable provisions of ERISA and the Internal Revenue Code;
- whether, under the facts and circumstances appertaining to the Benefit Plan in question, the fiduciary s responsibility to the plan has been satisfied;
- whether the investment will produce UBTI to the Benefit Plan (see Federal Income Tax Considerations Treatment of Tax-Exempt Stockholders); and
- the need to value the assets of the Benefit Plan annually.

Under ERISA, a plan fiduciary s responsibilities include the following duties:

to act solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits to them, as well as defraying reasonable expenses of plan administration;

to invest plan assets prudently;

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- to diversify the investments of the plan unless it is clearly prudent not to do so;
- to ensure sufficient liquidity for the plan; and
- to consider whether an investment would constitute or give rise to a prohibited transaction under ERISA or the Internal Revenue Code.

ERISA also requires that the assets of an employee benefit plan be held in trust and that the trustee, or a duly authorized named fiduciary or investment manager, have exclusive authority and discretion to manage and control the assets of the plan.

Prohibited Transactions

Section 406 of ERISA and Section 4975 of the Internal Revenue Code prohibit specified transactions involving the assets of a Benefit Plan which are between the plan and any party in interest or disqualified person with respect to that Benefit Plan unless an administrative or statutory exemption applies. These transactions are prohibited regardless of how beneficial they may be for the Benefit Plan. Prohibited transactions include the sale, exchange or leasing of property, and the lending of money or the extension of credit, between a Benefit Plan and a party in interest or disqualified person. The transfer to, or use by or for the benefit of, a party in interest, or disqualified person of any assets of a Benefit Plan is also prohibited, as is the furnishing of services between a plan and a party in interest. A fiduciary of a Benefit Plan also is prohibited from engaging in self-dealing, acting for a person who has an interest adverse to the plan or receiving any consideration for its own account from a party dealing with the plan in a transaction involving plan assets. Furthermore, Section 408 of the Internal Revenue Code states that assets of an IRA trust may not be commingled with other property except in a common trust fund or common investment fund.

Plan Asset Considerations

In order to determine whether an investment in our shares by Benefit Plans creates or gives rise to the potential for either prohibited transactions or a commingling of assets as referred to above, a fiduciary must consider whether an investment in our shares will cause our assets to be treated as assets of the investing Benefit Plans. Neither ERISA nor the Internal Revenue Code define the term plan assets ; however, U.S. Department of Labor Regulations provide guidelines as to whether, and under what circumstances, the underlying assets of an entity will be deemed to constitute assets of a Benefit Plan when the plan invests in that entity (Plan Assets Regulation). Under the Plan Assets Regulation, the assets of corporations, partnerships or other entities in which a Benefit Plan makes an equity investment will generally be deemed to be assets of the Benefit Plan unless the entity satisfies one of the exceptions to this general rule. As discussed below, we have received an opinion of counsel that, based on the Plan Assets Regulation, it is more likely than not that the underlying assets would not be deemed to be plan assets of Benefit Plans investing in shares, assuming the conditions set forth in the opinion are satisfied, based upon the fact that at least one of the specific exemptions set forth in the Plan Assets Regulation is satisfied, as determined under the criteria set forth below.

Specifically, the Plan Assets Regulation provides that the underlying assets of REITs will not be treated as assets of a Benefit Plan investing therein if the interest the Benefit Plan acquires is a publicly-offered security. A publicly-offered security must be:

sold as part of a public offering registered under the Securities Act of 1933, as amended, and be part of a class of securities registered under the Securities Exchange Act of 1934, as amended, within a specified time period;

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part of a class of securities that is owned by 100 or more persons who are independent of the issuer and one another; and

freely transferable.

Our shares are being sold as part of an offering of securities to the public pursuant to an effective registration statement under the Securities Act, and are part of a class that will be registered under the Securities Exchange Act within the specified period. In addition, we anticipate having well in excess of 100 independent stockholders. Thus, both the first and second criterion of the publicly-offered security exception will be satisfied.

Whether a security is freely transferable depends upon the particular facts and circumstances. For example, our shares are subject to certain restrictions on transferability intended to ensure that we continue to qualify for federal income tax treatment as a REIT. The regulation provides, however, that where the minimum investment in a public offering of securities is $10,000 or less, the presence of a restriction on transferability intended to prohibit transfers which would result in a termination or reclassification of the entity for state or federal tax purposes will not ordinarily affect a determination that such securities are freely transferable. The minimum investment in our shares is less than $10,000; thus, the restrictions imposed in order to maintain our status as a REIT should not cause the shares to be deemed not freely transferable.

In the event that our underlying assets were treated by the Department of Labor as the assets of investing Benefit Plans, our management would be treated as fiduciaries with respect to each Benefit Plan stockholder, and an investment in our shares might constitute an ineffective delegation of fiduciary responsibility to Wells Capital, our advisor, and expose the fiduciary of the Benefit Plan to co-fiduciary liability under ERISA for any breach by Wells Capital of the fiduciary duties mandated under ERISA. Further, if our assets are deemed to be plan assets, an investment by an IRA in our shares might be deemed to result in an impermissible commingling of IRA assets with other property.

If Wells Capital, our advisor, or its affiliates were treated as fiduciaries with respect to Benefit Plan stockholders, the prohibited transaction restrictions of ERISA and the Internal Revenue Code would apply to any transaction involving our assets. These restrictions could, for example, require that we avoid transactions with entities that are affiliated with us or our affiliates or restructure our activities in order to obtain an administrative exemption from the prohibited transaction restrictions. Alternatively, we might have to provide Benefit Plan stockholders with the opportunity to sell their shares to us or we might dissolve or terminate.

If a prohibited transaction were to occur, the Internal Revenue Code imposes an excise tax equal to 15% of the amount involved and authorizes the IRS to impose an additional 100% excise tax if the prohibited transaction is not corrected in a timely manner. These taxes would be imposed on any disqualified person who participates in the prohibited transaction. In addition, Wells Capital and possibly other fiduciaries of Benefit Plan stockholders subject to ERISA who permitted the prohibited transaction to occur or who otherwise breached their fiduciary responsibilities, or a non-fiduciary participating in a prohibited transaction, could be required to restore to the Benefit Plan any profits they realized as a result of the transaction or breach, and

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make good to the Benefit Plan any losses incurred by the Benefit Plan as a result of the transaction or breach. With respect to an IRA that invests in our shares, the occurrence of a prohibited transaction involving the individual who established the IRA, or his or her beneficiary, would cause the IRA to lose its tax-exempt status under Section 408(e)(2) of the Internal Revenue Code.

We have obtained an opinion from Alston & Bird LLP that it is more likely than not that our shares will be deemed to constitute publicly-offered securities and, accordingly, that it is more likely than not that our underlying assets should not be considered plan assets under the Plan Assets Regulation, assuming the offering takes place as described in this prospectus. If our underlying assets were not deemed to be plan assets, the problems discussed in the immediately preceding three paragraphs are not expected to arise.

Other Prohibited Transactions

Regardless of whether the shares qualify for the publicly-offered security exception of the Plan Assets Regulation, a prohibited transaction could occur if we, Wells Capital, any selected broker-dealer or any of their affiliates is a fiduciary (within the meaning of Section 3(21) of ERISA) with respect to any Benefit Plan purchasing the shares. Accordingly, unless an administrative or statutory exemption applies, shares should not be purchased by a Benefit Plan with respect to which any of the above persons is a fiduciary. A person is a fiduciary with respect to a Benefit Plan under Section 3(21) of ERISA if, among other things, the person has discretionary authority or control with respect to the Benefit Plan or plan assets, or provides investment advice for a fee with respect to plan assets. Under a regulation issued by the Department of Labor, a person shall be deemed to be providing investment advice if that person renders advice as to the advisability of investing in our shares and that person regularly provides investment advice to the Benefit Plan pursuant to a mutual agreement or understanding (written or otherwise) (1) that the advice will serve as the primary basis for investment decisions, and (2) that the advice will be individualized for the Benefit Plan based on its particular needs.

Annual Valuation

A fiduciary of an employee benefit plan subject to ERISA is required to determine annually the fair market value of each asset of the plan as of the end of the plan s fiscal year and to file a report reflecting that value with the Department of Labor. When the fair market value of any particular asset is not available, the fiduciary is required to make a good faith determination of that asset s fair market value assuming an orderly liquidation at the time the determination is made. In addition, a trustee or custodian of an IRA must provide an IRA participant with a statement of the value of the IRA each year. In discharging its obligation to value assets of a plan, a fiduciary subject to ERISA must act consistently with the relevant provisions of the plan and the general fiduciary standards of ERISA.

Unless and until our shares are listed on a national securities exchange or are included for quotation on the Nasdaq National Market, it is not expected that a public market for the shares will develop. To date, neither the Internal Revenue Service nor the Department of Labor has promulgated regulations specifying how a plan fiduciary should determine the fair market value of the shares, namely when the fair market value of the shares is not determined in the marketplace. Therefore, to assist fiduciaries in fulfilling their valuation and annual reporting responsibilities with respect to ownership of shares, we intend to have our advisor prepare annual reports of the estimated value of our shares.

Eventually, we may engage a third-party valuation firm to value our shares; however, we intend to use our advisor s estimate until at least three fiscal years after completion of our offering stage. (We view our offering stage as complete upon the termination of our first public equity offering that is followed by a one-year period in which we do not engage in another public equity offering. For purposes of this definition, we do not consider a public equity offering to include offerings on behalf of selling stockholders or offerings related to a dividend reinvestment plan, employee benefit plan or the redemption of interests in Wells OP II). Furthermore, our advisor has indicated that during this initial period it intends to use the most recent price paid to acquire a share in our offering (ignoring purchase price discounts for certain categories of purchasers) as its estimated per share value of our shares. Although this approach to valuing our shares has the advantage of avoiding the cost of paying for appraisals or other valuation services, the estimated value may bear little relationship and will likely exceed what you might receive for your shares if you tried to sell them or if we liquidated the portfolio.

After three years from completion of our offering stage, the estimated value of our shares will be based upon a number of assumptions that may not be accurate or complete. We do not currently anticipate obtaining appraisals for our properties and, accordingly, the estimates should not be viewed as an accurate reflection of the fair market value of our properties, nor will they represent the amount of net proceeds that would result from an immediate sale of our properties. For these reasons, the estimated valuations should not be utilized for any purpose other than to assist plan fiduciaries in fulfilling their annual valuation and reporting responsibilities. Even after our advisor no longer uses the most recent offering price as the estimated value of one of our shares, you should be aware of the following:

- the estimated values may not be realized by us or by you upon liquidation (in part because estimated values do not necessarily indicate the price at which assets could be sold and because the estimates may not take into account the expenses of selling our assets);
- you may not realize these values if you were to attempt to sell your shares; and
- using the estimated values, or the method used to establish values, may not comply with the ERISA or IRA requirements described above.

DESCRIPTION OF SHARES

Our amended and restated charter authorizes the issuance of 1,000,000,000 shares of capital stock, of which 900,000,000 shares are designated as common stock with a par value of $0.01 per share, and 100,000,000 shares are designated as preferred stock with a par value of $0.01 per share. In addition, our board of directors may amend our charter to increase or decrease the amount of our authorized shares.

As of the date of this prospectus, 100 shares of our common stock were issued and outstanding, and no shares of preferred stock were issued and outstanding.

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Common Stock

The holders of common stock are entitled to one vote per share on all matters voted on by stockholders, including election of our directors. Our charter does not provide for cumulative voting in the election of our directors. Therefore, the holders of a majority of the outstanding common shares can elect our entire board of directors. Subject to any preferential rights of any outstanding series of preferred stock, the holders of common stock are entitled to such dividends as may be declared from time to time by our board of directors out of legally available funds and, upon liquidation, are entitled to receive all assets available for distribution to our stockholders. Holders of shares of common stock will not have preemptive rights, which means that you will not have an automatic option to purchase any new shares that we issue.

Our board of directors has authorized the issuance of shares of our capital stock without certificates. We expect that, until our shares are listed on a national securities exchange or the Nasdaq National Market, we will not issue shares in certificated form. We maintain a stock ledger that contains the name and address of each stockholder and the number of shares that the stockholder holds. With respect to uncertificated stock, we will continue to treat the stockholder registered on our stock ledger as the owner of the shares until the new owner delivers a properly executed form to us, which form we will provide to any registered holder upon request.

Preferred Stock

Our charter authorizes our board of directors to designate and issue one or more classes or series of preferred stock without stockholder approval. Our board of directors may determine the relative rights, preferences and privileges of each class or series of preferred stock so issued, which may be more beneficial than the rights, preferences and privileges attributable to the common stock. The issuance of preferred stock could have the effect of delaying or preventing a change in control. Our board of directors has no present plans to issue preferred stock, but may do so at any time in the future without stockholder approval.

Meetings and Special Voting Requirements

An annual meeting of the stockholders will be held each year, at least 30 days after delivery of our annual report. Special meetings of stockholders may be called only upon the request of a majority of our directors, a majority of the independent directors, the chairman, the president or upon the written request of stockholders holding at least 10% of the shares entitled to be cast on any issue proposed to be considered at the special meeting. The presence in person or by proxy of stockholders entitled to cast a majority of all the votes entitled to be cast at the meeting constitutes a quorum. Unless otherwise provided by the Maryland General Corporation Law or our charter, the affirmative vote of a majority of all votes cast is necessary to take stockholder action, except that a plurality of the votes cast is sufficient to elect a director.

Our charter provides that, to the extent permitted by Maryland law, the concurrence of the board is not required in order for the stockholders to amend the charter, dissolve the corporation or remove directors. However, we have been advised that Maryland law does require board approval in order to amend our charter or dissolve. Without the approval of a majority of the shares entitled to vote on the matter, the board of directors may not:

amend the charter to adversely affect the rights, preferences and privileges of the stockholders;

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- amend charter provisions relating to director qualifications, fiduciary duties, liability and indemnification, conflicts of interest, investment policies or investment restrictions;
- cause our liquidation or dissolution after our initial investment in property;
- sell all or substantially all of our assets other than in the ordinary course of business; or
- cause our merger or reorganization.

Wells Capital is selected and approved as our advisor annually by our directors. While the stockholders do not have the ability to vote to replace Wells Capital or to select a new advisor, stockholders do have the ability, by the affirmative vote of a majority of the shares entitled to vote on such matter, to remove a director from our board.

Restriction on Ownership of Shares

Ownership Limit

In order for us to qualify as a REIT, during the last half of each taxable year, not more than 50% of the value of our outstanding shares may be owned, directly or indirectly, by five or fewer individuals, as defined in the Internal Revenue Code to include certain entities. In addition, the outstanding shares must be owned by 100 or more persons independent of us and each other during at least 335 days of a 12-month taxable year or during a proportionate part of a shorter taxable year. Each of the requirements specified in the two preceding sentences shall not apply until after the first taxable year for which we make an election to be taxed as a REIT. We may prohibit certain acquisitions and transfers of shares so as to ensure our continued qualification as a REIT under the Internal Revenue Code. However, we cannot assure you that this prohibition will be effective.

In order to assist us in preserving our status as a REIT, our charter contains a limitation on ownership that prohibits any person or group of persons from acquiring, directly or indirectly, beneficial ownership of more than 9.8% of our outstanding shares unless exempted by our board of directors. Our charter provides that any transfer of shares that would violate our share ownership limitations is null and void and the intended transferee will acquire no rights in such shares, unless the transfer is approved by our board of directors based upon receipt of information that such transfer would not violate the provisions of the Internal Revenue Code for qualification as a REIT.

Shares that, if transferred, would be in excess of the 9.8% ownership limit (without an exemption from our board of directors) will be transferred automatically to a trust effective on the day before the reported transfer of such shares. The record holder of the shares that are held in trust will be required to submit such number of shares to us in the name of the trustee of the trust. We will designate a trustee of the share trust that will not be affiliated with us. We will also name one or more charitable organizations as a beneficiary of the share trust. Shares held in trust will remain issued and outstanding shares and will be entitled to the same rights and privileges as all other shares of the same class or series. The trustee will receive all dividends and distributions on the shares held in trust and will hold such dividends or distributions in trust for the benefit of the beneficiary. The trustee may vote any shares held in trust.

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At our direction, the trustee will transfer the shares held in trust to a person whose ownership will not violate the ownership limit. The transfer shall be made within 20 days of our receipt of notice that shares have been transferred to the trust. During this 20-day period, we will have the option of redeeming such shares. Upon any such transfer or redemption, the purported transferee or holder shall receive a per share price equal to the lesser of (1) the price per share in the transaction that caused the ownership limit violation or (2) the market price per share on the date of the transfer or redemption.

Any person who (1) acquires shares in violation of the foregoing restrictions or who owns shares that were transferred to any such trust is required to give immediate written notice to us of such event, or (2) transfers or receives shares subject to such limitations is required to give us 15 days written notice prior to such transaction. In both cases, such persons shall provide to us such other information as we may request in order to determine the effect, if any, of such transfer on our status as a REIT.

The foregoing restrictions will continue to apply until our board of directors determines it is no longer in our best interest to continue to qualify as a REIT. The ownership limit also does not apply to the underwriter in an offering of shares or to a person or persons exempted from the ownership limit by our board of directors based upon appropriate assurances that our qualification as a REIT would not be jeopardized.

Any person who owns 5% or more of the outstanding shares during any taxable year will be asked to deliver to us a statement or affidavit setting forth the number of shares beneficially owned, directly or indirectly.

Suitability Standards and Minimum Purchase Requirements

State law and our charter require that purchasers of our stock meet standards regarding (i) net worth or income and (ii) minimum purchase amounts. These standards are described above at Suitability Standards immediately following the cover page of this prospectus and below at Plan of Distribution Minimum Purchase Requirements. The standards apply not only to purchasers in this offering, but also to potential transferees of your shares. As a result, the requirements regarding suitability and minimum purchase amounts, which are applicable until our shares of common stock are listed on a national securities exchange or the Nasdaq National Market, may make it more difficult for you to sell your shares.

Dividends

Dividends will be paid on a quarterly basis regardless of the frequency with which such dividends are declared. Dividends will be paid to investors who are stockholders as of the record dates selected by our board of directors. We expect to calculate our quarterly dividends based upon daily record and dividend declaration dates so our investors will be entitled to be paid dividends immediately upon their purchase of shares. We then make quarterly dividend payments following such calculation.

We are required to make distributions sufficient to satisfy the requirements for qualification as a REIT for tax purposes. Generally, income distributed as dividends will not be taxable to us under the Internal Revenue Code if we distribute at least 90% of our taxable income. See Federal Income Tax Considerations Annual Distribution Requirements.

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Dividends will be declared at the discretion of our board of directors. Our board will be guided, in substantial part, by its desire to cause us to comply with the REIT requirements. Because we may receive income from interest or rents at various times during our fiscal year, dividends may not reflect our income earned in that particular distribution period but may be made in anticipation of cash flow that we expect to receive during a later quarter and may be made in advance of actual receipt of funds in an attempt to make dividends relatively uniform. We may borrow money, issue securities or sell assets in order to make dividend distributions.

We are not prohibited from distributing our own securities in lieu of making cash dividends to stockholders, provided that the securities so distributed to stockholders are readily marketable. Stockholders who receive marketable securities in lieu of cash dividends may incur transaction expenses in liquidating the securities.

Dividend Reinvestment Plan

We currently have a dividend reinvestment plan available that allows you to have dividends and other distributions otherwise distributable to you invested in additional shares of our common stock. The following discussion summarizes the principal terms of the dividend reinvestment plan. The full text of our Dividend Reinvestment Plan is included as Appendix B to this prospectus.

Eligibility

Participation in the dividend reinvestment plan is limited to investors who have purchased shares in this offering. See Plan of Distribution Compensation of Dealer Manager and Participating Broker-Dealers below for other restrictions on eligibility to purchase shares under the dividend reinvestment plan. We may elect to deny your participation in the dividend reinvestment plan if you reside in a jurisdiction or foreign country where, in our judgment, the burden or expense of compliance with applicable securities laws makes your participation impracticable or inadvisable.

Election to Participate

Assuming you are eligible, you may elect to participate in the dividend reinvestment plan by completing the Subscription Agreement or other approved enrollment form available from the dealer manager or a participating broker-dealer. Your participation in the dividend reinvestment plan will begin with the next distribution made after receipt of your enrollment form. Once enrolled, you may continue to purchase shares under our dividend reinvestment plan until we have sold all of the shares registered in this offering, have terminated this offering or have terminated the dividend reinvestment plan. You can choose to have all or a portion of your dividends reinvested through the dividend reinvestment plan. You may also change the percentage of your dividends that will be reinvested at any time if you complete a new enrollment form or other form provided for that purpose. Any election to increase your level of participation must be made through your participating broker-dealer or, if you purchased your shares in this offering other than through a participating broker-dealer, through the dealer manager.

Stock Purchases

Shares will be purchased under the dividend reinvestment plan on the quarterly distribution payment dates. The purchase of fractional shares is a permissible, and likely, result of the reinvestment of dividends under the dividend reinvestment plan.

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The purchase price per share will be the higher of $9.55 or 95% of the estimated value of a share of our common stock, as estimated by our advisor or another firm chosen for that purpose. We intend to use our advisor s estimate until at least three fiscal years after completion of our offering stage. We view our offering stage as complete upon the termination of our first public equity offering that is followed by a one-year period in which we do not engage in another public equity offering. (For purposes of this definition, we do not consider a public equity offering to include offerings on behalf of selling stockholders or offerings related to a dividend reinvestment plan, employee benefit plan or the redemption of interests in Wells OP II). Our advisor has indicated that during this initial period it intends to use the most recent price paid to acquire a share in our offering (ignoring purchase price discounts for certain categories of purchasers) as its estimated per share value of our shares. This estimated value may bear little relationship and will likely exceed what you might receive for your shares if you tried to sell them or if we liquidated the portfolio.

Account Statements

Our dealer manager or a participating broker-dealer will provide a confirmation of your quarterly purchases under the dividend reinvestment plan. The dealer manager or participating broker-dealer is to provide the confirmation to you or your designee within five business days after the end of each quarter, which confirmation is to disclose the following information:

- each distribution reinvested for your account during the quarter;
- the date of the reinvestment;
- the number and price of the shares purchased by you; and
- the total number of shares in your account.

In addition, within 90 days after the end of each calendar year, we will provide you with an individualized report on your investment, including the purchase dates, purchase price, number of shares owned, and the amount of distributions made in the prior year. We will send to all participants in the plan, without charge, all supplements to and updated versions of this prospectus which we are required to provide under applicable securities laws.

Fees and Commissions

If we paid a selling commission in connection with the sale of shares in our primary offering, we will pay a 5% selling commission on any dividends that are earned with respect to those shares and reinvested under our dividend reinvestment plan. Otherwise, we will not pay selling commissions on shares sold under our dividend reinvestment plan. No dealer manager fee will be paid on shares sold under the plan. Whether we pay a selling commission will not affect your purchase price under the dividend reinvestment plan; rather, it will affect the net proceeds to us from the sale. We will not receive a fee for selling shares under the dividend reinvestment plan. Sales under our dividend reinvestment plan, however, will result in greater fee income for our advisor. See Management Compensation.

Voting

You may vote all whole shares acquired through the dividend reinvestment plan.

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Tax Consequences of Participation

If you elect to participate in the dividend reinvestment plan and are subject to federal income taxation, you will incur a tax liability for distributions allocated to you even though you have elected not to receive the distributions in cash but rather to have the distributions withheld and reinvested pursuant to the dividend reinvestment plan. Specifically, you will be treated as if you have received the distribution from us in cash and then applied such distribution to the purchase of additional shares. You will be taxed on the amount of such distribution as a dividend to the extent such distribution is from current or accumulated earnings and profits, unless we have designated all or a portion of the dividend as a capital gain dividend. See Federal Income Tax Considerations Taxation of U.S. Stockholders and Distributions Generally. We will withhold 28% of the amount of dividends or distributions paid if you fail to furnish a valid taxpayer identification number, fail to properly report interest or dividends or fail to certify that you are not subject to withholding.

Termination of Participation

You may terminate your participation in the dividend reinvestment plan at any time by providing us with written notice. Any transfer of your shares will effect a termination of the participation of those shares in the dividend reinvestment plan. You must promptly notify us should you no longer meet the suitability standards described above at Suitability Standards immediately following the cover page of this prospectus or cannot make the other representations or warranties set forth in the Subscription Agreement at any time prior to the listing of the shares on a national stock exchange or the Nasdaq National Market. We will terminate your participation to the extent that a reinvestment of your dividends in our shares would cause you to exceed the ownership limitation contained in our charter.

Amendment or Termination of Plan

We may amend or terminate the dividend reinvestment plan for any reason at any time upon 10 days prior written notice to participants.

Proposed Share Redemption Program

Our board of directors has approved (but delayed the adoption) of a share redemption program that would enable our stockholders to sell their shares to us in limited circumstances. We will not adopt the program until the earlier of (i) the completion of this primary offering, which may last until November 26, 2005 or (ii) receipt by us of SEC exemptive relief from rules restricting issuer purchases during distributions, which relief we may never obtain. Moreover, even when one of these conditions is met, our board of directors could choose not to adopt the proposed share redemption program or to amend its provisions without stockholder approval. Upon adoption, our proposed share redemption program would permit you to sell your shares back to us after you have held them for at least one year, subject to the significant conditions and limitations described below.

Initially, the price at which we would repurchase your stock under the share redemption program would be $8.40 unless the shares were being redeemed in connection with the death of a stockholder. Our proposed share redemption program provides that this $8.40 redemption price would remain fixed until three years after we complete our offering stage. For purposes of the proposed share redemption program, we define the completion of our offering stage in the same

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manner as described above under Dividend Reinvestment Plan Stock Purchases. Thereafter, the redemption price would equal 95% of the estimated per share value of our shares, as estimated by our advisor or another firm we might choose for that purpose. We would report this redemption price to you in the annual report and three quarterly reports that we are required to send or furnish to you.

Our share redemption program would limit the number of shares we could redeem to those that we can purchase with net proceeds from the sale of shares under our dividend reinvestment plan. In addition, during any calendar year, we would not redeem more than 5% of the weighted average number of shares outstanding during the prior calendar year.

As proposed, we would redeem shares on the last business day of each month. Requests for redemption would have to be received at least five business days before that date in order for us to repurchase the shares that month. If we could not purchase all shares presented for redemption in any month, we would attempt to honor redemption requests on a pro rata basis. We would deviate from pro rata purchases in two minor ways: (i) if a pro rata redemption would result in you owning less than half of the minimum amounts described at Plan of Distribution - Minimum Purchase Requirements, then we would redeem all of your shares; and (ii) if a pro rata redemption would result in you owning more than half but less than all of those minimum amounts, then we would not redeem any shares that would reduce your holdings below the minimum amounts. In the event that you were redeeming all of your shares, there would be no holding period requirement for shares purchased pursuant to our dividend reinvestment plan.

If we did not completely satisfy a stockholder s redemption request at month-end because the request was not received in time or because of the restrictions on the number of shares we could redeem under the program, we would treat the unsatisfied portion of the redemption request as a request for redemption in the following month unless the stockholder withdrew his or her request before the next date for redemptions. Any stockholder could withdraw a redemption request upon written notice to the address provided below before the date for redemption.

In several respects we would treat redemptions sought upon the death of a stockholder differently from other redemptions. First, there would be no one-year holding requirement. Second, the redemption price would be the amount paid for the shares until three years after we completed our offering stage. At that time, the redemption price would be the amount paid to acquire the shares from us or 100% of the estimate of our per share value, whichever is greater. Finally, we would not limit redemptions upon the death of a stockholder with respect to the proceeds from our dividend reinvestment plan or the number of our outstanding shares.

We will notify you upon adoption of the share redemption program. Thereafter, qualifying stockholders who desire to redeem their shares would need to give written notice to Wells Investment Securities, our dealer manager, at 6200 The Corners Parkway, Suite 250, Norcross, Georgia 30092, ATTN: Investor Services. Wells Investment Securities would be responsible for all services to be performed in connection with the Share Redemption Plan, although it might outsource clerical duties to our advisor.

After adoption of the share redemption program, our board of directors could amend, suspend or terminate the program upon 30 days notice. We would notify you of such developments (i) in the annual or quarterly reports mentioned above or (ii) by means of a separate mailing to you, accompanied by disclosure in a current or periodic report under the Securities Exchange Act of 1934. During this offering, we would also include this information in a prospectus supplement or post-effective amendment to the registration statement, as then required under federal securities laws.

Our proposed share redemption program would only provide stockholders a limited ability to redeem shares for cash until a secondary market develops for the shares, at which time the program would terminate. No such market presently exists, and we cannot assure you that any market for your shares will ever develop.

Registrar and Transfer Agent

Wells Capital, a registered transfer agent, will serve as the registrar and transfer agent for our common stock.

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Restrictions on Roll-Up Transactions

In connection with any proposed transaction considered a Roll-up Transaction (defined below) involving us and the issuance of securities of an entity, which we refer to as a Roll-up Entity, that would be created or would survive after the successful completion of the Roll-up Transaction, an appraisal of all properties will be obtained from a competent independent appraiser. The properties will be appraised on a consistent basis, and the appraisal will be based on the evaluation of all relevant information and will indicate the value of the properties as of a date immediately preceding the announcement of the proposed Roll-up Transaction. The appraisal will assume an orderly liquidation of properties over a 12-month period. The terms of the engagement of the independent appraiser will clearly state that the engagement is for our benefit and the benefit of our stockholders. A summary of the appraisal, indicating all material assumptions underlying the appraisal, will be included in a report to stockholders in connection with any proposed Roll-up Transaction.

A Roll-up Transaction is a transaction involving the acquisition, merger, conversion or consolidation, directly or indirectly, of us and the issuance of securities of a Roll-up Entity. This term does not include:

- a transaction involving our securities that have been for at least 12 months listed on a national securities exchange or included for quotation on the Nasdaq National Market; or
- a transaction involving the conversion to corporate, trust, or association form of only us if, as a consequence of the transaction, there will be no significant adverse change in stockholder voting rights, the term of our existence, compensation to Wells Capital or our investment objectives.

In connection with a proposed Roll-up Transaction, the person sponsoring the Roll-up Transaction must offer to stockholders who vote no on the proposal the choice of:

(1) accepting the securities of the Roll-up Entity offered in the proposed Roll-up Transaction; or

(2) one of the following:

  (A) remaining as stockholders of us and preserving their interests therein on the same terms and conditions as existed previously; or

  (B) receiving cash in an amount equal to the stockholder s pro rata share of the appraised value of our net assets.

We are prohibited from participating in any proposed Roll-up Transaction:

- that would result in the stockholders having democracy rights in a Roll-up Entity that are less than those provided in our bylaws and described elsewhere in this prospectus, including rights with respect to the election and removal of directors, annual reports, annual and special meetings, amendment of our articles of incorporation, and dissolution of us;

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that includes provisions that would operate to materially impede or frustrate the accumulation of shares by any purchaser of the securities of the Roll-up Entity, except to the minimum extent necessary to preserve the tax status of the Roll-up Entity, or which would limit the ability of an investor to exercise the voting rights of its securities of the Roll-up Entity on the basis of the number of shares held by that investor;

in which investors rights to access of records of the Roll-up Entity will be less than those provided in the section of this prospectus entitled Description of Shares Meetings and Special Voting Requirements; or

in which any of the costs of the Roll-up Transaction would be borne by us if the Roll-up Transaction is not approved by the stockholders.

THE OPERATING PARTNERSHIP AGREEMENT

General

Wells Operating Partnership II, L.P., which we refer to as Wells OP II, was formed in July 2003 to acquire, own and operate properties on our behalf. As a result of this structure, we are considered to be an umbrella partnership real estate investment trust, or UPREIT. An UPREIT is a structure REITs often use to acquire real property from owners on a tax deferred basis (the sellers can generally accept partnership units and defer taxable gain otherwise required to be recognized by them upon the disposition of their properties). Such owners may also desire to achieve diversity in their investment and other benefits afforded to stockholders in a REIT. For purposes of satisfying the asset and income tests for qualification as a REIT for tax purposes, the REIT s proportionate share of the assets and income of Wells OP II will be deemed to be assets and income of the REIT.

We expect that substantially all of our assets will be held by Wells OP II. We are the sole general partner of Wells OP II. Wells Capital, our advisor, has purchased $200,000 of limited partnership units in Wells OP II and is currently the only limited partner. As the sole general partner, we have the exclusive power to manage and conduct the business of Wells OP II.

The following is a summary of material provisions of the limited partnership agreement of Wells OP II. This summary is qualified by the specific language in the limited partnership agreement. You should refer to the limited partnership agreement, which we have filed as an exhibit to the registration statement, for more detail.

Capital Contributions

As we accept subscriptions for shares, we will transfer substantially all of the net proceeds of the offering to Wells OP II as a capital contribution; however, we will be deemed to have made capital contributions in the amount of the gross offering proceeds received from investors. Wells OP II will be deemed to have simultaneously paid the selling commissions and other costs associated with the offering. If Wells OP II requires additional funds at any time in excess of capital contributions made by us and Wells Capital or from borrowing, we may borrow funds from a financial institution or other lender and lend such funds to Wells OP II on the same terms and conditions as are applicable to our borrowing of such funds. In addition, we are authorized to cause Wells OP II to issue partnership interests for less than fair market value if we conclude in good faith that such issuance is in the best interest of Wells OP II and us.

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Operations

The limited partnership agreement of Wells OP II provides that, so long as we remain qualified as a REIT, Wells OP II is to be operated in a manner that will enable us to satisfy the requirements for being classified as a REIT for tax purposes. As a general partner of Wells OP II, we are also empowered to do anything to ensure that Wells OP II will not be classified as a publicly traded partnership for purposes of Section 7704 of the Internal Revenue Code. Classification as a publicly traded partnership could result in Wells OP II being taxed as a corporation, rather than as a partnership.

Distributions and Allocations of Profits and Losses

The limited partnership agreement provides that Wells OP II will distribute cash flow from operations to its partners in accordance with their relative percentage interests on at least a quarterly basis in amounts we, as general partner, determine. The effect of these distributions will be that a holder of one unit of limited partnership interest in Wells OP II will receive the same amount of annual cash flow distributions as the amount of annual dividends paid to the holder of one of our shares.

Similarly, the limited partnership agreement provides that taxable income is allocated to the partners of Wells OP II in accordance with their relative percentage interests. Subject to compliance with the provisions of Sections 704(b) and 704(c) of the Internal Revenue Code and corresponding Treasury Regulations, the effect of these allocations will be that a holder of one unit of limited partnership interest in Wells OP II will be allocated taxable income for each taxable year in an amount equal to the amount of taxable income to be recognized by a holder of one of our shares. Losses, if any, will generally be allocated among the partners in accordance with their respective percentage interests in Wells OP II. Losses cannot be passed through to our stockholders.

If Wells OP II liquidates, debts and other obligations must be satisfied before the partners may receive any distributions. Any distributions to partners then will be made to partners in accordance with their respective positive capital account balances.

Rights, Obligations and Powers of the General Partner

As Wells OP II s general partner, we generally have complete and exclusive discretion to manage and control Wells OP II s business and to make all decisions affecting its assets. This authority generally includes, among other things, the authority to:

- acquire, purchase, own, operate, lease and dispose of any real property and any other property;
- construct buildings and make other improvements on owned or leased properties;
- authorize, issue, sell, redeem or otherwise purchase any debt or other securities;

borrow money;

make or revoke any tax election;

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- maintain insurance coverage in amounts and types as we determine is necessary;
- retain employees or other service providers;
- form or acquire interests in joint ventures; and
- merge, consolidate or combine Wells OP II with another entity.

Wells OP II will pay all the administrative and operating costs and expenses it incurs in acquiring and operating real properties. Wells OP II also will pay all of our administrative costs and expenses and such expenses will be treated as expenses of Wells OP II. Such expenses will include:

- all expenses relating to our formation and continuity of existence;
- all expenses relating to the public offering and registration of our securities;
- all expenses associated with the preparation and filing of our periodic reports under federal, state or local laws or regulations;
- all expenses associated with our compliance with applicable laws, rules and regulations; and
- all of our other operating or administrative costs incurred in the ordinary course of business.

The only costs and expenses we may incur for which we will not be reimbursed by Wells OP II will be costs and expenses relating to properties we may own outside of Wells OP II. We will pay the expenses relating to such properties directly.

Exchange Rights

The limited partners of Wells OP II have the right to cause Wells OP II to redeem their limited partnership units for cash equal to the value of an equivalent number of our shares, or, at our option, we may purchase their limited partnership units for cash or by issuing one share of our common stock for each limited partnership unit redeemed. These exchange rights may not be exercised, however, if and to the extent that the delivery of shares upon such exercise would:

- result in any person owning shares in excess of the ownership limit in our charter (unless exempted by our board of directors);

- result in our shares being owned by fewer than 100 persons;
- result in us being "closely held" within the meaning of Section 856(h) of the Code; or
- cause us to own 10% or more of the ownership interests in a tenant within the meaning of Section 856(d)(2)(B) of the Code.

Furthermore, limited partners may exercise their exchange rights only after their limited partnership units have been outstanding for one year. A limited partner may not deliver more than two exchange notices each calendar year and may not exercise an exchange right for less

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than 1,000 limited partnership units, unless such limited partner holds less than 1,000 units. In that case, he must exercise his exchange right for all of his units.

Change in General Partner

We are generally not allowed to withdraw as the general partner of Wells OP II or transfer our general partnership interest in Wells OP II (except to a wholly owned subsidiary). The principal exception to this is if we merge with another entity and (1) the holders of a majority of partnership units (including those we hold) approve the transaction; (2) the limited partners receive or have the right to receive an amount of cash, securities or other property equal in value to the amount they would have received if they had exercised their exchange rights immediately before such transaction; (3) we are the surviving entity and our stockholders do not receive cash, securities, or other property in the transaction; or (4) the successor entity contributes substantially all of its assets to Wells OP II in return for an interest in Wells OP II and agrees to assume all obligations of the general partner of Wells OP II. If we voluntarily seek protection under bankruptcy or state insolvency laws, or if we are involuntarily placed under such protection for more than 90 days, we would be deemed to be automatically removed as the general partner. Otherwise, the limited partners have no right to remove us as general partner.

Transferability of Interests

With certain exceptions, the limited partners may not transfer their interests in Wells OP II, in whole or in part, without our written consent as the general partner. In addition, pursuant to our charter Wells Capital may not transfer its interest in Wells OP II as long as it is acting as our advisor.

Amendment of Limited Partnership Agreement

An amendment to the limited partnership agreement requires the consent of the holders of a majority of the partnership units (including the partnership units we hold). Additionally, we, as general partner, must approve any amendment. However, certain amendments require the consent of the holders of a majority of the partnership units (excluding the partnership units we or one of our affiliates holds). Such amendments include:

- any amendment affecting the exchange right to the detriment of the limited partners (except for certain business combinations where we merge with another entity and leave Wells OP II in existence to hold all the assets of the surviving entity);

- any amendment that would adversely affect the limited partners rights to receive distributions, except for amendments we make to create and issue preferred partnership units;

- any amendment that would alter how we allocate profits and losses, except for amendments we make to create and issue preferred partnership units;

any amendment that would impose on the limited partners any obligation to make additional capital contributions.

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PLAN OF DISTRIBUTION

General

We are publicly offering a maximum of 785,000,000 shares through Wells Investment Securities, our dealer manager, a registered broker-dealer affiliated with Wells Capital, our advisor. Of this amount, we are offering 600,000,000 shares in our primary offering at a price of $10.00 per share (except as noted below) on a best efforts basis, which means that the dealer manager must use only its best efforts to sell the shares and has no firm commitment or obligation to purchase any of the shares. We are offering the remaining 185,000,000 shares through our dividend reinvestment plan at a purchase price equal to the higher of $9.55 per share or 95% of the estimated value of a share as estimated by our advisor or another firm we choose for that purpose. Our primary 600,000,000-share offering will terminate by November 26, 2005; thereafter, we may only continue to offer shares in this offering through our dividend reinvestment program. We reserve the right to terminate this offering at any time.

Compensation of Dealer Manager and Participating Broker-Dealers

Except as provided below, Wells Investment Securities, our dealer manager and affiliate, will receive selling commissions of 7.0% of the gross offering proceeds for shares sold in our primary offering and 5% of the gross offering proceeds for shares sold pursuant to our dividend reinvestment plan. Except for shares sold under our dividend reinvestment plan, for which there will be no dealer manager fee, and in other instances described below, the dealer manager will receive 2.5% of the gross offering proceeds as compensation for acting as the dealer manager and for expenses incurred in connection with marketing our shares and paying the employment costs of the dealer manager s wholesalers. Out of its dealer manager fee, the dealer manager may pay salaries and commissions to its wholesalers in the aggregate amount of up to 1% of the gross offering proceeds. We will not pay referral or similar fees to any accountants, attorneys or other persons in connection with the distribution of the shares.

We currently expect the dealer manager to utilize three channels to sell our shares, each of which has a different selling commission and dealer manager fee structure. The dealer manager may authorize other broker-dealers that are members of the NASD, which we refer to as participating broker-dealers, to sell our shares. Our first distribution channel involves those participating broker-dealers compensated solely on a commission basis for the sale. Our second distribution channel will be sales through investment advisery representatives affiliated with a participating broker-dealer in which the representative is compensated for investment advisery services on a fee-for-service basis. Our third distribution channel will be sales through independent investment advisers (i.e., they are not affiliated with a broker-dealer) and through banks acting as trustees or fiduciaries.

In the event of the sale of shares in our primary offering by a participating broker-dealer involving a registered representative compensated on a commission basis for the sale, the dealer manager will reallow its selling commissions in an amount equal to 7.0% of the gross offering proceeds attributable to the participating broker-dealer. In the event of the sale of shares in our primary offering through an investment advisery representative affiliated with a participating broker-dealer in which the representative is compensated on a fee-for-service basis by the investor, the dealer manager will waive its right to a commission, and we will sell such shares for $9.30 per share, reflecting that selling commissions in the amount of $0.70 per share will not be payable.

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The dealer manager may reallow to a participating broker-dealer a portion of the dealer manager fee earned on the proceeds raised by the participating broker-dealer. This reallowance would be in the form of a marketing fee and may also include a reimbursement of certain of a participating broker-dealer s distribution-related costs, such as the costs and expenses of attending educational conferences sponsored by our dealer manager, and direct attendance fees we may pay for employees of our dealer manager or other affiliates to attend a seminar sponsored by a participating broker-dealer. That portion of the reallowance constituting a marketing fee shall not exceed 1.5% of the gross sales of the broker-dealer; the total reallowance to any participating broker-dealer may not exceed 2.5% of the gross sales of the broker-dealer; and, in the aggregate, the entire dealer manager reallowance to all participating broker-dealers will not exceed 1.5% of the gross offering proceeds. In addition, we will reimburse any participating broker-dealer for bona fide due diligence expenses, not to exceed 0.5% of the gross offering proceeds attributable to the participating broker-dealer.

In the event of the sale of shares in our primary offering through an independent investment adviser (or bank acting as a trustee or fiduciary), the dealer manager will waive its right to a selling commission and will reduce the dealer manager fee to 1.5% of gross offering proceeds. We will sell such shares for $9.20 per share, reflecting that selling commissions in the amount of $0.70 per share will not be payable and that the dealer manager fee will be reduced from 2.5% to 1.5%, or approximately $0.10 per share.

With respect to selling commissions in connection with sales under our dividend reinvestment plan, the dealer manager will reallow its selling commissions, which are equal to 5.0% of the gross offering proceeds, in cases where the reinvested dividends relate to sales through participating broker-dealers in which the participating broker-dealer was compensated solely on a commission basis. For all other distribution channels, there are no selling commissions paid for sales under the dividend reinvestment plan. Despite there being no selling commissions for sales through these other distribution channels, the purchase price remains at least $9.55 per share for all purchases under the dividend reinvestment plan. We will not allow investors to purchase shares under the dividend reinvestment plan through distribution channels that would be eligible to purchase shares in the primary offering at that time at prices below $9.55 per share.

The table below sets out the nature and amount of compensation we will pay to the dealer manager and the participating broker-dealers in this offering assuming we sell 785,000,000 shares. We estimate that 14% of our sales in this offering will be made through distribution channels that are not entitled to selling commissions and for which we will pay no dealer manager fees or reduced dealer manager fees. (See Use of Proceeds above.) However, to show the maximum amount of dealer manager and participating broker-dealer compensation that we may pay in this offering, this table assumes that all shares are sold through distribution channels associated with the highest possible selling commissions and dealer manager fees and assumes a $9.55 price for each share sold through our dividend reinvestment program.

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Dealer Manager and

Participating Broker-Dealer Compensation [1]

Dealer manager fee (maximum)	$ 150,000,000(2)
Selling commissions (maximum)	$ 508,337,500(2)
Salary allocations of sales managers, their support personnel and the personnel coordinating due diligence of participating broker-dealers	$ 3,100,000(3)
Expense reimbursements for retail seminars[4]	$ 6,420,600(3)
Expense reimbursements for educational conferences[4]	$ 400,000(3)
Legal fees allocable to dealer manager	$ 500,000(3)
Reimbursement of due diligence expenses[5]	$ 250,000(3)
Total	$ 669,008,100

(1) Assumes maximum of 785,000,000 shares sold in this offering. Excludes compensation payable to affiliates of dealer manager for services other than underwriting. See Management Compensation.

(2) Assumes no shares purchased by our directors, officers or employees or those of Wells Capital or its affiliates. As described below, the dealer manager fee and selling commissions are waived for those purchasers. Also assumes that no shares are purchased at prices reflecting volume discounts as described below.

(3) Amounts shown are estimates.

(4) These fees consist of expense reimbursements for actual costs incurred by employees of Wells Capital or its affiliates to attend educational conferences that our dealer manager sponsors and seminars sponsored by participating broker-dealers.

(5) We will reimburse the bona fide due diligence expenses of only the participating broker-dealers, up to a maximum of 0.5% of the gross proceeds attributable to a participating broker-dealer.

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Under the rules of the NASD, total underwriting compensation, including sales commissions, the dealer manager fee and underwriter expense reimbursement, may not exceed 10% of our gross offering proceeds, except for bona fide due diligence expenses, which may not exceed 0.5% of our gross offering proceeds. The NASD and many states also limit our total organization and offering expenses to 15% of gross offering proceeds. With Wells Capital s obligation to reimburse us to the extent the organization and offering expenses (other than the dealer manager fee and selling commissions) exceed 2% of our gross offering proceeds, our total organization and offering expenses are capped at 11.5%, as shown in the following table:

Organization and Offering Expenses

Expense	Maximum Percent of Gross Offering Proceeds
Selling commissions	7.0%
Dealer manager fee	2.5%
All other organization and offering expenses	2.0%
Total	11.5%

Our dealer manager sponsors educational conferences for broker-dealers and their representatives. Our dealer manager will pay the travel, lodging and meal costs of invitees. The other costs of the educational conferences will be borne by Wells-sponsored programs, including us. Our estimated costs associated with these educational conferences are included in our estimates of our organization and offering expenses. All conferences will be held in the vicinity of our headquarters, which is in Norcross, Georgia.

We will indemnify the participating broker-dealers and the dealer manager against some civil liabilities, including certain liabilities under the Securities Act and liabilities arising from breaches of our representations and warranties contained in the underwriting agreement. If we are unable to provide this indemnification, we may contribute to payments the indemnified parties may be required to make in respect of those liabilities.

We may sell shares in our primary offering to participating broker-dealers, their retirement plans, their representatives and the family members, IRAs and qualified plans of their representatives for $9.30 per share, reflecting that selling commissions in the amount of $0.70 per share will not be payable in consideration of the services rendered by such broker-dealers and representatives in the offering. For purposes of this discount, we consider a family member to be a spouse, parent, child, sibling, mother- or father-in-law, son- or daughter-in law or brother- or sister-in-law. The net proceeds to us from such sales made net of commissions will be substantially the same as the net proceeds we receive from other sales of shares.

Our directors and officers, as well as directors, officers and employees of Wells Capital or its affiliates, may purchase shares in our primary offering at a discount. The purchase price for such shares shall be $9.05 per share reflecting the fact that selling commissions in the amount of $0.70 per share and dealer manager fees in the amount of $0.25 per share will not be payable in connection with such sales. The net proceeds to us from such sales made net of commissions will be substantially the same as the net proceeds we receive from other sales of shares. Wells Capital and its affiliates are expected to hold their shares purchased as stockholders for investment and not with a view towards distribution.

An investor purchasing more than 50,000 shares at any one time through a single participating broker-dealer will be eligible for a discount on the purchase price of the shares above 50,000. The selling commission payable to the participating broker-dealer will be commensurately reduced. The following table shows the discounted price per share and reduced selling commissions payable for volume discounts.

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Shares Purchased in the Transaction	Commission Rate	Price Per Share
1 to 50,000	7.0%	$ 10.00
50,001 to 100,000	6.0%	$ 9.90
100,001 to 200,000	5.0%	$ 9.80
200,001 to 300,000	4.0%	$ 9.70
300,001 to 400,000	3.0%	$ 9.60
400,001 to 500,000	2.0%	$ 9.50
500,001 and up	1.0%	$ 9.40

The reduced selling price per share and selling commissions are applied to the incremental shares falling within the indicated range only. Thus, for example, an investment of $1,249,996 would result in a total purchase of 126,020 shares as follows:

50,000 shares at $10.00 per share (total: $500,000) and a 7.0% commission;

50,000 shares at $9.90 per share (total: $495,000) and a 6.0% commission; and

26,020 shares at $9.80 per share (total: $254,996) and a 5.0% commission.

Subscription Procedures

We will not sell any shares unless we sell a minimum of 250,000 shares to the public for $10 per share by November 26, 2004. Pending satisfaction of this condition, all subscription payments will be placed in an account held by the escrow agent, SouthTrust Bank, in trust for subscribers benefit, pending release to us. If we do not sell at least 250,000 shares to the public for $10 per share by November 26, 2004, we will return all funds in the escrow account (including interest), and we will stop selling shares. Different escrow procedures apply to Pennsylvania investors. See Special Notice to Pennsylvania Investors below.

To purchase shares in this offering, you must complete the Subscription Agreement, a sample of which is contained in this prospectus as Appendix A. You should pay for your shares by check payable to Wells Real Estate Investment Trust II, Inc. Subscriptions will be effective only upon our acceptance, and we reserve the right to reject any subscription in whole or in part. After meeting the applicable minimum offering requirements, subscription payments will be deposited into a special account in our name under the joint authorization of the dealer manager and us until such time as we have accepted or rejected the subscription. Subscriptions will be accepted or rejected within 30 days of receipt by us and, if rejected, all funds shall be returned to the rejected subscribers within 10 business days. If accepted, the funds will be transferred into our general account. We may not accept a subscription for shares until at least five business days after the date you receive this prospectus. You will receive a confirmation of your purchase. We generally admit stockholders on a daily basis.

Investors who desire to purchase shares in this offering at regular intervals may be able to do so through their participating broker-dealer or, if they are investing in this offering other than through a participating broker-dealer, the dealer manager by completing an automatic investment plan enrollment form. Participation in the automatic investment plan is limited to investors who have already met the minimum purchase requirement in this offering of $1,000. The minimum periodic investment is $100 per month.

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We will provide a confirmation of your monthly purchases under the automatic investment plan within five business days after the end of each month. The confirmation will disclose the following information:

- the amount of the investment;
- the date of the investment;
- the number and price of the shares purchased by you; and
- the total number of shares in your account.

We will pay dealer manager fees and selling commissions in connection with sales under the automatic investment plan to the same extent that we pay those fees and commissions on shares sold in this offering outside of the automatic investment plan.

You may terminate your participation in the automatic investment plan at any time by providing us with written notice. Your participation in the plan will also terminate should you no longer meet the suitability standards described above at Suitability Standards immediately following the cover page of this prospectus.

Investors who desire to establish an IRA for purposes of investing in shares may do so by having Wells Advisors, Inc., a qualified non-bank IRA custodian affiliated with our advisor, act as their IRA custodian. In the event that an IRA is established having Wells Advisors as the IRA custodian, the authority of Wells Advisors will be limited to holding the shares on behalf of the beneficiary of the IRA and making distributions or reinvestments in shares solely at the discretion of the beneficiary of the IRA. Wells Advisors will not have the authority to vote any of the shares held in an IRA except strictly in accordance with the written instructions of the beneficiary of the IRA.

Suitability Standards

Those selling shares on our behalf have the responsibility to make every reasonable effort to determine that the purchase of shares in this offering is a suitable and appropriate investment based on information provided by the stockholder regarding the stockholder s financial situation and investment objectives. In making this determination, those selling shares on our behalf have a responsibility to ascertain that the prospective stockholder:

- meets the minimum income and net worth standards set forth under Suitability Standards immediately following the cover page of this prospectus;
- can reasonably benefit from an investment in our shares based on the prospective stockholder s overall investment objectives and portfolio structure;

is able to bear the economic risk of the investment based on the prospective stockholder s overall financial situation; and

has apparent understanding of:

the fundamental risks of the investment;

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- the risk that the stockholder may lose the entire investment;
- the lack of liquidity of the shares;
- the restrictions on transferability of the shares;
- the background and qualifications of Wells Capital and its affiliates; and
- the tax consequences of the investment.

Relevant information for this purpose will include at least the age, investment objectives, investment experience, income, net worth, financial situation and other investments of the prospective stockholder, as well as any other pertinent factors. Those selling shares on our behalf must maintain, for a six-year period, records of the information used to determine that an investment in shares is suitable and appropriate for each stockholder.

Minimum Purchase Requirements

For your initial purchase, you must invest at least $1,000, except as described below. In order to satisfy the minimum purchase requirement for retirement plans, unless otherwise prohibited by state law, a husband and wife may jointly contribute funds from their separate IRAs, provided that each such contribution is made in increments of $100. You should note that an investment in our shares will not, in itself, create a retirement plan and that, in order to create a retirement plan, you must comply with all applicable provisions of the Internal Revenue Code.

The minimum purchase for Maine, New York and North Carolina investors is $2,500, except for IRAs, which must invest a minimum of $1,000. The minimum purchase amount for Minnesota investors is $2,500, except for IRAs and other qualified retirement plans, which must invest a minimum of $2,000.

Except in the states of Ohio, Maine, Minnesota, Nebraska and Washington, if you have purchased units or shares in other Wells-sponsored public programs, you may invest less than the minimum amount set forth above, but in no event less than $25. If you have satisfied the applicable minimum purchase requirement, any additional purchase must be in amounts of at least $25, except for additional purchases of shares pursuant to our dividend reinvestment plan or reinvestment plans of other Wells-sponsored public real estate programs.

Until our shares of common stock are listed on a national securities exchange, you may not transfer your shares in a manner that causes you or your transferee to own fewer than the number of shares required for the minimum purchase described above, except in the following circumstances: transfers by gift; transfers by inheritance; intrafamily transfers; family dissolutions; transfers to affiliates; and by operation of law.

Special Notice to Pennsylvania Investors

Because the minimum offering of our common stock is less than $600,000,000, you are cautioned to evaluate carefully our ability to fully accomplish our stated objectives and to inquire as to the current dollar volume of our subscription proceeds. Notwithstanding our $2.5 million minimum offering amount for all other jurisdictions, we will not sell any shares to Pennsylvania investors unless we raise a minimum of $200 million in gross offering proceeds (including sales made to residents of other jurisdictions). Pending satisfaction of this condition, all Pennsylvania

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subscription payments will be placed in an account held by the escrow agent, SouthTrust Bank, in trust for Pennsylvania subscribers benefit, pending release to us. If we have not reached this $200 million threshold within 120 days of the date that we first accept a subscription payment from a Pennsylvania investor, we will, within 10 days of the end of that 120-day period, notify Pennsylvania investors in writing of their right to receive refunds, without interest. If you request a refund within 10 days of receiving that notice, we will arrange for the escrow agent to return promptly by check the funds deposited in the Pennsylvania escrow account (or to return your check if the escrow agent has not yet collected on it) to each subscriber. Amounts held in the Pennsylvania escrow account from Pennsylvania investors not requesting a refund will continue to be held for subsequent 120-day periods until we raise at least $200 million or until the end of the subsequent escrow periods. At the end of each subsequent escrow period, we will again notify you of your right to receive refunds with interest from the day after the expiration of the initial 120-day period.

SUPPLEMENTAL SALES MATERIAL

In addition to this prospectus, we may utilize certain sales material in connection with the offering of the shares, although only when accompanied by or preceded by the delivery of this prospectus. These supplemental sales materials may include information relating to this offering, the past performance of Wells Capital, our advisor, and its affiliates, property brochures and articles and publications concerning real estate. In certain jurisdictions, some or all of our supplemental sales material may not be permitted.

We are offering shares only by means of this prospectus. Although the information contained in our supplemental sales materials will not conflict with any of the information contained in this prospectus, the supplemental materials do not purport to be complete and should not be considered a part of or as incorporated by reference in this prospectus or the registration statement of which this prospectus is a part.

LEGAL MATTERS

The validity of the shares of our common stock being offered hereby will be passed upon for us by Alston & Bird LLP, Raleigh, North Carolina. Alston & Bird LLP has also represented Wells Capital, our advisor, as well as various other affiliates of Wells Capital, in other matters and may continue to do so in the future.

EXPERTS

Our consolidated balance sheet at November 20, 2003, appearing in this registration statement and related prospectus, has been audited by Ernst & Young LLP, independent auditors, as set forth in their report thereon appearing elsewhere herein, and is included in reliance upon such report given on the authority of such firm as experts in accounting and auditing.

WHERE YOU CAN FIND MORE INFORMATION

We have filed a registration statement on Form S-11 with the SEC with respect to the shares of our common stock to be issued in the offering. This prospectus is a part of that registration statement and, as allowed by SEC rules, does not include all of the information you can find in the registration statement or the exhibits to the registration statement. For additional information relating to us, we refer you to the registration statement and the exhibits to the

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registration statement. Statements contained in this prospectus as to the contents of any contract or document referred to are necessarily summaries of such contract or document and in each instance, if the contract or document is filed as an exhibit to the registration statement, we refer you to the copy of the contract or document filed as an exhibit to the registration statement.

After commencement of the offering, we will file annual, quarterly and special reports, proxy statements and other information with the SEC. We intend to furnish our stockholders with annual reports containing consolidated financial statements certified by an independent public accounting firm. The registration statement is, and any of these future filings with the SEC will be, available to the public over the Internet at the SEC s website at http://www.sec.gov. You may read and copy any filed document at the SEC s public reference room in Washington, D.C. at 450 Fifth Street, N.W., Judiciary Plaza, Washington D.C. Please call the SEC at (800) SEC-0330 for further information about the public reference rooms.

One of our affiliates also maintains an Internet site at http://www.wellsref.com at which there is additional information about us and our affiliates, but the contents of that site are not incorporated by reference in or otherwise a part of this prospectus.

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PRIOR PERFORMANCE TABLES

All other schedules are omitted because they are not applicable or because the required information is included in the financial statements or notes thereto.

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Report of Independent Auditors

To the Board of Directors and Stockholder

Wells Real Estate Investment Trust II, Inc.

We have audited the accompanying consolidated balance sheet of Wells Real Estate Investment Trust II, Inc. (the Company) as of November 20, 2003. This consolidated balance sheet is the responsibility of the Company s management. Our responsibility is to express an opinion on this consolidated balance sheet based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated balance sheet is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated balance sheet. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall balance sheet presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated balance sheet referred to above presents fairly, in all material respects, the consolidated financial position of Wells Real Estate Investment Trust II, Inc. at November 20, 2003 in conformity with accounting principles generally accepted in the United States.

/s/ Ernst & Young LLP

Atlanta, Georgia

November 20, 2003

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Wells Real Estate Investment Trust II, Inc.

Consolidated Balance Sheet

November 20, 2003

Assets	
Cash	**$ 201,000**
Total Assets	**$ 201,000**
Liabilities and Stockholder s Equity	
Liabilities	
Total Liabilities	**$**
Commitments and Contingencies	
Minority Interest of Limited Partner in Operating Partnership	**$ 200,000**
Stockholder s Equity	
Preferred Stock, $0.01 par value; 100,000,000 shares authorized, no shares issued and outstanding	
Common Stock, $0.01 par value; 900,000,000 shares authorized, 100 shares issued and outstanding	**1**
Additional Paid-in Capital	**999**
Total Stockholder s Equity	**1,000**
Total Liabilities and Stockholder s Equity	**$ 201,000**

See accompanying notes.

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WELLS REAL ESTATE INVESTMENT TRUST II, INC.

NOTES TO CONSOLIDATED BALANCE SHEET

November 20, 2003

1. ORGANIZATION

Wells Real Estate Investment Trust II, Inc. (Wells REIT II) was formed on July 3, 2003 as a Maryland corporation that intends to qualify as a real estate investment trust (REIT). Wells REIT II expects to engage in the acquisition and ownership of commercial real properties throughout the United States, including properties that are under construction, are newly constructed or have operating histories. Wells REIT II may invest in office buildings, shopping centers, other commercial and industrial properties or other real estate properties. All such properties may be acquired directly or through joint ventures with real estate limited partnerships sponsored by Wells Capital, Inc. (the Advisor), affiliates of the Advisor, or third parties.

Substantially all of Wells REIT II s business is expected to be conducted through Wells Operating Partnership II, L.P. (Wells OP II), a Delaware limited partnership. Wells OP II was formed on July 3, 2003, and is expected to acquire, develop, own, lease, and operate real properties on behalf of Wells REIT II, directly, through wholly owned subsidiaries or through joint ventures. Wells REIT II is the general partner of Wells OP II and possesses full legal control and authority over the operations of Wells OP II. On September 9, 2003, the Advisor purchased 20,000 limited partner units in Wells OP II in exchange for $200,000.

As of November 20, 2003, Wells REIT II and Wells OP II have neither purchased nor contracted to purchase any properties, nor has the Advisor identified any properties in which there is a reasonable probability that Wells REIT II or Wells OP II will invest.

As of November 20, 2003, Wells REIT II had sold 100 shares to the Advisor at the proposed initial public offering price of $10 per share and no other shares have been issued by Wells REIT II.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

The consolidated balance sheet includes the accounts of Wells REIT II and any entities for which Wells REIT II has a controlling financial interest. In determining whether a controlling financial interest exists, Wells REIT II considers ownership of voting interests, protective rights and participatory rights of the investors. Any intercompany balances and transactions are eliminated upon consolidation. As of November 20, 2003, Wells REIT II has no investments in other entities, except for its interest in Wells OP II, which is included in the consolidated balance sheet of Wells REIT II.

Entities in which Wells REIT II does not have a controlling financial interest are accounted for using the equity method of accounting.

Upon formation, Wells REIT II adopted Financial Accounting Standards Board Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46). The interpretation provides additional guidance on the appropriate accounting for variable interest entities. Wells OP II is a variable interest entity (VIE), as that term is defined in FIN 46. Under FIN 46, the primary beneficiary of a VIE is required to

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consolidate the VIE. Wells REIT II is deemed to be the primary beneficiary of Wells OP II since its activities are deemed to be most closely associated with Wells OP II. Consequently, Wells REIT II has consolidated its interest in Wells OP II in its consolidated balance sheet.

Minority Interest of Limited Partner in Wells OP II

In May 2003, the Financial Accounting Standards Board (FASB) issued Statement No. 150 Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (FAS 150), certain components of which were deferred by the FASB in October 2003 for an indefinite period. This statement establishes standards for classifying and measuring as liabilities certain financial instruments that embody obligations of the issuer and have characteristics of both liabilities and equity. FAS 150 requires, among other things, that a minority interest in a consolidated entity be classified as a liability and reported at settlement value if an unconditional obligation to exercise or redeem the minority interest exists. As Wells OP II is an infinite life partnership and the redemption or conversion of the minority interest is conditioned upon future events, the limited partnership interest in Wells OP II is accounted for as a minority interest in the accompanying consolidated balance sheet. Until further guidance is provided during the deferral period for FAS 150, this interest will continue to be classified as minority interest in Wells REIT II s consolidated balance sheet.

Use of Estimates

The preparation of the consolidated balance sheet in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated balance sheet and accompanying notes. Actual results could differ from those estimates.

Cash and Cash Equivalents

Wells REIT II considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. Cash equivalents may include cash and short term investments. Short term investments are stated at cost, which approximates fair value and may consist of investments in money market accounts. There are no restrictions on the use of Wells REIT II s cash as of November 20, 2003.

Distribution Policy

Wells REIT II intends to make distributions each taxable year (not including a return of capital for federal income tax purposes) equal to at least 90% of the taxable income of Wells REIT II. Wells REIT II

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expects to declare dividends in advance of the quarter to which they relate based on a daily rate and pay the dividends at the end of the quarter.

Dividends to be distributed to stockholders will be determined by the board of directors of Wells REIT II and will be dependent upon a number of factors relating to Wells REIT II, including funds available for payment of dividends, financial condition, the timing of property acquisitions, capital expenditure requirements, and annual distribution requirements in order to maintain Wells REIT II s status as a REIT under the Internal Revenue Code.

Offering and Related Costs

Organization and offering costs (as described in Note 4) of Wells REIT II are incurred or paid by the Advisor on behalf of Wells REIT II. As of November 20, 2003, the Advisor had incurred organization and offering expenses on behalf of Wells REIT II of approximately $1,962,000, which will be reimbursed by Wells REIT II upon the sale of shares to the public under the terms of the Advisory Agreement discussed in Note 4. Upon reimbursement, organizational costs will be expensed, and offering costs will be charged to stockholders equity.

Allocation of Purchase Price of Acquired Assets

Upon the acquisition of real properties, it will be Wells REIT II s policy to allocate the purchase price of properties to acquired tangible assets, consisting of land and building, and identified intangible assets and liabilities, consisting of the value of above-market and below-market leases, and the value of in-place leases, based in each case on their fair values.

The fair values of the tangible assets of an acquired property (which includes land and building) will be determined by valuing the property as if it were vacant, and the as-if-vacant value will then be allocated to land and building based on management s determination of the relative fair value of these assets. Management will determine the as-if vacant fair value of a property using methods similar to those used by independent appraisers. Factors considered by management in performing these analyses will include an estimate of carrying costs during the expected lease-up periods considering current market conditions and costs to execute similar leases. In estimating carrying costs, management will include real estate taxes, insurance, and other operating expenses during the expected lease-up periods based on current market demand. Management will estimate costs to execute similar leases, including leasing commissions and other related costs.

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The fair values of above-market and below-market in-place leases will be recorded based on the present value (using an interest rate that reflects the risks associated with the leases acquired) of the difference between (i) the contractual amounts to be paid pursuant to the in-place leases and (ii) management s estimate of fair market lease rates for the corresponding in-place leases, measured over a period equal to the remaining terms of the leases. The capitalized above-market and below-market lease values will be amortized as an adjustment to rental income over the remaining terms of the respective leases.

The fair values of in-place leases will include direct costs associated with obtaining a new tenant, opportunity costs associated with lost rentals, which are avoided by acquiring an in-place lease, and tenant relationships. Direct costs associated with obtaining a new tenant will include commissions, tenant improvements and other direct costs and will be estimated based on management s consideration of current market costs to execute a similar lease. These direct costs will be included in deferred leasing costs in the consolidated balance sheet and will be amortized to expense over the remaining terms of the respective leases. The value of opportunity costs will be calculated using the contractual amounts to be paid pursuant to the in-place leases over a market absorption period for a similar lease. Customer relationships will be valued based on expected renewal of a lease or the likelihood of obtaining a particular tenant for other locations. These lease intangibles will be included in intangible lease assets in the consolidated balance sheet and will be amortized to rental income over the remaining terms of the respective leases.

Income Taxes

Wells REIT II intends to elect to be taxed as a REIT under the Internal Revenue Code of 1986, as amended, and intends to operate as such beginning with its taxable period ending December 31, 2003. To qualify as a REIT, Wells REIT II must meet certain organizational and operational requirements, including a requirement to distribute at least 90% of Wells REIT II s ordinary taxable income to stockholders. As a REIT, Wells REIT II generally will not be subject to federal income tax on taxable income that it distributes to stockholders. If Wells REIT II fails to qualify as a REIT in any taxable year, it will then be subject to federal income taxes on its taxable income at regular corporate rates and will not be permitted to qualify for treatment as a REIT for federal income tax purposes for four years following the year during which qualification is lost unless the Internal Revenue Service grants Wells REIT II relief under certain statutory provisions. Such an event could materially adversely affect Wells REIT II s net income and net cash available for distribution to stockholders. However, Wells REIT II intends to organize and operate in such a manner as to qualify for treatment as a REIT.

3. STOCKHOLDER S EQUITY

General

Wells REIT II s charter authorizes it to issue 1,000,000,000 shares of capital stock, consisting of 900,000,000 common shares and 100,000,000 preferred shares, each as defined by the charter.

The common shares have a par value of $0.01 per share and entitle the holders to one vote per share on all matters upon which stockholders are entitled to vote, to receive dividends and other distributions as authorized by the board of directors in accordance with the Maryland General Corporation Law and to all rights of a stockholder pursuant to the Maryland General Corporation Law. The common stock has no preferences or preemptive, conversion or exchange rights. As of November 20, 2003, Wells REIT II has issued 100 shares of common stock.

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Wells REIT II is authorized to issue one or more series of preferred stock. Prior to the issuance of such shares, the board of directors shall have the power from time to time to classify or reclassify, in one or more series, any unissued shares constituting such series and the designation, preferences, conversion, and other rights, voting powers, restrictions, limitations as to dividends and other distributions, qualifications and terms and conditions of redemption of such shares. As of November 20, 2003, Wells REIT II has issued no shares of preferred stock.

Stock Option Plan

On September 16, 2003, the board of directors and stockholder of Wells REIT II adopted a Stock Option Plan, which provides for grants of non-qualified stock options to be made to selected employees of the Advisor and Wells Management Company, Inc. (Wells Management). A total of 750,000 shares have been authorized and reserved for issuance under the Stock Option Plan. At November 20, no stock options have been granted under the plan; therefore all 750,000 shares are available for option grants, subject to limitations set forth in the charter. The exercise price per share for the options must be the greater of (1) $11.00, or (2) the Fair Market Value (as defined in the Stock Option Plan) on the date the option is granted. The conflicts committee of Wells REIT II s board of directors, upon recommendation and consultation with the Advisor and Wells Management, will grant options under the plan. The conflicts committee has the authority to set the term and vesting period of the stock options as long as no option has a term greater than five years from the date the stock option is granted. If the conflicts committee determines that the potential benefits of the stock options may be inappropriately diluted or enlarged as a result of certain corporate transactions or events, the conflicts committee may adjust the number and kind of shares or the exercise price with respect to any option. No stock option may be exercised if such exercise would jeopardize Wells REIT II s status as a REIT under the Internal Revenue Code, and no stock option may be granted if the grant, when combined with those issuable upon exercise of outstanding options or warrants granted to Wells REIT II s advisor, directors, officers or any of their affiliates, would exceed 10% of Wells REIT II s issued and outstanding shares. No option may be sold, pledged, assigned or transferred by an employee in any manner other than by will or the laws of descent or distribution.

Independent Director Stock Option Plan

On September 16, 2003, the board of directors and stockholder of Wells REIT II adopted an Independent Director Stock Option Plan (the Director Plan), which provides for grants of stock to be made to independent non-employee directors of Wells REIT II. A total of 100,000 shares have been authorized and reserved for issuance under the Director Plan. At November 20, 2003, no options have been granted under the plan; therefore all 100,000 shares are available for option grants, subject to limitations set forth in the charter. Options to purchase 2,500 shares of common stock at the greater of $12 per share or the Fair Market Value (as defined in the Director Plan) are granted upon initially becoming an independent director of Wells REIT II, or at the date the stockholders approved the Director Plan. Of these shares, 20% are exercisable immediately on the date of grant. An additional 20% of these shares become exercisable on each anniversary following the date of grant for a period of four years. Additionally, effective on the date of each annual stockholder meeting, beginning in 2004, each independent director will be granted an option to purchase 1,000 additional shares of common stock at the greater of (1) $12 per share or (2) the Fair Market Value. These options are 100% exercisable at the completion of two years of service after the date of grant. All options granted under the Director Plan expire no later than the tenth anniversary of the date of grant and may expire sooner if the independent director dies, is disabled, or ceases to serve as a director. In the event that the potential benefits of the stock options may be inappropriately diluted or enlarged as a result of a certain corporate transaction or event, a corresponding adjustment to the consideration payable with respect to all stock options shall be made. No stock option may be exercised if such exercise would jeopardize Wells REIT II s status as a REIT under the Internal Revenue Code, and no stock option may be granted if the

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grant, when combined with those issuable upon exercise of outstanding options or warrants granted to Wells REIT II s advisor, directors, officers or any of their affiliates, would exceed 10% of Wells REIT II s issued and outstanding shares. No option may be sold, pledged, assigned or transferred by an independent director in any manner other than by will or the laws of descent or distribution.

Dividend Reinvestment Plan

On September 16, 2003, the board of directors and stockholder of Wells REIT II adopted a dividend reinvestment plan (the DRP), through which common stockholders may elect to reinvest an amount equal to the dividends declared on their common shares in additional shares of Wells REIT II s common stock in lieu of receiving cash dividends. Under the plan as amended by the board of directors on October 9, 2003, shares may be purchased by eligible stockholders at the higher of $9.55 per share or 95% of the estimated per share value, as estimated by the Advisor or another firm chosen by the board of directors for that purpose. Participants in the DRP may purchase fractional shares so that 100% of the dividends will be used to acquire shares of Wells REIT II s stock. Wells REIT II will pay selling commissions of 5.0% in connection with sales under the DRP to the extent it paid commissions on the shares to which the dividends relate. No dealer manager fees will be paid on shares issued under the DRP. The board of directors, by majority vote, may amend or terminate the DRP for any reason upon 10 days prior written notice to the participants of the DRP. Participants may purchase shares under the DRP as long as a registration statement registering such DRP shares remains effective unless all 185,000,000 shares reserved under the DRP have been sold.

Proposed Share Redemption Program

The board of directors of Wells REIT II has approved a share redemption program but has delayed its adoption until the earlier of (i) the completion of Wells REIT II s primary public offering or (ii) receipt by Wells REIT II of exemptive relief from the Securities and Exchange Commission from rules restricting issuer purchases during distributions. Upon satisfaction of either of these conditions, Wells REIT II intends to implement the program. If adopted, the program would allow stockholders who hold their shares for more than one year to sell their shares back to Wells REIT II, through Wells Investment Securities, subject to certain limitations and penalties. The proposed share redemption program provides that Wells REIT II may repurchase a stockholder s stock for $8.40 per share. This redemption price would remain fixed until three years after Wells REIT II completes its offering stage. Wells REIT II defines the completion of its offering stage as the termination of its first public equity offering that is followed by a one-year period in which Wells REIT II does not engage in another public equity offering (other than a secondary offering or an offering related to a dividend reinvestment plan, employee benefit plan or the issuance of shares upon redemption of interests in Wells OP II). After that three-year period, the redemption price would equal 95% of the per share value of Wells REIT II as estimated by the Advisor or another firm chosen by the board of directors for that purpose. However, redemptions sought upon the death of a stockholder would not require a one-year holding period, and the redemption price would be the amount paid to Wells REIT II for the shares until three years after completion of the offering stage. At that time, the redemption price would be the higher of the amount paid to Wells REIT II for the shares or 100% of the Advisor s estimated per share net asset value. The shares redeemed under the plan other than upon the death of a stockholder could not exceed the lesser of (i) the amount redeemable from net proceeds from the sale of shares through the DRP, or (ii) in any calendar year, 5% of the weighted average common shares outstanding during the preceding year. The board of directors could amend or terminate Wells REIT II s share redemption program upon 30 days notice or prior to satisfaction of either of the preconditions to adoption noted above.

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4. RELATED PARTY TRANSACTIONS

Advisory Agreement

Wells REIT II has entered into an Advisory Agreement with the Advisor, which entitles the Advisor to earn specified fees upon the completion of certain services with regard to the investment of funds in real estate projects and sales of properties, among other services.

The Advisor will incur or pay organization and offering costs (other than selling commissions and the dealer manager fee) of Wells REIT II. These costs include Wells REIT II s legal, accounting, printing, and filing fees and other offering expenses, such as the salaries of the Advisor s employees and other costs of the Advisor relating to the preparation of supplemental sales materials and holding educational conferences. If Wells REIT II raises $2.5 million from the sale of capital stock to the public, Wells REIT II is obligated to reimburse the Advisor for those costs in an amount equal to the lesser of actual costs incurred or 2% of the gross proceeds from the offering and sale of shares of common stock to the public. As of November 20, 2003, the Advisor had incurred organization and offering expenses on behalf of Wells REIT II of approximately $1,962,000 for which Wells REIT II will reimburse the Advisor upon the sale of shares to the public. If Wells REIT II does not raise at least $2.5 million as described above, Wells REIT II has no obligation to reimburse the Advisor for these costs.

Wells REIT II will pay an asset management fee to the Advisor for services related to formulating and implementing strategies to administer, promote, manage, operate, maintain, improve, finance and refinance, market, lease, and dispose of properties. The asset management fee will be payable monthly in an amount equal to one-twelfth of 0.75% of the sum of the cost of all occupied properties Wells REIT II owns plus the cost of investments in joint ventures, provided that the amount paid in any calendar quarter may not exceed 1.0% of the net asset value of those investments at each quarter s end after deducting debt used to acquire or refinance properties. Additionally, Wells REIT II will reimburse the Advisor for all costs and expenses the latter incurs in fulfilling its duties as the asset portfolio manager. These costs and expenses may include wages and salaries and other employee-related expenses of the Advisor s employees engaged in the management, administration, operations, and marketing functions. Employee-related expenses include taxes, insurance and benefits relating to such employees, and legal, travel and other out-of-pocket expenses which

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are directly related to the services they provide. The Advisor will allocate its reimbursable costs of providing these services among Wells REIT II and the various Wells Real Estate Funds based on time spent on each entity by individual personnel.

Wells REIT II will pay a fee to the Advisor for services related to the acquisition and disposition of investment properties. Wells REIT II will pay the Advisor acquisition fees equal to 2.0% of the aggregate purchase price of all shares Wells REIT II sells. These acquisition fees serve as compensation for services the Advisor will render in connection with the investigation, selection and acquisition of properties. Wells REIT II will pay the acquisition fees upon its receipt of proceeds from the shares it sells, but the Advisor will be obligated to reimburse Wells REIT II for any unearned acquisition fee upon termination of the Advisory Agreement. Wells REIT II will also reimburse the Advisor for expenses it pays to third parties in connection with acquisitions or potential acquisitions. Additionally, when Wells REIT II sells a property, it will pay the Advisor a fee equal to 3.0% of the sales price if the Advisor provided a substantial amount of services in connection with the sale (as determined by the conflicts committee). This fee may be in addition to real estate commissions paid to third parties. However, the total real estate commissions (including such disposition fee) may not exceed the lesser of (i) 6.0% of the sales price of each property or (ii) the level of real estate commissions customarily charged in light of the size, type, and location of the property. As of November 20, 2003, the Advisor has not earned any such fees with regard to Wells REIT II.

The Advisor may also earn success-based fees in connection with the listing of Wells REIT II s shares of common stock or the sale of Wells REIT II s assets. If Wells REIT II sells properties and receives proceeds enabling it to distribute to stockholders all of the capital stockholders invested plus an amount sufficient to provide stockholders with an annualized, non-cumulative return of 8.0%, the Advisor will be entitled to an incentive fee. This incentive fee will equal 10% of the net sales proceeds remaining only after Wells REIT II has made the distributions providing shareholders a complete return of capital and the 8.0% return. Furthermore, if Wells REIT II lists its shares on a national securities exchange or national over-the-counter market system, the Advisor will be entitled to a fee. This fee will only be payable if the market value of Wells REIT II s outstanding stock plus distributions paid prior to listing exceeds the sum of the amount of capital stockholders invested plus the amount that would be required to be paid to stockholders to provide an annualized, non-cumulative return of 8.0%. The fee would equal 10% of that excess and would be offset by any incentive fees previously paid. Further, if Wells REIT II pays this fee following a listing of shares, it will not be obligated to pay any further incentive fees to the Advisor. As of November 20, 2003, the Advisor has not earned any such fees with regard to Wells REIT II.

The Advisory Agreement has a one-year term and automatically renews unless either side gives notice of its intent not to renew. Wells REIT II may terminate the Advisory Agreement upon 60 days written notice. If Wells REIT II terminates the Advisory Agreement, Wells REIT II will pay the Advisor all unpaid reimbursements of expenses and all earned but unpaid fees. In addition, the Advisor would be entitled to 10% of the amount, if any, by which

the sum of the net value of Wells REIT II s properties plus all distributions paid to the termination date exceeded

the difference between (A) the sum of (1) the total investments by stockholders (after any redemptions) plus (2) distributions attributable to the sale of properties plus (3) the amount of distributions that would be required to be paid to stockholders to provide an annualized, non-cumulative return of 8.0% and (B) any prior incentive fee paid to the Advisor.

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Dealer Manager Agreement

Wells REIT II has executed a dealer manager agreement whereby Wells Investment Securities, Inc. (WIS), an affiliate of the Advisor, performs the dealer manager function for Wells REIT II. For these services, WIS shall earn a fee of up to 7% of the gross offering proceeds from the sale of the shares of Wells REIT II. Additionally, WIS shall earn a dealer manager fee of up to 2.5% of the gross offering proceeds at the time the shares are sold. Some of the fees under the dealer manager agreement may be re-allowed to participating broker-dealers, and some of the fees may be reduced for certain classes of purchasers or for purchasers under the DRP. As of November 20, 2003, WIS has not earned any such fees with regard to Wells REIT II.

Conflict of Interest

The Advisor also is a general partner or advisor in various other entities affiliated with the Wells Real Estate Funds. As such, there are conflicts of interest where the Advisor, while serving in the capacity as general partner or advisor for Wells Real Estate Funds, may be in competition with Wells REIT II in connection with property acquisitions or for tenants in similar geographic markets.

Additionally, certain members of the board of Wells REIT II also serve on the board of another REIT sponsored by the Advisor and will encounter certain conflicts of interest regarding investment and operations decisions.

5. NASD ENFORCEMENT ACTION

On August 26, 2003, WIS and Leo F. Wells, III, the president and a director of Wells REIT II, settled an NASD enforcement action against them by entering into a Letter of Acceptance, Waiver and Consent (AWC) with the NASD which contained findings by the NASD including that WIS and Mr. Wells had violated certain of its Conduct Rules related to providing non-cash compensation of more than $100 to associated persons of NASD member firms in connection with their attendance at the annual educational conferences sponsored by WIS in 2001 and 2002, and that WIS and Mr. Wells failed to adhere to all the terms of a written undertaking made in March 2001. WIS consented to a censure, and Mr. Wells consented to suspension from acting in a principal capacity with a member firm for one year. WIS and Mr. Wells also agreed to the imposition of a joint and several fine in the amount of $150,000. Wells REIT II does not expect any material impact on the financial position or results of operations of Wells REIT II as a result of this settlement.

6. LEGAL PROCEEDING

On October 9, 2003, Stephen L. Flood, the Luzerne County Controller, and the Luzerne County Retirement Board (the Luzerne Board) on behalf of the Luzerne County Employee Retirement System (the Retirement System) filed a lawsuit in the U.S. District Court, Middle District of Pennsylvania against 26 separate defendants including Wells Real Estate Investment Trust, Inc., another REIT affiliated with the Advisor and WIS (Wells REIT I), Wells Real Estate Funds, Inc., the parent company of WIS and the Advisor, and WIS (collectively, the Wells Defendants).

The complaint alleges, among other things, that (1) certain former members of the Luzerne Board named as defendants invested $10 million in Wells REIT I on behalf of the Plan, (2) such former members of the Luzerne Board breached their fiduciary duties to the Retirement System by, among other things, permitting the investment of the Retirement System s funds in investments not suitable for the Retirement System because they were long-term illiquid investments, permitting the Retirement System to pay

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excessive fees and commissions to co-defendants and accepting political contributions in exchange for awarding advisory and management agreements, (3) the Wells Defendants and others knew or should have known that the investment, and the fees and commissions associated with the investment, were not proper for the Retirement System because the investment was a long-term illiquid investment, (4) the Wells Defendants and others knew or should have known that certain Luzerne Board members and certain investment advisers and managers were breaching their fiduciary duties to the Retirement System, (5) the defendants engaged in and conspired to engage in an improper scheme to intentionally defraud the Retirement System, and (6) the investment was not approved by a majority of the Luzerne Board at a public meeting, and consequently, the investment was an inappropriate and void action.

The Retirement System is seeking damages of not less than $25 million, treble damages and punitive damages from all defendants on a joint and several liability basis. Management believes that this lawsuit is without merit with respect to the Wells Defendants, and the Wells Defendants intend to vigorously defend this lawsuit.

7. ECONOMIC DEPENDENCY

Wells REIT II will be dependent on the Advisor and its affiliates for certain services that are essential to Wells REIT II, including the sale of Wells REIT II s shares of common and preferred stock available for issue, asset acquisition and disposition decisions, asset management services and other general and administrative responsibilities. In the event that these companies are unable to provide the respective services, Wells REIT II will be required to obtain such services from other sources.

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PRIOR PERFORMANCE TABLES

The following Prior Performance Tables (Tables) provide information relating to real estate investment programs sponsored by Wells Capital, Inc., our advisor, and its affiliates (Wells Public Programs) which have investment objectives similar to Wells Real Estate Investment Trust II, Inc. (Wells REIT II), including the provision of current income to the stockholders through the payment of cash dividends, the preservation and return of capital contributions to such stockholders and the realization of growth in the value of the properties acquired upon the ultimate sale of such properties. (See Investment Objectives and Criteria.) Except for Wells Real Estate Investment Trust, Inc. (Wells REIT I), all of the Wells Public Programs have used capital, and no acquisition indebtedness, to acquire their properties.

Prospective investors should read these Tables carefully together with the summary information concerning the Wells Public Programs as set forth in the Prior Performance Summary section of this prospectus.

Investors in Wells REIT II will not own any interest in the other Wells Public Programs and should not assume that they will experience returns, if any, comparable to those experienced by investors in other Wells Public Programs.

The advisor is responsible for the acquisition, operation, maintenance and resale of the real estate properties for both Wells REIT II and other Wells Public Programs. The financial results of other Wells Public Programs thus may provide some indication of our advisor s performance of its obligations during the periods covered. However, general economic conditions affecting the real estate industry and other factors contribute significantly to financial results.

The following tables are included herein:

Table I - Experience in Raising and Investing Funds

Table II - Compensation to Sponsor

Table III - Annual Operating Results of Wells Public Programs

Table IV - Results of Completed Programs has been omitted since none of the Wells Public Programs have been liquidated.

Table V - Sales or Disposals of Properties

Additional information relating to the acquisition of properties by the Wells Public Programs is contained in **Table VI**, which is included in Part II of the registration statement that Wells REIT II has filed with the SEC. Copies of any or all information will be provided to prospective investors at no charge upon request.

The following are definitions of certain terms used in the Tables:

Acquisition Fees shall mean fees and commissions paid by a Wells Public Program in connection with its purchase or development of a property, except development fees paid to a person not affiliated with the Wells Public Program or with a general partner or advisor of the Wells Public Program in connection with the actual development of a project after acquisition of the land by the Wells Public Program.

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Organization Expenses shall include legal fees, accounting fees, securities filing fees, printing and reproduction expenses and fees paid to the sponsor in connection with the planning and formation of the Wells Public Program.

Underwriting Fees shall include selling commissions and wholesaling fees paid to broker-dealers for services provided by the broker-dealers during the offering.

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TABLE I

EXPERIENCE IN RAISING AND INVESTING FUNDS

(UNAUDITED)

This Table provides a summary of the experience of the sponsors of Wells Public Programs for which offerings have been completed since December 31, 1999. Information is provided with regard to the manner in which the proceeds of the offerings have been applied. Also set forth is information pertaining to the timing and length of these offerings and the time period over which the proceeds have been invested in the properties. All figures are as of December 31, 2002.

	Wells Real Estate Fund XII, L.P.	Wells Real Estate Investment Trust, Inc.
Dollar Amount Offered	$ 70,000,000	$ 1,572,000,000
Dollar Amount Raised	$ 35,611,192(1)	$ 1,458,206,058(2)
Percentage Amount Raised	100%	100%
Less Organizational and Offering Costs Underwriting Fees	9.5%	9.5%
Organizational and Offering Costs	3.0%	3.0%
Reserves[3]	0.0%	0.0%
Percent Available for Investment	87.5%	87.5%
Acquisition and Development Costs		
Prepaid Items and Fees related to Purchase of Property	0.0%	0.0%
Cash Down Payment	84.0%	81.7%
Acquisition Fees[4]	3.5%	3.5%
Development and Construction Costs	0.0%	2.3%
Reserve for Payment of Indebtedness	0.0%	0.0%
Total Acquisition and Development Cost	87.5%	87.5%
Percent Leveraged	0.0%	0.0%
Date Offering Began	03/22/99	(4)
Length of Offering	24 mo.	(4)
Months to Invest 90% of Amount Available for Investment (Measured from Beginning of Offering)	26 mo.	(4)
Number of Investors as of 12/31/02	1,337	37,270

(1) Total dollar amount registered and available to be offered was $70,000,000. Wells Real Estate Fund XII, L.P. closed its offering on March 21, 2001, and the total dollar amount raised was $35,611,192.

(2) Because Wells Real Estate Investment Trust, Inc. terminated its first offering prior to December 31, 1999, this amount includes only Wells Real Estate Investment Trust, Inc. s second and third offerings. The total dollar amount registered and available to be offered in the second offering was $222,000,000. Wells Real Estate Investment Trust, Inc. began its second offering on December 20, 1999 and closed its second offering on December 19, 2000. It took Wells Real Estate Investment Trust, Inc. 10 months to invest 90% of the amount available for investment in the second offering. The total dollar amount raised in its second offering was $175,229,193. The total dollar amount

registered and available to be offered in the third offering was $1,350,000,000. Wells Real Estate Investment Trust, Inc. began its third offering on December 20, 2000 and closed its third offering on July 26, 2002. It took Wells Real Estate Investment Trust, Inc. 21 months to invest 90% of the amount available for investment in the third offering. The total dollar amount raised in its third offering was $1,282,976,862.

(3) Does not include general partner contributions held as part of reserves.

(4) Includes acquisition fees, real estate commissions, general contractor fees and/or architectural fees paid to affiliates of the general partners.

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TABLE II

COMPENSATION TO SPONSOR

(UNAUDITED)

The following Table sets forth the compensation received by Wells Capital, Inc., our advisor, and its affiliates, including compensation paid out of offering proceeds and compensation paid in connection with the ongoing operations of Wells Public Programs having similar or identical investment objectives, the offerings of which have been completed since December 31, 1999. All figures are as of December 31, 2002.

	Wells Real Estate Fund XII, L.P.	Wells Real Estate Investment Trust, Inc.[(1)]	Other Public Programs[(2)]
Date Offering Commenced	03/22/99	12/20/99	
Dollar Amount Raised	$ 35,611,192	$ 1,458,206,058	$ 284,902,808
Amount paid to Sponsor from Proceeds of Offering:			
Underwriting Fees[(3)]	$ 362,416	$ 59,280,729	$ 1,646,381
Acquisition Fees:			
Real Estate Commissions	$ 1,246,392	$ 51,037,212	$ 13,223,204
Acquisition and Advisory Fees[(4)]			
Dollar Amount of Cash Generated from Operations Before Deducting Payments to Sponsor[(5)]	$ 520,102	$ 113,853,928	$ 7,980,284
Amount Paid to Sponsor from Operations:			
Property Management Fee[(2)]	$ 158,647	$ 3,250,927	$ 2,342,594
Partnership Management Fee			
Reimbursements	$ 205,071	$ 1,130,152	$ 3,186,612
Leasing Commissions	$ 158,647	$ 3,250,927	$ 2,342,594
General Partner Distributions			
Other			
Dollar Amount of Property Sales and Refinancing Payments to Sponsors:			
Cash			
Notes			
Amount Paid to Sponsor from Property Sales and Refinancing:			
Real Estate Commissions			
Incentive Fees			
Other			

(1) Because Wells Real Estate Investment Trust, Inc. terminated its first offering prior to December 31, 1999, this amount includes only the Wells Real Estate Investment Trust, Inc. s second and third offerings. The total dollar amount registered and available to be offered in the second offering was $222,000,000. Wells Real Estate Investment Trust, Inc. closed its second offering on December 19, 2000, and the total dollar amount raised in its second offering was $175,229,193. The total dollar amount registered and available to be offered in the third offering was $1,350,000,000. Wells Real Estate Investment Trust, Inc. closed its third offering on July 26, 2002, and the total dollar amount raised in its third offering was $1,282,976,862.

(2) Includes compensation paid to the general partners from Wells Real Estate Fund I, Wells Real Estate Fund II, Wells Real Estate Fund II-OW, Wells Real Estate Fund III, L.P., Wells Real Estate Fund IV, L.P., Wells Real Estate Fund V, L.P., Wells Real Estate Fund VI, L.P., Wells Real Estate Fund VII, L.P., Wells Real Estate Fund VIII, L.P., Wells Real Estate Fund IX, L.P., Wells Real Estate Fund X, L.P. and Wells Real Estate Fund XI, L.P. during the past three years but excludes compensation paid to the general partners from Wells Real Estate Fund XIII, L.P. and Wells Real Estate Fund XIV, L.P. since these offerings had not been completed as of December 31, 2002. In addition to the amounts shown, affiliates of the general partners of Wells Real Estate Fund I are entitled to certain property management and leasing fees but have elected to defer the payment of such fees until a later year on properties owned by Wells Real Estate Fund I. As of December 31, 2002, the aggregate amount of such deferred fees totaled $2,881,491.

(3) Includes net underwriting compensation and commissions paid to Wells Investment Securities, Inc. in connection with the offering which were not reallowed to participating broker-dealers.

(4) Fees paid to the general partners or their affiliates for acquisition and advisory services in connection with the review and evaluation of potential real property acquisitions.

(5) Includes $2,263 in net cash used in operating activities and $522,365 in payments to sponsor for Wells Real Estate Fund XII, L.P., $106,221,922 in net cash provided by operating activities and $7,632,006 in payments to sponsor for Wells Real Estate Investment Trust, Inc. and $108,482 in net cash provided by operating activities and $7,871,802 in payments to sponsor for other public programs.

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TABLE III

ANNUAL OPERATING RESULTS OF WELLS PUBLIC PROGRAMS

(UNAUDITED)

The following three Tables set forth operating results of Wells Public Programs the offerings of which have been completed since December 31, 1997. The information relates only to public programs with investment objectives similar to those of Wells Real Estate Investment Trust II, Inc. All figures are as of December 31 of the year indicated.

WELLS REAL ESTATE FUND XI, L.P.

	2002	2001	2000	1999	1998
Gross Revenues[1]	$ 839,691	$ 960,676	$ 975,850	$ 766,586	$ 262,729
Profit on Sale of Properties					
Less: Operating Expenses[2]	92,876	90,326	79,861	111,058	113,184
Depreciation and Amortization[3]	0	0	0	25,000	6,250
Net Income GAAP Basis[4]	$ 746,815	$ 870,350	$ 895,989	$ 630,528	$ 143,295
Taxable Income: Operations	$ 965,422	$ 1,038,394	$ 944,775	$ 704,108	$ 177,692
Cash Generated (Used by):					
Operations	(105,148)	(128,985)	(72,925)	40,906	(50,858)
Joint Ventures	1,473,190	1,376,673	1,333,337	705,394	102,662
	$ 1,368,042	$ 1,247,688	$ 1,260,412	$ 746,300	$ 51,804
Less Cash Distribution to Investors:					
Operating Cash Flow	1,294,485	1,247,688	1,205,303	746,300	51,804
Return of Capital		4,809		49,761	48,070
Undistributed Cash Flow From Prior Year Operations		55,109			
Cash Generated (Deficiency) after Cash Distributions	$ 73,557	$ (59,918)	$ 55,109	$ (49,761)	$ (48,070)
Special Items (not including sales and financing):					
Source of Funds:					
General Partner Contributions					
Increase in Limited Partner Contributions					16,532,801
	$ 73,557	$ (59,918)	$ 55,109	$ (49,761)	$ 16,484,731
Use of Funds:					
Sales Commissions and Offering Expenses				214,609	1,779,661
Return of Original Limited Partner s Investment				100	
Property Acquisitions and Deferred Project Costs				9,005,979	5,412,870

Cash Generated (Deficiency) after Cash Distributions and Special Items	$ 73,557	$ (59,918)	$ 55,109	$ (9,270,449)	$ 9,292,200
Net Income and Distribution Data per $1,000 Invested:					
Net Income on GAAP Basis:					
Ordinary Income (Loss)					
- Operations Class A Units	91	101	103	77	50
- Operations Class B Units	(168)	(158)	(155)	(112)	(77)
Capital Gain (Loss)					
Tax and Distribution Data per $1,000 Invested:					
Federal Income Tax Results:					
Ordinary Income (Loss)					
- Operations Class A Units	93	100	97	71	18
- Operations Class B Units	(109)	(100)	(112)	(73)	(17)
Capital Gain (Loss)					
Cash Distributions to Investors per $1,000 Invested:					
Source (on GAAP Basis)					
- Investment Income Class A Units	90	97	90	60	8
- Return of Capital Class A Units	4				
- Return of Capital Class B Units					
Source (on Cash Basis)					
- Operations Class A Units	94	97	90	56	4
- Return of Capital Class A Units				4	4
- Operations Class B Units					
Source (on a Priority Distribution Basis)[5]					
- Investment Income Class A Units	75	75	69	46	6
- Return of Capital Class A Units	19	22	21	14	2
- Return of Capital Class B Units					
Amount (in Percentage Terms) Remaining Invested in Program Properties at the end of the Last Year Reported in the Table	100%				

(1) Includes $142,163 in equity in earnings of joint ventures and $120,566 from investment of reserve funds in 1998; $607,579 in equity in earnings of joint ventures and $159,007 from investment of reserve funds in 1999; $967,900 in equity in earnings of joint ventures and $7,950 from investment of reserve funds in 2000; $959,631 in equity in earnings of joint ventures and $1,045 from investment of reserve funds in 2001; and $837,509 in equity in earnings of joint ventures and $2,182 from investment of reserve funds in 2002. As of December 31, 2002, the leasing status was 100% including developed property in initial lease up.

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(2) Includes partnership administrative expenses.

(3) Included in equity in earnings of joint ventures in gross revenues is depreciation of $105,458 for 1998; $353,840 for 1999; $485,558 for 2000; $491,478 for 2001; and $492,404 for 2002.

(4) In accordance with the partnership agreement, net income or loss, depreciation and amortization are allocated $254,862 to Class A Limited Partners, $(111,067) to Class B Limited Partners and $(500) to General Partners for 1998; $1,009,368 to Class A Limited Partners, $(378,840) to Class B Limited Partners and $0 to the General Partners for 1999; $1,381,547 to Class A Limited Partners, $(485,558) to Class B Limited Partners and $0 to General Partners for 2000; $1,361,828 to Class A Limited Partners, $(491,478) to Class B Limited Partners and $0 to the General Partners for 2001; and $ 1,239,219 to Class A Limited Partners, $ (492,404) to Class B Limited Partners and $ 0 to the General Partners for 2002.

(5) Pursuant to the terms of the partnership agreement, an amount equal to the cash distributions paid to Class A Limited Partners is payable as priority distributions out of the first available net proceeds from the sale of partnership properties to Class B Limited Partners. The amount of cash distributions paid per unit to Class A Limited Partners is shown as a return of capital to the extent of such priority distributions payable to Class B Limited Partners. As of December 31, 2002, the aggregate amount of such priority distributions payable to Class B Limited Partners totaled $1,057,338.

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TABLE III

ANNUAL OPERATING RESULTS OF WELLS PUBLIC PROGRAMS

(UNAUDITED)

WELLS REAL ESTATE FUND XII, L.P.

	2002	2001	2000	1999
Gross Revenues[(1)]	$ 1,727,330	$ 1,661,194	$ 929,868	$ 160,379
Profit on Sale of Properties				
Less: Operating Expenses[(2)]	179,436	105,776	73,640	37,562
Depreciation and Amortization[(3)]	0	0	0	0
Net Income GAAP Basis[(4)]	$ 1,547,894	$ 1,555,418	$ 856,228	$ 122,817
Taxable Income: Operations	$ 1,929,381	$ 1,850,674	$ 863,490	$ 130,108
Cash Generated (Used By):				
Operations	(176,478)	(73,029)	247,244	3,783
Joint Ventures	2,824,519	2,036,837	737,266	61,485
	$ 2,648,041	$ 1,963,808	$ 984,510	$ 65,268
Less Cash Distributions to Investors:				
Operating Cash Flow	2,648,041	1,963,808	779,818	62,934
Return of Capital				
Undistributed Cash Flow From Prior Year Operations	2,156	164,482		
Cash Generated (Deficiency) after Cash Distributions	$ (2,156)	$ (164,482)	$ 204,692	$ 2,334
Special Items (not including sales and financing):				
Source of Funds:				
General Partner Contributions				
Increase in Limited Partner Contributions		10,625,431	15,617,575	9,368,186
	$ (2,156)	$ 10,460,949	$ 15,822,267	$ 9,370,520
Use of Funds:				
Sales Commissions and Offering Expenses		1,338,556	1,952,197	1,171,024
Return of Original Limited Partner s Investment				100
Property Acquisitions and Deferred Project Costs		9,298,085	16,246,485	5,615,262
Cash Generated (Deficiency) after Cash Distributions and Special Items	$ (2,156)	$ (175,692)	$ (2,376,415)	$ 2,584,134
Net Income and Distribution Data per $1,000 Invested:				
Net Income on GAAP Basis:				
Ordinary Income (Loss)				
- Operations Class A Units	94	98	89	50
- Operations Class B Units	(151)	(131)	(92)	(56)
Capital Gain (Loss)				

Tax and Distribution Data per $1,000 Invested:				
Federal Income Tax Results:				
Ordinary Income (Loss)				
- Operations Class A Units	91	84	58	23
- Operations Class B Units	(95)	(74)	(38)	(25)
Capital Gain (Loss)				
Cash Distributions to Investors per $1,000 Invested:				
Source (on GAAP Basis)				
- Investment Income Class A Units	93	77	41	8
- Return of Capital Class A Units				
- Return of Capital Class B Units				
Source (on Cash Basis)				
- Operations Class A Units	93	77	41	8
- Return of Capital Class A Units				
- Operations Class B Units				
Source (on a Priority Distribution Basis)[5]				
- Investment Income Class A Units	70	55	13	6
- Return of Capital Class A Units	23	22	28	2
- Return of Capital Class B Units				
Amount (in Percentage Terms) Remaining Invested in Program Properties at the end of the Last Year Reported in the Table	100%			

(1) Includes $124,542 in equity in earnings of joint ventures and $35,837 from investment of reserve funds in 1999; $664,401 in equity in earnings of joint ventures and $265,467 from investment of reserve funds in 2000; $1,577,523 in equity in earnings of joint ventures and $83,671 from investment of reserve funds in 2001; and $1,726,553 in equity in earnings of joint ventures and $777 from investment of reserve funds in 2002. As of December 31, 2002, the leasing status was 100% including developed property in initial lease up.

(2) Includes partnership administrative expenses.

(3) Included in equity in earnings of joint ventures in gross revenues is depreciation of $72,427 for 1999; $355,210 for 2000; $1,035,609 for 2001; and $1,107,728 for 2002.

(4) In accordance with the partnership agreement, net income or loss, depreciation and amortization are allocated $195,244 to Class A Limited Partners, $(71,927) to Class B Limited Partners and $(500) to the General Partners for 1999; $1,209,438 to Class A Limited Partners, $(353,210) to Class B Limited Partners and $0 to General Partners for 2000; $2,591,027 to Class A Limited Partners, $(1,035,609) to Class B Limited Partners and $0 to the General Partners for 2001; and $2,655,622 to Class A Limited Partners, $(1,107,728) to Class B Limited Partners, $0 to General Partners for 2002.

(5) Pursuant to the terms of the partnership agreement, an amount equal to the cash distributions paid to Class A Limited Partners is payable as priority distributions out of the first available net proceeds from the sale of partnership properties to Class B Limited Partners. The amount of cash distributions paid per unit to Class A Limited Partners is shown as a return of capital to the extent of such priority distributions payable to Class B Limited Partners. As of December 31, 2002, the aggregate amount of such priority distributions payable to Class B Limited Partners totaled $1,524,597.

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TABLE III

ANNUAL OPERATING RESULTS OF WELLS PUBLIC PROGRAMS

(UNAUDITED)

WELLS REAL ESTATE INVESTMENT TRUST, INC.

	2002 (000s)	2001 (000s)	2000 (000s)	1999 (000s)	1998 (000s)
Rental income	$ 107,526	$ 44,204	$ 20,505	$ 4,735	$ 21
Tenant reimbursements	$ 18,992	$ 6,830	$ 2,318	$ 2,058	$ 0
Equity in income of joint ventures	$ 4,700	$ 3,721	$ 2,294	$ 1,244	$ 263
Interest and other income	$ 8,410	$ 1,521	$ 574	$ 516	$ 111
Gross revenues	$ 139,628	$ 56,276	$ 25,691	$ 8,553	$ 395
Less:					
Operating costs	$ 36,356	$ 15,026	$ 5,195	$ 2,491	$ 61
Depreciation expense	$ 38,780	$ 15,345	$ 7,743	$ 1,726	$ 0
Interest expense	$ 4,638	$ 4,181	$ 4,200	$ 451	$ 0
Net income GAAP basis	$ 59,854	$ 21,724	$ 8,553	$ 3,885	$ 334
Taxable income	$ 80,521	$ 26,362	$ 10,280	$ 4,095	$ 383
Cash generated by (used by):					
Operations	$ 104,572	$ 42,349	$ 7,320	$ 4,008	($ 276)
Joint ventures	$ 7,388	$ 4,239	$ 3,529	$ 1,372	$ 178
Less:					
Cash distributions to investors	($104,996)	($36,737)	($16,971)	($3,806)	($103)
Cash generated (deficiency) after cash distributions	$ 6,964	$ 9,851	($6,122)	$ 1,574	($201)
Net income data per $1,000 invested:					
GAAP net income	$ 41	$ 43	$ 40	$ 50	$ 40
Taxable net income	$ 55	$ 52	$ 48	$ 53	$ 46
Cash Distributions to investors per $1,000 invested:					
Taxable ordinary income	$ 59	$ 54	$ 44	$ 70	$ 31
Tax deferred return of capital (tax deferred)	$ 17	$ 22	$ 29	$ 0	$ 0
Total distributions	$ 76	$ 76	$ 73	$ 70	$ 31

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TABLE V

SALES OR DISPOSALS OF PROPERTIES

(UNAUDITED)

The following Table sets forth sales or other disposals of properties by Wells Public Programs within the most recent three years. The information relates to only public programs with investment objectives similar to those of Wells Real Estate Investment Trust II, Inc. All figures are as of December 31, 2002.

			Selling Price, Net Of Closing Costs And GAAP Adjustments					Cost Of Properties Including Closing And Soft Costs			
Property	Date Acquired	Date Of Sale	Cash Received Net Of Closing Costs	Mortgage Balance At Time Of Sale	Purchase Money Mortgage Taken Back By Program	Adjustments Resulting From Application Of GAAP	Total	Original Mortgage Financing	Total Acquisition Cost, Capital Improvement, Closing And Soft Costs (1)	Total	Excess (Deficiency) Of Property Operating Cash Receipts Over Cash Expenditures
3875 Peachtree Place, Atlanta, GA	12/1/85	08/31/00	$ 727,982	-0-	-0-	-0-	$ 727,982(2)	-0-	$ 582,337	$ 582,337	-0-
Crowe s Crossing Shopping Center, DeKalb County, GA	12/31/86	01/11/01	$ 6,487,000	-0-	-0-	-0-	$ 6,487,000(3)	-0-	$ 9,255,594	$ 9,255,594	-0-
Cherokee Commons Shopping Center, Cherokee County, GA	10/30/87	10/01/01	$ 8,434,089	-0-	-0-	-0-	$ 8,434,089(4)	-0-	$ 10,450,555	$ 10,450,555	-0-
Greenville Center, Greenville, SC	6/20/90	9/30/02	$ 2,271,187	-0-	-0-	-0-	$ 2,271,187(5)	-0-	$ 4,297,901	$ 4,297,901	-0-
Tanglewood Commons Outparcel, Clemmens, NC	5/30/95	10/07/02	$ 524,398	-0-	-0-	-0-	$ 524,398(6)	-0-	$ 506,326	$ 506,326	-0-
Heritage Retail Center, Tucker, GA	9/4/86	4/7/03	$ 3,156,288	-0-	-0-	-0-	$ 3,156,288(7)	-0-	$ 2,865,947	$ 2,865,947	-0-

(1) Amount shown does not include pro rata share of original offering costs.
(2) Includes Wells Real Estate Fund I s share of taxable gain from this sale in the amount of $205,019, all of which is allocated to capital gain.
(3) Includes taxable gain from this sale in the amount of $11,496, all of which is allocated to capital gain.

(4) Includes taxable gain from this sale in the amount of $207,613, all of which is allocated to capital gain.
(5) Includes taxable loss from this sale in the amount of $910,227.
(6) Includes taxable gain from this sale in the amount of $13,062, all of which is allocated to capital gain.
(7) Includes taxable loss from this sale in the amount of $147,135.

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APPENDIX A

WELLS REAL ESTATE INVESTMENT TRUST II, INC.

SUBSCRIPTION AGREEMENT

INVESTOR INSTRUCTIONS

Please follow these instructions carefully. Failure to do so may result in the rejection of your subscription.

1. REGISTRATION AND CONTACT INFORMATION

Please enter the exact name in which the Shares are to be held. For joint tenants with right of survivorship or tenants in common, include the names of both investors. In the case of partnerships or corporations, include the name of an individual to whom correspondence will be addressed. Trusts should include the name of the trustee. All investors must complete the space provided for taxpayer identification number or social security number. By signing in Section 5, the investor is certifying that this number is correct. Enter the mailing address and telephone numbers of the registered owner of this investment. In the case of a qualified plan or trust, this will be the address of the trustee. Indicate the birth date of the registered owner unless the registered owner is a legal entity.

2. TYPE OF OWNERSHIP

Please check the appropriate box to indicate the type of investor subscribing.

3. DIVIDENDS (YOU MUST CHECK AT LEAST ONE OF THE FOLLOWING)

Please check the appropriate block to indicate to whom the dividends should be paid, in what form they should be paid and the address of the individual(s) or institution receiving the distribution if dividends are to be paid to a third party. If no blocks are checked in this section, the funds will be paid to the registered owner and mailed to the address indicated in Section 1.

For a discussion of the Dividend Reinvestment Plan, including a discussion of selling commissions payable by the Company in connection with dividend reinvestments, please see the section of the Prospectus entitled Description of Shares Dividend Reinvestment Plan.

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4. INVESTMENT

A minimum investment of $1,000 is required, except for certain states that require a higher minimum investment as set forth under the section of the Prospectus entitled Plan of Distribution Minimum Purchase Requirements, which immediately follows the cover page of the Prospectus. A CHECK FOR THE FULL PURCHASE PRICE OF THE SHARES SUBSCRIBED FOR SHOULD BE MADE PAYABLE TO THE ORDER OF WELLS REAL ESTATE INVESTMENT TRUST II, INC. Investors who have satisfied the minimum purchase requirements in another public real estate program sponsored by Wells Capital, Inc. or its affiliates may invest as little as $25, except for residents of Maine, Minnesota, Nebraska or Washington. Only persons meeting the standards set forth under the section of the Prospectus entitled Suitability Standards may purchase shares. Please indicate the state in which the sale was made if other than state of residence.

All additional investments must be for at least $25. If additional investments in the Company are made, the investor agrees to notify the participating broker-dealer (Broker/Dealer) or investment adviser named in Section 6 of the Subscription Agreement.

Note: THE COMPANY WILL NOT ACCEPT CASH, STARTER OR COUNTER CHECKS, MONEY ORDERS OR TRAVELERS CHECKS DUE TO ANTI-MONEY LAUNDERING CONSIDERATIONS.

5. SUBSCRIBER SIGNATURES

Please separately initial the representations in paragraphs (a) through (e) where indicated. Please note the higher suitability requirements described in the Prospectus for residents of California, Iowa, Maine, Massachusetts, Michigan, Missouri, New Jersey and Tennessee and the requirement that residents of Iowa, Missouri, Ohio and Pennsylvania have a net worth of at least 10 times their investment in the Company. Except in the case of fiduciary accounts, the investor may not grant any person a power of attorney to make such representations on his or her behalf. Each investor must sign and date this Section. If title is to be held jointly, all parties must

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sign. If the registered owner is a partnership, corporation or trust, a general partner, officer or trustee of the entity must sign.

Note: THESE SIGNATURES DO NOT HAVE TO BE NOTARIZED.

6. BROKER/DEALER OR INDEPENDENT INVESTMENT ADVISER

Who must sign this Section. If the investment is made through an investment adviser unaffiliated with a broker-dealer (Independent Investment Adviser), this Section 6 must be signed by an authorized representative of the Investment Adviser. If the investment is made through a bank acting in a trustee or fiduciary capacity (a Bank), there is a separate subscription agreement that must be obtained from the Dealer Manager to complete the investment. Otherwise, this section must be signed by an authorized representative of the participating Broker/Dealer.

Required Representations. By signing this section, the Broker/Dealer or Independent Investment Adviser represents that it has made every reasonable effort to determine that the purchase of shares in this offering is a suitable and appropriate investment for each investor based on information provided by the investor regarding the investor s financial situation and investment objectives. In making this determination, the Broker/Dealer or Independent Investment Adviser ascertained that the prospective stockholder:

- meets the minimum income and net worth standards set forth in the Prospectus at Suitability Standards ;
- can reasonably benefit from an investment in the shares based on the prospective stockholder s overall investment objectives and portfolio structure;
- is able to bear the economic risk of the investment based on the prospective stockholder s overall financial situation; and
- has apparent understanding of:
  - the fundamental risks of the investment;
  - the risk that the stockholder may lose the entire investment;
  - the lack of liquidity of the shares;
  - the restrictions on transferability of the shares;
  - the background and qualifications of Wells Capital and its affiliates; and

the tax consequences of the investment.

Relevant information for this purpose will include at least the age, investment objectives, investment experience, income, net worth, financial situation and other investments of the prospective stockholder, as well as any other pertinent factors. The Broker/Dealer or Independent Investment Adviser agrees to maintain records of the information used to determine that an investment in shares is suitable and appropriate for the stockholder for a period of six years.

In addition, the registered representative of a Broker/Dealer represents that he or she and the Broker/Dealer are duly licensed to offer the shares in the state where the investment was made and in the state of the investor s address set forth in Section 1 of the Subscription Agreement. An Independent Investment Adviser represents that such adviser is either registered under the Investment Advisers Act of 1940 or exempt from registration.

Commission Rate. Broker/Dealers should select only one commission rate. Full commission may not be selected if the investment is made through an investment advisery representative compensated on a fee-for-service basis in connection with the sale or if the purchase is for a Broker/Dealer, its retirement plan or its representative (or the retirement plan or family members of its representative).

Note: The Subscription Agreement, together with a check for the full purchase price, should be delivered or mailed to one of the addresses noted at the top of the Subscription Agreement by the Broker/Dealer or Independent Investment Adviser, as applicable. Only original, completed copies of Subscription Agreements can be accepted. The Company cannot accept photocopied or otherwise duplicated Subscription Agreements.

IF YOU NEED FURTHER ASSISTANCE IN COMPLETING THIS SUBSCRIPTION

AGREEMENT, PLEASE CALL 1-800-557-4830.

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APPENDIX B

DIVIDEND REINVESTMENT PLAN

Wells Real Estate Investment Trust II, Inc., a Maryland corporation (the Company), has adopted a Dividend Reinvestment Program (the DRP), the terms and conditions of which are set forth below. Capitalized terms shall have the same meaning as set forth in the Company s charter unless otherwise defined herein.

1. Number of Shares Issuable. The number of shares of Common Stock authorized for issuance under the DRP is 185,000,000.

2. Participants. Participants are purchasers of Common Stock issued in the offering covered by the Company s Registration Statement on Form S-11 (file no. 333-107066) (the Offering) who elect to participate in the DRP.

3. Dividend Reinvestment. The Company will apply that portion (as designated by a Participant) of the dividends and other distributions (Distributions) declared and paid in respect of a Participant s shares of Common Stock to the purchase of additional shares of Common Stock for such Participant. Such shares will be sold through the broker-dealer and/or dealer manager through whom the Company sold the underlying shares to which the Distributions relate in the Offering unless the Participant makes a new election through a different distribution channel. The Company will pay selling commissions and the dealer manager fee as described in the registration statement relating to the Offering.

4. Procedure for Participation. Qualifying stockholders may elect to become a Participant by completing and executing the Subscription Agreement, an enrollment form or any other Company-approved authorization form as may be available from the dealer manager or participating broker-dealers. To increase their participation, Participants must complete a new enrollment form and make the election through the dealer manager or the Participant s broker-dealer, as applicable. Participation in the DRP will begin with the next Distribution payable after receipt of a Participant s subscription, enrollment or authorization. Shares will be purchased under the DRP on the date that the Company makes a Distribution. Distributions will be paid quarterly and are calculated with a daily record and Distribution declaration date.

5. Purchase of Shares. Participants will acquire Common Stock at a price equal to the higher of $9.55 per share or 95% of the estimated value of one share as estimated by the Company s advisor or other firm chosen by the board of directors for that purpose. Participants in the DRP may also purchase fractional shares so that 100% of the Distributions will be used to acquire shares. However, a Participant will not be able to acquire shares under the DRP to the extent such purchase would cause it to exceed the Ownership Limit (unless exempted by the Company s board of directors). A stockholder may not participate in the DRP through distribution channels that would be eligible to purchase shares in the Offering outside of the DRP at prices below $9.55 per share.

6. Taxation of Distributions. The reinvestment of Distributions in the DRP does not relieve Participants of any taxes which may be payable as a result of those Distributions and their reinvestment pursuant to the terms of this Plan.

7. Share Certificates. The shares issuable under the DRP shall be uncertificated until the board of directors determines otherwise.

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8. Voting of DRP Shares. In connection with any matter requiring the vote of the Company s stockholders, each Participant will be entitled to vote all of the whole shares acquired by the Participant through the DRP. Fractional shares will not be voted.

9. Reports. Within 90 days after the end of the calendar year, the Company shall provide each Participant with (i) an individualized report on the Participant s investment, including the purchase date(s), purchase price and number of shares owned, as well as the amount of Distributions received during the prior year; and (ii) all material information regarding the DRP and the effect of reinvesting dividends, including the tax consequences thereof. The Company shall provide such information reasonably requested by the dealer manager or a participating broker-dealer in the Offering in order for the dealer manager or participating broker-dealer to meet its obligation to deliver written notification to Participants of the information required by Rule 10b-10(b) promulgated under the Securities Exchange Act of 1934.

10. Termination by Participant. A Participant may terminate participation in the DRP at any time by delivering to the Company a written notice. To be effective for any Distribution, such notice must be received by the Company at least ten business days prior to the last day of the fiscal period to which the Distribution relates. Any transfer of shares by a Participant will terminate participation in the DRP with respect to the transferred shares. Upon termination of DRP participation, Distributions will be distributed to the stockholder in cash.

11. Amendment or Termination of DRP by the Company. The board of directors of the Company may amend or terminate the DRP for any reason upon 10 days written notice to the Participants.

12. Liability of the Company. The Company shall not be liable for any act done in good faith, or for any good faith omission to act. To the extent that indemnification may apply to liabilities arising under the Securities Act of 1933, as amended, or the securities act of a state, the Company has been advised that, in the opinion of the Securities and Exchange Commission and certain state securities commissioners, such indemnification is contrary to public policy and, therefore, unenforceable.

13. Governing Law. This DRP shall be governed by the laws of the State of Maryland.

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Until February 29, 2004, all dealers that effect transactions in these securities, whether or not participating in this offering, may be required to deliver a prospectus. This is in addition to the obligation of dealers to deliver a prospectus when acting as soliciting dealers.

We have not authorized any dealer, salesperson or other individual to give any information or to make any representations that are not contained in this prospectus. If any such information or statements are given or made, you should not rely upon such information or representation. This prospectus does not constitute an offer to sell any securities other than those to which this prospectus relates, or an offer to sell, or a solicitation of an offer to buy, to any person in any jurisdiction where such an offer or solicitation would be unlawful. This prospectus speaks as of the date set forth below. You should not assume that the delivery of this prospectus or that any sale made pursuant to this prospectus implies that the information contained in this prospectus will remain fully accurate and correct as of any time subsequent to the date of this prospectus.

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Our shares are not FDIC insured, may lose value and are not bank guaranteed. See Risk Factors beginning on page 21 to read about risks you should consider before buying shares of our common stock.

WELLS REAL ESTATE

INVESTMENT TRUST II, INC.

Maximum Offering of

785,000,000 Shares

of Common Stock

Minimum Offering of

250,000 Shares

of Common Stock

PROSPECTUS

WELLS INVESTMENT

SECURITIES, INC.

November 26, 2003

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WELLS REAL ESTATE INVESTMENT TRUST II, INC.

SUPPLEMENT NO. 9 DATED MAY 18, 2004

TO THE PROSPECTUS DATED NOVEMBER 26, 2003

This document supplements, and should be read in conjunction with, the Prospectus of Wells Real Estate Investment Trust II, Inc. (REIT II) dated November 26, 2003. This Supplement No. 9 supersedes and replaces all prior supplements to the Prospectus. Capitalized terms used in this Supplement have the same meanings as set forth in the Prospectus. The purpose of this Supplement is to disclose:

- the status of our ongoing public offering;
- a Management s Discussion and Analysis of Financial Condition and Results of Operations similar to that which was filed in the Quarterly Report on Form 10-Q, dated May 17, 2004;
- unaudited financial statements as of March 31, 2004 and for the period from January 1, 2004 through March 31, 2004;
- unaudited pro forma financial statements as of March 31, 2004 and for the periods from January 1, 2003 (pre-inception) through December 31, 2003 and January 1, 2004 through March 31, 2004; and
- all other material items that have been previously disclosed by supplement to the Prospectus.

Status of the Offering

We commenced our initial public offering of 600 million shares of common stock on December 1, 2003. As of May 13, 2004, we had received aggregate gross offering proceeds of approximately $128.7 million from the sale of approximately 12.9 million shares in our initial public offering. After payment of approximately $2.6 million in acquisition fees, payment of approximately $12.0 million in selling commissions and dealer manager fees and $2.6 million in other organization and offering expenses, as of May 13, 2004, we had raised aggregate net offering proceeds of approximately $111.5 million.

Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis should be read in conjunction with our accompanying consolidated financial statements and notes thereto. This discussion and analysis is similar to that which was included in our Quarterly Report on Form 10-Q, dated May 17, 2004, and speaks only as of that date.

Forward-Looking Statements

This section and other sections in the Prospectus contain forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933 and 21E of the Securities Exchange Act of 1934, including discussion and analysis of our financial condition, amounts of anticipated cash distributions to stockholders in the future and certain other matters. Readers of this Prospectus should be aware that there are various factors that could cause actual results to differ materially from any forward-looking statements made in this Prospectus, which include changes in general economic conditions, changes in real estate conditions, construction costs which may exceed estimates, construction delays, increases in interest rates, lease-up risks, inability to obtain new tenants upon the expiration of existing leases and the potential need to fund tenant improvements or other capital expenditures out of operating cash flow. See the Risk Factors section beginning on page 21 of the Prospectus.

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Liquidity and Capital Resources

During the three months ended March 31, 2004, we received proceeds from our initial offering of common stock and began operations as a real estate investment and operating company. With the net proceeds of this stock offering and with utilization of capacity under a secured credit agreement, we funded the purchase of three real estate properties and funded certain overhead costs. Additionally, approximately $0.7 million of general and administrative expenses have been funded by the Advisor and included in accounts payable and accrued expenses. These overhead costs were partially offset by net operating income generated by the properties we acquired. Net capital generated from the financing activities described above was approximately $92.4 million consisting of approximately $54.6 million in net stock offering proceeds and $37.8 million from our line of credit. Of this capital, we invested approximately $76.9 million in real estate properties, including earnest money paid, and paid $1.1 million in deferred financing costs. We generated net cash from operating activities of $0.4 million and paid dividends to stockholders of $0.1 million. As of March 31, 2004, we had cash and cash equivalents of approximately $14.8 million available for repayment of the line of credit, investment in properties, or reimbursement of the Advisor.

Short-term Liquidity and Capital Resources

We intend to continue to generate capital from our ongoing offering of common stock and to utilize indebtedness to assist in the funding for and timing of our acquisitions. As of March 31, 2004, we had one property under contract for a purchase price of $79.3 million. Subsequent to March 31, 2004, we executed an additional five contracts for an aggregate purchase price of $393.4 million. Approximately $21.0 million in earnest money relates to these contracts, approximately $19.3 million of which is non-refundable. Completion of these acquisitions is dependent upon our ability to raise sufficient amounts of equity capital and indebtness, subject to limitations in our credit agreement discussed below; therefore, we cannot predict with certainty when or if these acquisitions will close. If we are unable to raise sufficient equity capital to allow us to fulfill our obligations under these contracts, we will be required to forfeit our non-refundable earnest money, which would negatively affect our results from operations in future periods.

As of March 31, 2004, we had short-term debt outstanding under our $175 million, 90-day, secured line of credit with Bank of America totaling approximately $37.8 million, and cash and cash equivalents of approximately $14.8 million. We utilized capacity under the line to fund our three acquisitions during the first quarter, and made repayments as we raised additional investor proceeds. This line of credit was set to expire on May 10, 2004, and permitted borrowings only to purchase lender-approved properties, which must be at least 85% occupied. The $175 million facility required that we use 86.5% of our gross offering proceeds to repay the facility, precluded us from borrowing funds except under the facility, and did not allow us to re-borrow amounts paid under the facility.

On May 10, 2004, we entered into a revolving $350 million, 180-day, secured interim facility agreement with Bank of America, N.A., superseding our $175 million facility agreement and refinancing our existing outstanding balance. In connection with closing our $350 line of credit, we paid and expect to pay fees and expenses totaling approximately $3.2 million. The agreement contains borrowing arrangements that provide for interest costs based on LIBOR for one, two, or three month periods, plus 225 basis points or the base rate plus 50 basis points, at our option. The base rate for any day is the higher of the Federal Funds Rate for such day plus 50 basis points or Bank of America s prime rate for such day. If Bank of America is not able to syndicate an acceptable portion of this line of credit, the terms of the line of credit, including, but not limited to, the interest rate and the amount available under the facility, may change. Like our initial $175 million facility, this $350 million facility permits borrowings only to purchase lender-approved properties and requires that we use 86.5% of our gross offering proceeds to repay the facility.

Under the terms of the $350 million line of credit, we are required to repay outstanding principal and accrued interest within 180 days. During the initial 180-day term, the agreement allows us to borrow

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up to 70% of the aggregate cost of the Borrowing Base. We are able to extend the initial maturity date by an additional 180 days if we seek an extension and meet the related conditions set forth in the agreement, including reducing the amount outstanding under the facility to 60% of the Borrowing Base. During the extension term, borrowing under the facility is limited to 60% of the Borrowing Base. At May 10, 2004, we were able to borrow up to approximately $2.5 million under the $350 million line of credit.

The agreement also stipulates that our net distributions, which equal total distributions less the amount reinvested through our dividend reinvestment plan, may not exceed the greater of 90% of our Funds from Operations (see Funds From Operations below) for the corresponding period and any equity proceeds not used for other purposes that are otherwise not required to pay down the line. With the obligation to use 86.5% of gross offering proceeds to repay the facility, the equity proceeds that we could use to fund distributions will be largely limited to approximately $14.8 million of available new proceeds raised before entering into the former $175 million bridge facility. The lender also adjusts the definition of Funds from Operations to add back the amortization of initial loan fees paid to the lender.

Debt covenants of our initial $175 million line of credit required that our leverage, i.e. our ratio of total debt to total purchase price of real estate assets plus cash and cash equivalents, be no more than 85% from March 26, 2004 through the debt s expiration. As of March 31, 2004, our leverage ratio was approximately 43%. As a result of subsequent capital-raising activities and borrowings to acquire the Manhattan Towers Property (see Note 8 to the accompanying financial statements for further explanation), our leverage ratio was approximately 59% as of April 30, 2004. Our $350 million facility requires that we maintain our leverage ratio at 70% or less. In future periods, this ratio will be dependent upon our level of borrowings to purchase properties and the amount of investor proceeds raised.

The $350 million facility is secured by mortgages on all lender-approved properties; however, only some of the mortgages are recorded in the property records. However, in the event we are in default under the facility, the lender may elect to record all of the mortgages and foreclose.

Our charter prohibits us from incurring debt that would cause our borrowings to exceed 50% of our assets (valued at cost before depreciation and other non-cash reserves) unless a majority of the members of the conflicts committee of our board of directors approves the borrowing. Our charter also requires that we disclose the justification for any borrowings in excess of the 50% leverage guideline in the next quarterly report. The conflicts committee approved the borrowings during the quarter to purchase our three real estate assets and the resulting leverage ratios. In each case, the conflicts committee determined that the excess leverage was justified for the following reasons:

- the borrowings enabled us to purchase the properties and earn rental income more quickly;
- the property acquisitions are likely to increase the net offering proceeds from our initial public offering, thereby improving our ability to meet our goal of acquiring a diversified portfolio of properties to generate current income for investors and preserve investor capital;
- the dealer-manager of our initial public offering has a strong record of raising capital for programs such as ours; therefore, our leverage is likely to exceed the charter s guidelines only for a short period of time;
- our Advisor informed the conflicts committee that we should raise sufficient equity to repay the borrowings and to meet the leverage requirements set forth in our $175 million line of credit;

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we had a non-binding commitment from Bank of America to provide a second interim facility that permits a 70% leverage ratio, with which we repaid the outstanding balance on our $175 million facility at its maturity; and

the prospectus for our initial public offering disclosed the likelihood that we would exceed the charter s leverage guidelines during the early stages of the offering.

For each share of our common stock, our board of directors declared dividends for the first quarter of 2004 and for the period from April 1, 2004 to April 15, 2004 at an annualized percentage rate of return of 2.5% based on a $10 per share investment. Our board of directors subsequently declared dividends for the period from April 1, 2004 to April 21, 2004 at an annualized rate of 5.0%, and dividends for the period from April 22, 2004 to June 15, 2004 at an annualized rate of 6.0%. Dividends accrue to stockholders on a daily record basis and are paid quarterly. We expect that the operations of the properties that we have acquired and intend to acquire will be adequate to maintain our dividend at 6% per annum.

The payment of dividends in the future will generally be dependent upon the cash flows from operating the properties currently owned and acquired in future periods, our financial condition, amounts paid for properties acquired, the timing of property acquisitions, capital expenditure requirements and distribution requirements in order to maintain our REIT status under the Internal Revenue Code.

Long-term Liquidity and Capital Resources

We expect that potential sources of capital will include proceeds from the sale of our common stock, proceeds from secured or unsecured financings from banks and other lenders, and net cash flows from operations. We expect that our principal uses of capital will be for property acquisitions, either directly or through investments in joint ventures, for the payment of tenant improvements, for the payment of offering-related costs, for the payment of operating expenses, including interest expense on any outstanding indebtedness, and for the payment of dividends.

In determining how and when to allocate cash resources, we will initially consider the source of the cash. We expect that substantially all net cash raised from operations will be used to pay dividends after certain capital expenditures, including tenant improvements and leasing commissions, are paid at the properties; however, we may use other sources to fund dividends as necessary. To the extent that cash flows from operations are lower due to fewer properties being acquired or lower returns on the properties, dividends paid may be lower. We expect that substantially all net cash resulting from equity raising or debt financing will be used to fund acquisitions, any capital expenditures identified at acquisition, or repayments of outstanding debt. To the extent sufficient equity or debt is not available, then the amount invested in real estate will be lower. Over the long term, we intend to maintain borrowings at an amount that is less than 50% of the purchase price of our properties (before depreciation) and other assets.

Results of Operations

As of March 31, 2004, our three real estate properties were 100% leased. Our results of operations are not indicative of those expected in future periods as we expect that rental income, tenant reimbursements, depreciation expense, operating expenses, asset management fees and net income will each increase in future periods as a result of owning the assets acquired during the three months ended March 31, 2004 for an entire period and as a result of anticipated future acquisitions of real estate assets.

Rental income for the three months ended March 31, 2004 totaled $810,694, with tenant reimbursements equaling $115,217. Property operating expenses were $273,654. Depreciation expense

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for the three months ended March 31, 2004 was $130,842, and asset management fees were approximately $24,830. We acquired our first property on February 10, 2004, which offered one full month s and a partial month s revenues and expenses for the quarter. Our second acquisition occurred March 19, 2004, providing additional revenues and expenses for a partial month, and our third property was acquired on the last day of the month. Net income from property operations was approximately $443,000 for the three months ended March 31, 2004, exclusive of portfolio level expenses such as interest and general and administrative expenses.

General and administrative expenses for the three months ended March 31, 2004 totaled $612,138, of which 99.8% was overhead-related costs. We sustained a net loss for the quarter of approximately $1.0 million, primarily as a result of incurring overhead-related general and administrative expenses and interest expense without sufficient rental revenues from properties to cover the costs. Loss per share for the three months ended March 31, 2004 was $(0.43). With the acquisition of new properties in future periods, we anticipate that general and administrative expenses, net income, and earnings per share will each increase. However, we expect general and administrative expenses to decrease as a percentage of total revenue.

Our property acquisitions were financed with short-term debt from our $175 million line of credit with Bank of America. During the three months ended March 31, 2004, we incurred amortization of deferred financing costs and interest expense of $908,339 related to our use of this debt. Our $350 million replacement facility includes provisions for lower interest rates. However, our debt financing costs in future periods will vary based on our level of future borrowings, which will depend on the level of investor proceeds raised, the cost of borrowings, and the opportunity to acquire real estate assets fitting our investment objectives.

Funds From Operations

Funds from Operations (FFO), as defined by the National Association of Real Estate Investment Trusts (NAREIT), generally means net income, computed in accordance with accounting principles generally accepted in the United States (GAAP) excluding extraordinary items (as defined by GAAP) and gains (or losses) from sales of property, plus depreciation and amortization on real estate assets, and after adjustments for unconsolidated partnerships, joint ventures and subsidiaries. We believe that FFO is helpful to investors as a measure of the performance of an equity REIT. However, our calculation of FFO, while consistent with NAREIT s definition, may not be comparable to similarly titled measures presented by other REITs. FFO does not represent cash generated from operating activities in accordance with GAAP and should not be considered as an alternative to net income as an indication of our performance or to cash flows as a measure of liquidity or ability to make distributions.

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The following table reflects the calculation of FFO for the three months ended March 31, 2004:

Net loss	$ (1,007,348)
Add:	
Depreciation of real estate assets	130,842
Amortization of deferred lease costs	50,555
FFO	$ (825,951)
Weighted average shares outstanding	2,357,638

In order to recognize revenues on a straight line basis over the terms of the respective leases, we recognized straight line rental revenue of approximately $219,000 during the three months ended March 31, 2004.

Amortization of intangible lease assets resulted in a net decrease in rental revenue of $97,653 for the three months ended March 31, 2004. Amortization of deferred financing costs was $588,056 for the three months ended March 31, 2004.

Election as a REIT

We intend to elect to be taxed as a REIT under the Internal Revenue Code of 1986, as amended, and have operated as such beginning with our taxable year ended December 31, 2003. As a REIT, we generally will not be subject to federal income tax. If we fail to qualify as a REIT in any taxable year, we will become subject to federal income taxes on taxable income for four years following the year during which qualification is lost, unless the Internal Revenue Service grants us relief under certain statutory provisions. Such an event could materially adversely affect our net income and net cash available for distribution to stockholders. However, management believes that we are currently organized and currently operate in such a manner as to qualify for treatment as a REIT and we intend to continue to operate in the foreseeable future in such a manner that will permit us to remain qualified as a REIT for federal income tax purposes for the current tax year. Accordingly, no provision for federal income taxes has been made in the accompanying consolidated financial statements. We are subject to certain state and local taxes related to the operations of properties in certain locations, which has been provided for in the accompanying consolidated financial statements.

Inflation

The real estate market has not recently been affected significantly by inflation due to the relatively low inflation rate. As a mitigating factor, there are provisions in the majority of our leases that protect us from inflation, as the majority of our leases are economically net leases. These provisions generally include rent steps, reimbursement billings for operating expense pass-through charges, real estate tax and insurance reimbursements or, in some cases, annual reimbursement of operating expenses above a certain allowance. However, due to the long-term nature of the leases, the leases may not reset frequently enough to cover inflation.

Application of Critical Accounting Policies

Our accounting policies have been established to conform with GAAP. The preparation of financial statements in conformity with GAAP requires us to use judgment in the application of

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accounting policies, including making estimates and assumptions. These judgments affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. If our judgment or interpretation of the facts and circumstances relating to various transactions had been different, it is possible that different accounting policies would have been applied, thus, resulting in a different presentation of the financial statements. Additionally, other companies may utilize different estimates that may impact comparability of our results of operations to those of companies in similar businesses.

Investment in Real Estate Assets

We are required to make subjective assessments as to the useful lives of our depreciable assets. We consider the period of future benefit of the asset to determine the appropriate useful lives. These assessments have a direct impact on net income. All assets are depreciated on a straight line basis. The estimated useful lives of our assets by class are generally as follows:

Building	40 years
Building improvements	10-25 years
Land improvements	20-25 years
Tenant improvements	Lease term
Intangible lease assets	Lease term

In the event that inappropriate useful lives or methods are used for depreciation, our operating results would be misstated.

Allocation of Purchase Price of Acquired Assets

Upon the acquisition of real properties, it is our policy to allocate the purchase price of properties to acquired tangible assets, consisting of land and building, and identified intangible assets and liabilities, consisting of the value of above-market and below-market leases and the value of in-place leases, based in each case on their fair values.

The fair values of the tangible assets of an acquired property (which includes land and building) are determined by valuing the property as if it were vacant, and the as-if-vacant value is then allocated to land and building based on our determination of the relative fair value of these assets. We determine the as-if-vacant fair value of a property using methods similar to those used by independent appraisers. Factors considered by us in performing these analyses include an estimate of carrying costs during the expected lease-up periods considering current market conditions and costs to execute similar leases. In estimating carrying costs, we include real estate taxes, insurance, and other operating expenses during the expected lease-up periods based on current market demand. We estimate costs to execute similar leases including leasing commissions, and other related costs.

The fair values of above-market and below-market in-place leases are recorded based on the present value (using an interest rate which reflects the risks associated with the leases acquired) of the difference between (i) the contractual amounts to be paid pursuant to the in-place leases and (ii) our estimate of fair market lease rates for the corresponding in-place leases, measured over a period equal to the remaining term of the leases. The capitalized above-market and below-market lease values are recorded as intangible lease assets or liabilities and amortized as an adjustment to rental income over the remaining terms of the respective leases.

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The fair values of in-place leases include direct costs associated with obtaining a new tenant, opportunity costs associated with lost rentals which are avoided by acquiring an in-place lease, and tenant relationships. Direct costs associated with obtaining a new tenant include commissions, tenant improvements and other direct costs and are estimated based on management s consideration of current market costs to execute a similar lease. These direct costs are included in deferred leasing costs in the accompanying consolidated balance sheets and are amortized to expense over the remaining terms of the respective leases. The value of opportunity costs is calculated using the contractual amounts to be paid pursuant to the in-place leases over a market absorption period for a similar lease. Customer relationships are valued based on expected renewal of a lease or the likelihood of obtaining a particular tenant for other locations. These lease intangibles are included in intangible lease assets in the accompanying consolidated balance sheets and are amortized to rental income over the remaining term of the respective leases.

Estimates of the fair values of the tangible and intangible assets require us to estimate market lease rates, property operating expenses, carrying costs during lease-up periods, discount rates, market absorption periods and the number of years the property is held for investment. The use of inappropriate estimates would result in an incorrect assessment of our purchase price allocations, which could impact the amount of our reported operating results.

Impairment of Real Estate Assets

We continually monitor events and changes in circumstances that could indicate that the carrying amounts of the real estate and related intangible assets, both operating properties and properties under construction, in which we have an ownership interest, either directly or through investments in joint ventures, may not be recoverable. When indicators of potential impairment are present which indicate that the carrying amounts of real estate and related intangible assets may not be recoverable, we assess the recoverability of these assets by determining whether the carrying value will be recovered through the undiscounted future operating cash flows expected from the use of the asset and its eventual disposition. In the event that such expected undiscounted future cash flows do not exceed the carrying value, we adjust the real estate and related intangible assets to the fair value and recognize an impairment loss.

Projections of expected future cash flows require that we estimate future market rental income amounts subsequent to the expiration of current lease agreements, property operating expenses, discount rates, the number of months it takes to re-lease the property and the number of years the property is held for investment, among other factors. The use of inappropriate assumptions in the future cash flow analysis would result in an incorrect assessment of the property s future cash flows and fair value, and could result in the misstatement of the carrying value of our real estate and related intangible assets and our operating results.

Commitments and Contingencies

We are subject to certain contingencies and commitments with regard to certain transactions. Refer to Notes 5, 6, and 7 to our consolidated financial statements for further explanation. Examples of such commitments and contingencies include:

Commitments under existing lease agreements (Note 5)

Properties under contract (Note 5)

Reimbursement of offering-related costs (Note 6)

Litigation against our Advisor and its affiliates (Note 7)

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Related-Party Transactions and Agreements

We have entered into agreements with our Advisor and its affiliates, whereby we pay certain fees or reimbursements to our Advisor or its affiliates for acquisition fees and expenses, organization and offering costs, sales commissions, dealer manager fees, asset and management fees and reimbursement of operating costs. See Note 6 to our consolidated financial statements included in this Supplement for a discussion of the various related-party transactions, agreements and fees.

Conflicts of Interest

Our Advisor is also a general partner in and advisor to various other entities including another REIT and several syndicated real estate partnerships. As such, there are instances where the Advisor, while serving in the capacity as general partner or advisor for these entities, may be in competition with us in connection with property acquisitions or for tenants in similar geographic markets. The compensation arrangements with our Advisor and its affiliates could influence our Advisor s and its affiliates advice to us.

Additionally, certain members of our board of directors also serve on the board of directors of another REIT sponsored by the Advisor. These directors may face situations where decisions that benefit one entity may be detrimental to the other entity.

Subsequent Events

Certain events occurred subsequent to March 31, 2004. Refer to Note 8 to our consolidated financial statements for further explanation. Such events include:

- Sale of shares of common stock
- Acquisition of Manhattan Towers property
- Declaration of dividends
- $350 million line of credit with Bank of America
- Amendment to the share redemption program

Credit Facility

On May 10, 2004, we entered into a revolving $350 million, 180-day, secured revolving financing facility with Bank of America, N.A., superseding the $175 million, 90-day, secured bridge financing facility. The new facility refinanced the existing indebtedness owed under the bridge facility. In connection with closing our $350 million facility, we paid and expect to pay fees and expenses totaling approximately $3.2 million. The agreement contains borrowing arrangements that provide for interest costs based on LIBOR for one, two or three-month periods, plus 225 basis points or the floating base rate plus 50 basis points, at our option. The base rate for any day is the higher of the Federal Funds Rate for such day plus 50 basis points or Bank of America s prime rate for such date. If Bank of America is unable to syndicate an acceptable portion of this line of credit, the terms of the line of credit, including, but not limited to, the interest rate, the amount available under the facility and the term of the facility, may change. Like our initial $175 million facility, this $350 million facility requires that we use 86.5% of our gross offering proceeds to repay the facility. Unlike the initial $175 million facility, the $350 million facility permits the use of loan proceeds for any property acquisition (subject to compliance with certain covenants) and for working capital; however, borrowing under the facility is limited to a certain percentage of the value of lender-approved properties.

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Under the terms of the $350 million line of credit, we are required to repay outstanding principal and accrued interest within 180 days. During the initial 180-day term, the agreement allows us to borrow up to 70% of the borrowing base, or the aggregate cost of the subset of lender-approved properties with an aggregate average occupancy rate of 85%. We are able to extend the initial maturity date by an additional 180 days if we seek an extension and meet the related conditions set forth in the agreement, including reducing the amount outstanding under the facility to 60% of the borrowing base. During the extension term, borrowing under the facility is limited to 60% of the borrowing base.

The agreement also stipulates that our net distributions, which equal total distributions less the amount reinvested through our dividend reinvestment plan, may not exceed the greater of 90% of our Funds from Operations for the corresponding period and any equity proceeds not used for other purposes which are otherwise not required to pay down the line. With the obligation to use 86.5% of our gross offering proceeds to repay the facility, the equity proceeds that we could use to fund distributions will be largely limited to approximately $14.8 million of available net proceeds raised before entering into our former $175 million bridge facility. Funds from Operations, as defined by the National Association of Real Estate Investment Trusts, generally means net income, computed in accordance with accounting principles generally accepted in the United States, excluding extraordinary items (as defined by GAAP) and gains (or losses) from sales of property, plus depreciation and amortization on real estate assets, and after adjustments for unconsolidated partnerships, joint ventures and subsidiaries. The lender also further adjusts the definition of Funds from Operations to add back the amortization of the initial loan fees paid to the lender.

Debt covenants of the $350 million line of credit require that we maintain our leverage, i.e., the ratio of total debt to total purchase price of real estate assets plus cash and cash equivalents, at 70% or less at all times during the initial or extended term of the facility. The $350 million facility is secured by mortgages on all lender-approved properties; however, only some of the mortgages are recorded in the property records. However, in the event we are in default under the facility, the lender may elect to record all of the mortgages and foreclose.

Our charter requires that the conflicts committee of our board of directors approve all borrowings that result in a leverage ratio in excess of 50%. Over the life of the program, we expect to maintain a low to moderate leverage ratio.

Borrowings under the facility to finance our acquisitions will create the following risks:

If the lead lender on the facility is unable to obtain sufficient commitments from other banks to participate in the facility, the facility could be modified or terminated prior to the initial maturity date.

Our agreement with the lead lender on the $350 million facility affords the lender certain rights if the lender fails to obtain by August 8, 2004 (90 days after entering into the facility) commitments of at least $175 million from other banks to participate in the facility. If such commitments are not obtained by such date, the lead lender may propose changes to the rate and other terms of the facility in order to attempt to obtain the required level of commitments. If we do not agree to the changed terms or if the required commitments cannot be obtained, the lead lender has the right to terminate the facility.

If we do not raise sufficient net offering proceeds, we may not be able to qualify for the 180-day extension. If we are not able to otherwise refinance the 180-day facility, we may default under our 180-day credit facility at initial maturity, and you could lose the value of your investment.

In order to extend our 180-day $350 million facility beyond November 6, 2004, by another 180 days, borrowing under the facility must not exceed 60% of the borrowing base. The borrowing base is

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currently valued at approximately $146.6 million and the current outstanding balance under the facility is $100.2 million, which is 68% of the borrowing base. We anticipate that our borrowing base will increase by approximately $14.0 million within the next couple of weeks once the New Manchester One Building is added to the borrowing base. As we acquire lender-approved properties, the borrowing base will grow, but to the extent property acquisitions are financed from the facility, the outstanding balance will also grow. If we do not raise sufficient offering proceeds during the term of the facility to pay the outstanding amount down to 60% of the borrowing base, the extension option will not be available.

Estimated Use of Proceeds

In connection with the registration of this offering in the State of Minnesota, we agreed to include an Estimated-Use-of-Proceeds table in this Supplement. The purpose of this table is to show, without reliance to the lead-in paragraphs or the footnotes to the table, the different selling commissions and dealer manager fees applicable to sales made through each of the primary distribution channels through which we intend to sell our shares in our primary offering as well as under our dividend reinvestment plan.

As explained more fully in the Prospectus under Plan of Distribution Compensation of Dealer Manager and Participating Broker-Dealers, we estimate that we will sell most of the shares in this offering at $10.00 per share through participating broker-dealers compensated on a commission basis; however, we will also sell shares at $9.30 per share or $9.20 per share through investment advisers (or banks acting as trustees or fiduciaries) compensated on a fee-for-service basis. Because the different selling prices largely correspond to differences in the selling commissions and dealer manager fees payable by us, the amount available for investment by us is not materially affected by the distribution channel through which we sell a share. For example, if we sell all the shares offered in this offering through the distribution channels set forth in the table below, the amount available to us for investment would be $8.83 per share, after payment of selling commissions, the dealer manager fee, other offering expenses and the acquisition fee (and assuming a $9.55 price per share for sales made under our dividend reinvestment plan). If, however, we sold all of the shares offered in this offering through participating broker-dealers at $10.00 per share (and $9.55 per share for sales under the dividend reinvestment plan), the amount available to us for investment would still be $8.81 per share.

The variable with the greatest impact on the dollar amount per share available to us for investment is the number of shares sold in this offering. As stated in the Prospectus, if we had sold only the minimum number of shares in this offering, which we have already surpassed, the amount available for investment would have been $8.65 per share, after payment of selling commissions, the dealer manager fee, other offering expenses and the acquisition fee. Through May 4, 2004, having raised gross proceeds of approximately $107.1 million, the amount available for investment after payment of the amounts described above, has been $8.67 per share. We have actually invested more than this amount for each share sold in the offering because we have incurred significant indebtedness in order to acquire properties and pay a current dividend to our stockholders sooner than we otherwise could. See Credit Facility in this Supplement for a discussion of our current indebtedness.

You should note also that the amount available to us for investment includes amounts that we expect to pay to redeem our shares under our share redemption program. We expect that substantially all of the net proceeds from the sale of shares under our dividend reinvestment plan will be used to acquire our shares. See Share Redemption Program in this Supplement.

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USE OF PROCEEDS FOR MAXIMUM OFFERING

(dollar amounts in millions)

	Estimated Sales Sold Through Commission-based Distribution Channels (675,100,000 shares)				Estimated Sales Sold Through Fee-based Distribution Channels (109,900,000 shares)						Total (785,000,000 shares)	
	Primary Offering (516,000,000 shares ($10.00/share)		Div. Reinv. Plan (159,100,000 shares) ($9.55/share)		Primary Offering (42,000,000 shares ($9.30/share)		Primary Offering (42,000,000 shares ($9.20/share)		Div. Reinv. Plan (25,900,000 shares) ($9.55/share)			
	$	%	$	%	$	%	$	%	$	%	$	%
Gross Offering Proceeds	5,160	100.0%	1,519	100.0%	391	100.0%	386	100.0%	247	100.0%	7,703	100.0%
Selling Commissions	361	7.0%	76	5.0%							437	5.67%
Dealer Manager fee	129	2.5%			10	2.5%	6	1.5%			145	1.88%
Other Organization and Offering Expenses (1)	23	0.45%	7	0.45%	2	0.45%	2	0.45%	1	0.45%	35	0.45%
Acquisition Fees (2)	103	2.0%	30	2.0%	8	2.0%	8	2.0%	5	2.0%	154	2.00%
Initial Working Capital Reserve (3)												
Amount Available for Investment (4)	4,544	88.0%	1,406	92.5%	371	95.1%	370	96.0%	241	97.5%	6,932	90.0%

(1) Includes all expenses (other than selling commissions and the dealer manager fee) to be paid by us in connection with the offering, including our legal, accounting, printing, mailing and filing fees, charges of our escrow holder, reimbursing the due diligence expenses of participating broker-dealers, and amounts to reimburse Wells Capital for the salaries of its employees and other costs in connection with preparing supplemental sales materials, holding educational conferences and attending retail seminars conducted by broker-dealers. Wells Capital has agreed to reimburse us to the extent organizational and offering expenses incurred by us, other than selling commissions and the dealer manager fee, exceed 2% of aggregate gross offering proceeds.

(2) We will pay Wells Capital, as our advisor, acquisition fees of 2.0% of gross offering proceeds for its services in connection with the selection, purchase, development and construction of real estate. We will pay Wells Capital the acquisition fee amount upon receipt of the offering proceeds rather than at the time a property is acquired. In addition to this acquisition fee, we may also incur customary third-party acquisition expenses in connection with the acquisition (or attempted acquisition) of a property. See note 4 below.

(3) Because we expect that the vast majority of leases for the properties acquired by us will provide for tenant reimbursement of operating expenses, we do not anticipate that a permanent reserve for maintenance and repairs of real estate properties will be established. However, to the extent that we have insufficient funds for such purposes, we may establish reserves from gross offering proceeds, out of cash flow generated by operating properties or out of the net cash proceeds received by us from any sale or exchange of properties.

(4) Amount available for investment will include customary third-party acquisition expenses, such as legal fees and expenses, costs of appraisals, accounting fees and expenses, title insurance premiums and other closing costs and miscellaneous expenses relating to the acquisition of real estate. We estimate that these third-party costs would average 0.5% of the contract purchase prices of property acquisitions. Until required in connection with the acquisition and development of properties, substantially all of the net proceeds of the offering and, thereafter, our working capital reserves, may be invested in short-term, highly liquid investments including government obligations, bank certificates of deposit, short-term debt obligations and interest-bearing accounts or other authorized investments as determined by our board of directors.

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Subscription Agreement Addendum

As stated in the Prospectus under Plan of Distribution Subscription Procedures, we may not accept a subscription for shares until at least five business days after the date you receive the Prospectus. You are required to represent in the Subscription Agreement that you have received a copy of the Prospectus. Consistent with these requirements, we added the following addendum to the Subscription Agreement:

You are entitled to a refund of your subscription amount upon written request to the Company if such request is received within five business days of the earlier of (i) your completion of the Subscription Agreement or (ii) your receipt of the Prospectus.

Tax Consequences of Participation in our Dividend Reinvestment Plan

To the extent you purchase shares through our dividend reinvestment plan at a discount to fair market value, you will be treated for tax purposes as receiving an additional distribution equal to the amount of the discount. Until at least December 31, 2006, we expect that (i) we will sell shares under the dividend reinvestment plan at $9.55 per share, (ii) no secondary trading market for our shares will develop, and (iii) our advisor will estimate the fair market value of a share to be $10.00. Therefore, at least until December 31, 2006, participants in our dividend reinvestment plan will be treated as having received a dividend of $10.00 for each $9.55 reinvested by them under our dividend reinvestment plan. See Dividend Reinvestment Plan in the Prospectus for information regarding the dividend reinvestment plan, including additional information regarding the tax consequences of participation in the plan.

Declaration of Dividends

Our board of directors has declared dividends on a daily record basis for the following periods and at the following rates (based on an assumed $10.00 per share purchase price):

Period	Annualized Rate
01/22/04 - 03/31/04	2.5%
04/01/04 - 04/21/04	5.0%
04/22/04 - 06/15/04	6.0%

As stated in the Prospectus, we may receive income from rents or interest at various times during our fiscal year. Dividends may not reflect our income earned in that particular distribution period but may be made in anticipation of cash flow that we expect to receive during a later period and may be made in advance of actual receipt of funds from operations in an attempt to make dividends relatively uniform. We may generally borrow money, issue securities or sell assets in order to make dividend distributions, although our $350 million line of credit prohibits the payment of dividends with any borrowings.

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Our Property Acquisitions

Weatherford Center (fka 515 Post Oak) Houston Building

On February 10, 2004, we purchased a 12-story office building containing approximately 260,000 rentable square feet located at 515 South Post Oak Boulevard in Houston, Texas for a purchase price of approximately $39.9 million, plus closing costs. The Weatherford Center Houston Building, fka 515 Post Oak Houston Building, was purchased from The Realty Associates Fund V, L.P., which is not affiliated with us or our Advisor.

The Weatherford Center Houston Building, which was completed in 1980 and renovated in 1993, is leased to Weatherford International, Ltd. (Weatherford) (approximately 96%) and various other office and retail tenants (approximately 4%). We do not intend to make significant renovations or improvements to the Weatherford Center Houston Building in the near term. We believe that the Weatherford Center Houston Building is adequately insured.

Weatherford is one of the leading oilfield service companies in the world. Based in Houston, Texas, Weatherford employs more than 15,000 people in approximately 440 locations across more than 100 countries. Weatherford reported a net worth, as of September 30, 2003, of approximately $2.6 billion.

The current aggregate annual base rent for Weatherford and the five additional tenants in the Weatherford Center Houston Building is approximately $4.3 million. The current weighted average remaining lease term for all tenants in the building is approximately eight years. Weatherford has a right of first offer and a right of first refusal to purchase the Weatherford Center Houston Building should we decide to sell the building in the future. In addition, Weatherford has the right of first refusal for all space in the Weatherford Center Houston Building currently not leased by Weatherford. Weatherford has the right, at its option, to extend the initial term of its lease for one additional five-year period at the then-current market rental rate.

Trammell Crow Houston Ltd, which is not affiliated with us or our Advisor, is the current on-site property manager for the Weatherford Center Houston Building.

New Manchester One Building

On March 19, 2004, we purchased a 404,000-square-foot single-story distribution facility subject to a ground lease located on an approximately 31-acre tract of land at 9103 Riverside Parkway in Douglasville, Georgia (Phase I) for a purchase price of approximately $19.3 million, of which $14.0 million was paid at closing Phase I with proceeds drawn from our $175.0 million bridge facility. The remaining $5.3 million will be funded at certain milestones during construction of an additional 189,000 rentable square feet (Phase II) on the same tract of land. Phase I was completed in December 2003, and the anticipated completion date for Phase II is November 2004. The ground lease, along with the Bond described below, were purchased from Carter New Manchester Building One, L.L.C. (Carter), which is not affiliated with us or our Advisor.

Fee simple title to the land upon which the New Manchester One Building is located is held by the Development Authority of Douglas County (the Development Authority), which issued a Development Authority of Douglas County Taxable Revenue Bond (the Bond) totaling $18 million in connection with the construction of the building. Certain real property tax abatement benefits are available to us because the fee simple title to the property is held by the Development Authority. The property tax abatement benefits will expire in 2011. The amount of rent payable under the ground lease (which we owe) and the payments due on the Bond (to which we are entitled) are approximately the

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same. We will acquire fee simple title upon exercise of an option to purchase contained in the ground lease. The purchase price will be approximately equal to the amount then due to us under the Bond. We are not likely to exercise the purchase option until the tax abatement benefits expire.

The New Manchester One Building is entirely leased to JVC Americas Corporation (JVC), a wholly owned subsidiary of Victor Company of Japan, Ltd., which is a majority-owned subsidiary of Matsushita Electric Co., Ltd. JVC primarily imports, manufactures and sells consumer and professional audio and video equipment and televisions to wholesale and retail dealers in the Americas.

The JVC lease is a net lease agreement that commenced in January 2004 and expires in December 2009. Phase II base rent will commence on the later of (i) 30 days following Phase II completion or (ii) December 1, 2004. The current annual base rent payable under the JVC lease for Phase I is approximately $1.1 million. It is anticipated that the initial annual base rent for Phase II will be approximately $0.5 million. We are obligated under the lease with JVC to construct Phase II. We have entered into an agreement with Carter to construct Phase II for a guaranteed price of $5.3 million payable as described above. Carter has also guaranteed completion of construction and the payment of scheduled rent for Phase II if substantial completion does not occur by December 1, 2004. JVC, at its option, has the right to extend the initial term of the lease for three additional three-year periods at the then-current market rental rate.

Wells Management Company, Inc., an affiliate of our Advisor, will manage the New Manchester One Building on our behalf. We believe that the New Manchester One Building is adequately insured.

Republic Drive Buildings

On March 31, 2004, we purchased two single-story engineering buildings containing an aggregate of approximately 169,000 rentable square feet (the Republic Drive Buildings). The Republic Drive Buildings are located on an approximate 20-acre tract of land at 333 Republic Drive and 777 Republic Drive, Allen Park, Michigan. The aggregate purchase price of the Republic Drive Buildings was approximately $18.9 million, plus closing costs. The acquisition was entirely funded with proceeds from the $175.0 million secured bridge facility with Bank of America, N.A. The Republic Drive Buildings were purchased from Ford Motor Land Development Corporation (Ford), which is not affiliated with us or our Advisor. Ford has a right of first offer to purchase the Republic Drive Buildings should we decide to sell the buildings in the future.

The Republic Drive Buildings, which were constructed in 2000, are 100% leased under a net lease to Roush Industries, Inc. (Roush). Roush manufactures parts and provides engineering, management and prototype services to the automotive, electronics, sports equipment and motorsports industries. Roush employs approximately 2,000 people and operates over 50 facilities in the United States, Mexico and Great Britain. The current annual base rent payable under the Roush lease, which expires in 2010, is approximately $1.9 million. Roush has the right, at its option, to extend the initial term of the lease for two additional five-year periods. Roush currently self-manages the Republic Drive Buildings.

We do not intend to make significant renovations or improvements to the Republic Drive Buildings in the near term. We believe that the Republic Drive Buildings are adequately insured.

Manhattan Towers Property

On April 2, 2004, we purchased two six-story office buildings containing approximately 310,000 rentable square feet (the Manhattan Towers Property). The Manhattan Towers Property is located on

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an approximate 5.1-acre parcel of land at 1230 and 1240 Rosecrans Avenue in Manhattan Beach, California. The purchase price of the Manhattan Towers Property was approximately $89.9 million, plus closing costs. The acquisition was entirely funded with proceeds from the $175.0 million, secured bridge facility with Bank of America, N.A. The Manhattan Towers Property was purchased from HSOV Manhattan Towers, L.P., which is not affiliated with us or our Advisor.

The Manhattan Towers Property, which was completed in 1985 and renovated in 2001, is leased to Northrop Grumman Space and Mission Systems Corporation (Northrop) (approximately 76%) and various other office and retail tenants (approximately 23%). Approximately 1% of the Manhattan Towers Property is currently vacant.

Northrop is the combination of two operating segments within Northrop Grumman Corporation (Northrop Grumman), the nation s second-largest defense contractor. Headquartered in Los Angeles, California, Northrop Grumman provides technologically advanced, innovative products, services and solutions in systems integration, defense electronics, information technology, advanced aircraft, shipbuilding and space technology. With approximately 120,000 employees and operations in all 50 states and 25 countries, Northrop Grumman serves U.S. and international military, government and commercial customers. Northrop Grumman reported a net worth, as of December 31, 2003, of approximately $15.8 billion.

The current aggregate annual base rent for Northrop and the 17 additional tenants in the Manhattan Towers Property is approximately $6.5 million. The current weighted average remaining lease term for all tenants in the buildings is approximately six years. Northrop has the right, at its option, to extend the initial term of its lease for two additional five-year periods. Northrop has the right to terminate approximately 11% of its space, or approximately 24,902 square feet, effective December 2006 or December 2007 for a termination fee equal to the sum of unamortized tenant improvements and leasing commissions and nine months of base rent, parking rent and the tenant s proportionate share of operating expenses and real estate taxes related to the terminated space.

Hines Interests L.P., which is not affiliated with us or our Advisor, is the current on-site property manager for the Manhattan Towers Property. We do not intend to make significant renovations or improvements to the Manhattan Towers Property in the near term. We believe that the Manhattan Towers Property is adequately insured.

Share Redemption Program

As described in the Prospectus, our board of directors had previously approved (but delayed the adoption of) the share redemption program until the earlier of (i) the completion of our primary offering, which may last until November 26, 2005, or (ii) receipt by us of an SEC exemption from the rules restricting issuer purchases during distributions. On December 9, 2003, the SEC granted us this exemption, based solely on our representations and the facts presented to the staff. As a result, the share redemption program is now in effect.

On April 21, 2004, our board of directors approved revisions to the share redemption program, which enables stockholders to sell their shares to us after one year from the date we issued the shares, subject to the limitations described below. The revisions, which will go into effect at the end of May 2004, are summarized in the bullets below:

We have increased the initial redemption price per share to $9.10 per share from $8.40, unless we sold the share for less than $10.00, in which case the initial redemption price would equal 91% of

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the price at which we sold the share. Higher redemption prices remain in effect for redemptions sought within two years of death, as described in the full description of the amended plan below.

The higher redemption price available upon death (at least 100% of the price at which we sold the share) will now also be available within two years of an investor s award of disability benefits from the Social Security Administration or, in limited circumstances, from the other governmental agencies described below. (We understand that workers may qualify for Social Security disability benefits only until age 65 and only as a result of a permanent disability rendering them incapable of substantial gainful activity.) We refer to redemptions that do not occur within two years of death or qualifying disability as Ordinary Redemptions.

We have revised the limits on the total amount of redemptions we can make:

Formerly, redemptions (other than those following death) were limited to those that we could effect solely from the net proceeds raised from the sale of shares under our dividend reinvestment plan since the commencement of the dividend reinvestment plan.

However, we will now limit redemptions so that aggregate redemptions since the beginning of the then-current calendar year through the redemption date do not exceed the net proceeds from the sale of shares under our dividend reinvestment plan during such period. Moreover, we will not redeem shares on any redemption date to the extent that such redemptions would cause the amount paid for Ordinary Redemptions since the beginning of the then-current calendar year to exceed 50% of the net proceeds from the sale of shares under our dividend reinvestment plan during such period.

We have generally retained the limit on redemptions (other than following death) during any calendar year to no more than 5% of the weighted average number of shares outstanding during the prior calendar year. However, under the revised program, redemptions following a qualifying disability would also be excepted from the 5% cap.

Set forth below is a full description of our revised share redemption program.

For Ordinary Redemptions (as defined above), the initial price at which we will repurchase a share under the share redemption program is 91% of the price at which we sold the share. We will pay $9.10 to redeem a share issued at $10.00. This initial redemption price will remain fixed until three years after we complete our offering stage. For purposes of the share redemption program, we define the completion of our offering stage in the same manner as described in the Prospectus under Dividend Reinvestment Plan Stock Purchases. Thereafter, the redemption price for Ordinary Redemptions will equal 95% of the estimated per share value of our shares, as estimated by our advisor or another firm we might choose for that purpose. We will report this redemption price to you in the annual report and three quarterly reports that we are required to send or furnish to you.

We will not redeem shares on any redemption date to the extent that such redemptions would cause the amount paid for Ordinary Redemptions since the beginning of the then-current calendar year to exceed 50% of the net proceeds from the sale of shares under our dividend reinvestment plan during such period. In addition, we will limit Ordinary Redemptions during any calendar year to no more than 5% of the weighted average number of shares outstanding in the prior calendar year. We will not make an Ordinary Redemption until one year after the issuance of the share to be redeemed.

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Subject to the limitations described above, we will redeem shares on the last business day of each month. Requests for redemption must be received at least five business days before a month-end redemption date in order for us to repurchase the shares that month. If we cannot purchase all shares presented for redemption, we will honor redemption requests at the applicable month-end on a pro rata basis. We will deviate from pro rata purchases in two minor ways: (i) if a pro rata redemption would result in you owning less than half of the minimum amounts described at Plan of Distribution Minimum Purchase Requirements in the Prospectus, then we would redeem all of your shares; and (ii) if a pro rata redemption would result in you owning more than half but less than all of those minimum amounts, then we would not redeem any shares that would reduce your holdings below the minimum amounts. In the event that you seek the redemption of all of your shares, there is no holding period requirement for shares purchased pursuant to our dividend reinvestment plan.

If we do not completely satisfy a stockholder s redemption request at month-end because the request was not received in time or because of the restrictions on the number of shares we can redeem under the program, we will treat the unsatisfied portion of the redemption request as a request for redemption in the following month unless the stockholder withdraws his or her request before the next date for redemptions. Any stockholder may withdraw a redemption request upon written notice to the address provided below before the date for redemption.

In several respects we treat redemptions sought within two years of a stockholder s death or qualifying disability (as defined below) differently from Ordinary Redemptions. First, there is no requirement that the shares be outstanding for at least a year before being redeemed. Second, the redemption price equals 100% of the price at which we sold the share until three years after we complete our offering stage. At that time, the redemption price will be 100% of the price at which we sold the share or 100% of the estimate of our per share value, whichever is greater. Finally, redemptions sought within two years of death or qualifying disability are subject only to the overall limitation that, during any calendar year, aggregate redemptions may not exceed 100% of the net proceeds from our dividend reinvestment plan during the calendar year.

In order for a disability to entitle a stockholder to the special redemption terms described above (a qualifying disability), (1) the stockholder must receive a determination of disability based upon a physical or mental condition or impairment arising after the date the stockholder acquired the shares to be redeemed, and (2) such determination of disability must be made by the governmental agency responsible for reviewing the disability retirement benefits that the stockholder could be eligible to receive (the applicable governmental agency). The applicable governmental agencies are limited to the following: (i) if the stockholder paid Social Security taxes and therefore could be eligible to receive Social Security disability benefits, then the applicable governmental agency is the Social Security Administration or the agency charged with responsibility for administering Social Security disability benefits at that time if other than the Social Security Administration; (ii) if the stockholder did not pay Social Security benefits and therefore could not be eligible to receive Social Security disability benefits, but the stockholder could be eligible to receive disability benefits under the Civil Service Retirement System (CSRS), then the applicable governmental agency is the U.S. Office of Personnel Management or the agency charged with responsibility for administering CSRS benefits at that time if other than the Office of Personnel Management; or (iii) if the stockholder did not pay Social Security taxes and therefore could not be eligible to receive Social Security benefits but suffered a disability that resulted in the stockholder s discharge from military service under conditions that were other than dishonorable and therefore could be eligible to receive military disability benefits, then the applicable governmental agency is the Veteran s Administration or the agency charged with the responsibility for administering military disability benefits at that time if other than the Veteran s Administration.

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Disability determinations by governmental agencies for purposes other than those listed above, including but not limited to worker s compensation insurance, administration or enforcement of the Rehabilitation Act or Americans with Disabilities Act, or waiver of insurance premiums, will not entitle a stockholder to the special redemption terms described above. Redemption requests following an award by the applicable governmental agency of disability benefits must be accompanied by: (1) the investor s initial application for disability benefits and (2) a Social Security Administration Notice of Award, a U.S. Office of Personnel Management determination of disability under CSRS, a Veteran s Administration record of disability-related discharge or such other documentation issued by the applicable governmental agency which we deem acceptable and demonstrates an award of the disability benefits.

We understand that the following disabilities do not entitle a worker to Social Security disability benefits:

- disabilities occurring after the legal retirement age,
- temporary disabilities, and
- disabilities that do not render a worker incapable of performing substantial gainful activity.

Therefore, such disabilities will not qualify for the special redemption terms except in the limited circumstances when the investor is awarded disability benefits by the other applicable governmental agencies described above.

A stockholder that is a trust may only redeem on the terms available in connection with the death or disability of a stockholder if the deceased or disabled was the sole beneficiary of the trust or if the only other beneficiary of the trust was the spouse of the deceased or disabled.

Qualifying stockholders who desire to redeem their shares should give written notice to Wells Investment Securities, our dealer manager, at 6200 The Corners Parkway, Suite 250, Norcross, Georgia 30092, ATTN: Investor Services. Wells Investment Securities is responsible for all services to be performed in connection with the share redemption program, although it has outsourced clerical duties to our advisor.

Our board of directors may amend, suspend or terminate the share redemption program upon 30 days notice. We will notify you of such developments (i) in the annual or quarterly reports mentioned above or (ii) by means of a separate mailing to you, accompanied by disclosure in a current or periodic report under the Securities Exchange Act of 1934. During this offering, we will also include this information in a prospectus supplement or post-effective amendment to the registration statement, as then required under federal securities laws.

Our share redemption program only provides stockholders a limited ability to redeem shares for cash until a secondary market develops for the shares, at which time the program will terminate. No such market presently exists, and we cannot assure you that any market for your shares will ever develop.

Issuance of Shares to Leo F. Wells, III

During the month of January 2004, we sold 110,497 shares of common stock to Leo F. Wells, III for $1,000,000 in our initial public offering at a price of $9.05 per share. As discussed more fully in the Plan of Distribution section of the Prospectus, our directors and officers, as well as directors, officers and employees of Wells Capital or its affiliates, may purchase shares in our primary offering at a discount. The purchase price for such shares is $9.05 per share reflecting the fact that selling

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commissions in the amount of $0.70 per share and dealer manager fees in the amount of $0.25 per share are not payable in connection with such sales. The net proceeds to us from such sales are substantially the same as the net proceeds we receive from other sales of shares.

Supplemental Sales Material

In addition to the Prospectus, as supplemented, we are using supplemental sales material in connection with the offering of the shares. The supplemental sales material does not contain all of the information material to an investment decision and should only be reviewed after reading the Prospectus. In some states, the use of supplemental sales material may not be permitted.

The following is a brief description of the supplemental sales material currently used in permitted jurisdictions:

The Wells Real Estate Funds REIT II Fact Sheet , first used December 17, 2003, briefly summarizes (i) the terms of the offering; (ii) our objectives and strategies; (iii) a profile of the investors for whom an investment in us is appropriate; (iv) exit alternatives available to investors; (v) some benefits of REIT ownership; and (vi) various risks to be considered before investing in us.

The Wells Real Estate Funds REIT II brochure, first used January 5, 2004, provides prospective investors with general information concerning investments in real estate, as well as information specific to an investment in us, including summary descriptions of (i) the benefits of owning an interest in real estate; (ii) the type of investors who may benefit from an investment in us; (iii) reasons to consider investing in a non-traded REIT; (iv) the benefits of long term investing; (vi) the principles of our investment strategy and (vii) various risks to be considered before investing in us.

Special Notice to Pennsylvania Investors

As disclosed in the Prospectus under Plan of Distribution Special Notice to Pennsylvania Investors, we will not sell any shares to Pennsylvania investors unless we raise a minimum of $200 million in gross offering proceeds (including sales made to residents of other jurisdictions). If we have not reached this $200 million threshold within 120 days of the date that we first accept a subscription payment from a Pennsylvania investor, we will notify Pennsylvania investors of their right to receive refunds. Amounts held in the Pennsylvania escrow account from Pennsylvania investors not requesting a refund will continue to be held for subsequent 120-day periods until we raise at least $200 million or until the end of the subsequent escrow periods. We have changed the terms of the escrow arrangement so that all such refunds, if any, will be with interest. (Before this change, interest was only to be returned with respect to refunds after the initial 120-day period.)

Our dealer manager has also decided to make a change relating to investments held in the special Pennsylvania escrow. The dealer manager has decided to advance to the participating broker-dealer the compensation to which the broker-dealer would be entitled upon breaking the Pennsylvania escrow. This advance would occur at the time we accept the subscription and before the release of funds from the Pennsylvania escrow. If we return the funds from a Pennsylvania subscriber at the end of a 120-day escrow period, the participating broker-dealer would be obligated to return the corresponding advanced compensation to the dealer manager. Upon the release of funds from escrow, we would pay the dealer manager as usual. The funds to pay the advance will come directly from the dealer manager and will not come from us or from the amounts held in the escrow account. The advances will not affect the timing or amount of the payments we make to the dealer manager.

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Experts

Our consolidated balance sheet, as of December 31, 2003, and the related consolidated statements of loss, stockholder s equity, and cash flows for the period from inception (July 3, 2003) through December 31, 2003, which are included in this Supplement, have been audited by Ernst & Young LLP, independent auditors, as set forth in their report thereon appearing elsewhere herein and are included in reliance upon such report given on the authority of such firm as experts in accounting and auditing.

The Statements of Revenues Over Certain Operating Expenses of the Weatherford Center Houston Building, the Republic Drive Buildings, and the Manhattan Towers Property for the year ended December 31, 2003, which are included in this Supplement, have been audited by Ernst & Young LLP, independent auditors, as set forth in their reports thereon appearing elsewhere herein, and are included in reliance upon such reports given on the authority of such firm as experts in accounting and auditing.

Erratum

The last sentence of the fourth paragraph of the section captioned Prior Performance Summary, which paragraph appears on page 90 of the Prospectus, is revised to read as follows: Accordingly, as of September 30, 2003, Wells REIT I had received aggregate gross offering proceeds of $3,960,364,301 from the sale of 396,036,430 shares of its common stock to 100,599 investors.

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WELLS REAL ESTATE INVESTMENT TRUST II, INC.

CONSOLIDATED BALANCE SHEETS

	March 31, 2004 (unaudited)	December 31, 2003
Assets:		
Real estate assets, at cost:		
Land	**$ 11,218,975**	$
Buildings and improvements, less accumulated depreciation of $130,842 at March 31, 2004	**42,765,019**	
Intangible lease assets, less accumulated amortization of $97,653 at March 31, 2004	**11,653,883**	
Total real estate assets	**65,637,877**	
Cash and cash equivalents	**14,847,362**	156,912
Restricted cash	**1,844,391**	981,924
Rents receivable	**257,931**	
Prepaid expenses and other assets	**3,742,889**	512,633
Deferred project costs	**441,000**	
Deferred financing costs, less accumulated amortization of $588,056 at March 31, 2004	**470,444**	
Deferred lease costs, less accumulated amortization of $50,555 at March 31, 2004	**7,536,437**	
Investment in bonds	**18,000,000**	
Total assets	**$ 112,778,331**	$ 1,651,469
Liabilities and Stockholders Equity:		
Line of credit	**$ 37,789,838**	$
Obligation under capital lease	**18,000,000**	
Accounts payable and accrued expenses	**1,833,741**	563,000
Escrowed investor proceeds	**1,844,391**	981,924
Due to affiliates	**503,290**	
Dividends payable	**59,848**	
Total liabilities	**60,031,108**	1,544,924
Minority Interest	**99,875**	106,015
Redeemable Common Shares	**48,753**	
Stockholders Equity:		
Common shares, $.01 par value; 900,000,000 shares authorized, 6,079,335 shares issued and outstanding at March 31, 2004, and 100 shares issued and outstanding at December 31, 2003	**60,793**	1
Additional paid-in capital	**53,594,373**	999
Accumulated deficit	**(1,007,818)**	(470)
Redeemable common shares	**(48,753)**	
Total stockholders equity	**52,598,595**	530
Total liabilities and stockholders equity	**$ 112,778,331**	$ 1,651,469

See accompanying notes.

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WELLS REAL ESTATE INVESTMENT TRUST II, INC.

CONSOLIDATED STATEMENT OF OPERATIONS

FOR THE THREE MONTHS ENDED MARCH 31, 2004 (UNAUDITED)

Revenues:	
Rental income	$ 810,694
Tenant reimbursements	115,217
Interest and other income	60,959
	986,870
Expenses:	
Depreciation	130,842
Property operating costs	273,654
Asset management fees	24,830
Amortization of deferred leasing costs	50,555
General and administrative	612,138
Interest expense	908,339
	2,000,358
Loss before minority interest	(1,013,488)
Minority interest in loss of consolidated subsidiaries	(6,140)
Net loss	$ (1,007,348)
Net loss per share	
Basic and diluted	$ (0.43)
Weighted average shares outstanding	
Basic and diluted	2,357,638
Dividends declared per share	$ 0.05

See accompanying notes.

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WELLS REAL ESTATE INVESTMENT TRUST II, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

FOR THE PERIOD FROM INCEPTION (JULY 3, 2003) TO DECEMBER 31, 2003

AND FOR THE THREE MONTHS ENDED MARCH 31, 2004 (UNAUDITED)

	Common Stock		Additional Paid-In	Accumulated	Redeemable Common	Total Stockholders
	Shares	Amount	Capital	Deficit	Shares	Equity
Balance, (inception) July 3, 2003		$	$	$	$	$
Issuance of common stock	100	1	999			1,000
Net loss				(470)		(470)
Balance, December 31, 2003	100	1	999	(470)		530
Issuance of common stock	**6,079,235**	**60,792**	**60,731,556**			**60,792,348**
Redeemable common shares					**(48,753)**	**(48,753)**
Dividends ($0.05 per share)			**(146,947)**			**(146,947)**
Commissions on stock sales and related dealer manager fees			**(5,775,368)**			**(5,775,368)**
Other offering costs			**(1,215,867)**			**(1,215,867)**
Net loss				**(1,007,348)**		**(1,007,348)**
Balance, March 31, 2004	**6,079,335**	**$ 60,793**	**$ 53,594,373**	**$ (1,007,818)**	**$ (48,753)**	**$ 52,598,595**

See accompanying notes.

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WELLS REAL ESTATE INVESTMENT TRUST II, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE THREE MONTHS ENDED MARCH 31, 2004 (UNAUDITED)

Cash Flows from Operating Activities:	
Net loss	$ (1,007,348)
Adjustments to reconcile net loss to net cash provided by operating activities:	
Minority interest in loss of consolidated entities	(6,140)
Depreciation	130,842
Amortization of deferred financing costs	588,056
Amortization of intangible lease assets	97,653
Amortization of deferred leasing costs	50,555
Changes in assets and liabilities:	
Rents receivable	(257,931)
Accounts payable and accrued expenses	836,702
Prepaid expenses and other assets	(30,257)
Total adjustments	1,409,480
Net cash provided by operating activities	402,132
Cash Flows from Investment Activities:	
Investment in real estate and related assets	(65,091,505)
Earnest money paid	(3,200,000)
Acquisition fees paid	(1,049,420)
Deferred lease costs paid	(7,586,992)
Net cash used in investing activities	(76,927,917)
Cash Flows from Financing Activities:	
Proceeds from line of credit	72,648,881
Repayment of line of credit	(34,859,043)
Dividends paid to stockholders	(87,099)
Issuance of common stock	60,792,348
Commissions on stock sales and related dealer manager fees paid	(5,170,932)
Other offering costs paid	(1,049,420)
Deferred financing costs paid	(1,058,500)
Net cash provided by financing activities	91,216,235
Net increase in cash and cash equivalents	14,690,450
Cash and cash equivalents, beginning of period	156,912
Cash and cash equivalents, end of period	$ 14,847,362
Supplemental Disclosures of Investing and Financing Non-Cash Activities	
Acquisition fees applied to investments	$ 774,867

Acquisition fees due to affiliate	$ 166,447
Other offering costs due to affiliate	$ 166,447
Assumption of obligation under capital lease and related bonds	$ 18,000,000
Dividends payable	$ 59,848
Sales commissions payable	$ 434,038
Dealer manager fees due to affiliate	$ 170,397

See accompanying notes.

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WELLS REAL ESTATE INVESTMENT TRUST II, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2004

(unaudited)

1. Organization

Wells Real Estate Investment Trust II, Inc. (Wells REIT II) was formed on July 3, 2003 as a Maryland corporation that qualifies as a real estate investment trust (REIT). Wells REIT II was formed to engage in the acquisition and ownership of commercial real properties throughout the United States, including properties that are under construction, are newly constructed or have operating histories. Wells REIT II may invest in office buildings, shopping centers, other commercial and industrial properties or other real estate properties. Properties may be acquired directly or through joint ventures with real estate limited partnerships sponsored by Wells Capital, Inc. (the Advisor), affiliates of the Advisor, or third parties.

Substantially all of Wells REIT II s business is conducted through Wells Operating Partnership II, L.P. (Wells OP II), a Delaware limited partnership. Wells OP II was formed on July 3, 2003 to acquire, develop, own, lease, and operate real properties on behalf of Wells REIT II, either directly, through wholly owned subsidiaries or through joint ventures. Wells REIT II is the general partner in Wells OP II and possesses full legal control and authority over the operations of Wells OP II. The Advisor is the sole limited partner of Wells OP II.

On November 26, 2003, Wells REIT II commenced its first public offering of up to 785.0 million shares of common stock pursuant to a Registration Statement filed on Form S-11 under the Securities Act of 1933, with 185.0 million of those shares being reserved for issuance through Wells REIT II s dividend reinvestment plan. Through March 31, 2004, Wells REIT II had sold approximately 6.1 million shares for gross proceeds of approximately $60.8 million. Of this amount, Wells REIT II incurred costs of approximately $1.2 million in acquisition fees and expenses, approximately $5.6 million in selling commissions and dealer manager fees, and approximately $1.2 million in organization and offering costs to the Advisor. With these net offering proceeds and indebtedness, Wells REIT II acquired approximately $74.0 million in real estate assets.

Wells REIT II s stock is not listed on any securities exchange. However, Wells REIT II s charter requires that, in the event that Wells REIT II s stock is not listed on a national securities exchange by October 2015, Wells REIT II must either seek stockholder approval of an extension or amendment of this listing deadline or stockholder approval to begin liquidating investments and distributing the resulting proceeds to the stockholders. If Wells REIT II seeks stockholder approval of an extension or amendment to this listing date and does not obtain it, Wells REIT II will then be required to seek stockholder approval to liquidate. If Wells REIT II seeks and does not obtain approval to liquidate, Wells REIT II will not be required to list or liquidate and could continue to operate as before.

2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements of Wells REIT II have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission, including the instructions to Form 10-Q and Article 10 of Regulation S-X, and do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, the statements for the unaudited interim period presented include all adjustments, which are of a normal and recurring nature, necessary to present a fair presentation of the results for such period. Results for this interim period are not necessarily indicative of full year results. For further information, refer to the financial statements and footnotes included in the Wells REIT II s Form 10-K for the year ended December 31, 2003. Consolidated results of operations and cash flows for the three months ended March 31, 2003 have not been presented because Wells REIT II had not been formed and was not operational during that period.

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Principles of Consolidation

The consolidated financial statements include the accounts of Wells REIT II and any entities for which Wells REIT II has a controlling financial interest or is deemed the primary beneficiary of a variable interest entity. In determining whether a controlling financial interest exists, Wells REIT II considers ownership of voting interests, protective rights and participatory rights of the investors. Any intercompany balances and transactions are eliminated upon consolidation.

Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Real Estate Assets

Real estate assets are stated at cost, less accumulated depreciation. Amounts capitalized to real estate assets consist of the cost of acquisition or construction and any tenant improvements or major improvements and betterments that extend the useful life of the related asset. All repairs and maintenance are expensed as incurred.

Wells REIT II s real estate assets are depreciated using the straight-line method over the useful lives of the assets by class generally as follows:

Building	40 years
Building improvements	10-25 years
Land improvements	20-25 years
Tenant improvements	Lease term
Intangible lease assets	Lease term

Management continually monitors events and changes in circumstances that could indicate that carrying amounts of real estate and related intangible assets may not be recoverable. When indicators of potential impairment are present, management assesses the recoverability of the assets by determining whether the carrying value of the real estate and related intangible assets will be recovered through the undiscounted future cash flows expected from the use and eventual disposition of the asset. In the event the expected undiscounted future cash flows do not exceed the carrying value, management adjusts the real estate and intangible assets to their fair value and recognizes an impairment loss. Management has determined that there has been no impairment in the carrying value of real estate assets held by Wells REIT II during the three months ended March 31, 2004.

Cash and Cash Equivalents

Wells REIT II considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. Cash equivalents may include cash and short term investments. Short term investments are stated at cost, which approximates fair value and may consist of investments in money market accounts.

Restricted Cash and Escrowed Investor Proceeds

Included in restricted cash and escrowed investor proceeds on the consolidated balance sheets are offering proceeds from Pennsylvania investors of approximately $1.8 million at March 31, 2004. These proceeds may not be utilized by Wells REIT II until Wells REIT II has received and accepted subscriptions for a minimum of $200 million in gross offering proceeds.

Rent Receivable

Rents receivable are recognized and carried at original amount earned less a provision for any uncollectible amounts. An allowance for uncollectible amounts is made when collection of the full amount is no longer probable. No bad debt expense was incurred during the three months ended March 31, 2004.

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Prepaid Expenses and Other Assets

Prepaid expenses and other assets include expenses paid as of the balance sheet date relating to future periods and will be expensed during the period to which the costs relate. Any amounts with no future economic benefit are written off when identified.

Deferred Project Costs

Wells REIT II pays certain fees to the Advisor with regard to the acquisition of properties that are capitalized to the cost of the properties and depreciated on the same basis and over the respective useful life of the related asset. Deferred project costs represent costs incurred for properties yet to be acquired.

Deferred Financing Costs

Deferred financing costs are capitalized and amortized on a straight-line basis over the term of the related financing arrangement. Amortization of deferred financing costs for the three months ended March 31, 2004 was $588,056 and was recorded in interest expense on the consolidated statement of operations.

Deferred Lease Costs

Costs incurred to procure operating leases, including those identified as part of the purchase price allocation process, are capitalized as deferred lease costs and amortized on a straight-line basis over the terms of the related leases. Amortization of deferred lease acquisition costs was $50,555 for the three months ended March 31, 2004.

Allocation of Purchase Price of Acquired Assets

Upon the acquisition of real properties, it is Wells REIT II s policy to allocate the purchase price of properties to acquired tangible assets, consisting of land and building, and identified intangible assets and liabilities, consisting of the value of above-market and below-market leases and the value of in-place leases, based in each case on their fair values.

The fair values of the tangible assets of an acquired property (which includes land and building) are determined by valuing the property as if it were vacant, and the as-if-vacant value is then allocated to land and building based on management s determination of the relative fair value of these assets. Management determines the as-if-vacant fair value of a property using methods similar to those used by independent appraisers. Factors considered by management in performing these analyses include an estimate of carrying costs during the expected lease-up periods considering current market conditions and costs to execute similar leases, including leasing commissions and other related costs. In estimating carrying costs, management includes real estate taxes, insurance, and other operating expenses during the expected lease-up periods based on current market demand.

The fair values of above-market and below-market in-place leases are recorded based on the present value (using an interest rate which reflects the risks associated with the leases acquired) of the difference between (i) the contractual amounts to be paid pursuant to the in-place leases and (ii) management s estimate of fair market lease rates for the corresponding in-place leases, measured over a period equal to the remaining terms of the leases. The capitalized above-market and below-market lease values are recorded as intangible lease assets or liabilities and amortized as an adjustment to rental income over the remaining terms of the respective leases.

The fair values of in-place leases include direct costs associated with obtaining a new tenant, opportunity costs associated with lost rentals which are avoided by acquiring an in-place lease, and tenant relationships. Direct costs associated with obtaining a new tenant include commissions, tenant improvements and other direct costs and are estimated based on management s consideration of current market costs to execute a similar lease. These direct costs are included in deferred lease costs in the accompanying consolidated balance sheets and are amortized to expense over the remaining terms of the respective leases. The value of opportunity costs is calculated using the contractual amounts to be paid pursuant to the in-place leases over a market absorption period for a similar lease. Customer relationships are valued based on expected renewal of a lease or the likelihood of obtaining a particular tenant for other locations. These lease intangibles are

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included in intangible lease assets in the accompanying consolidated balance sheets and are amortized to rental income over the remaining term of the respective leases.

During the three months ended March 31, 2004, Wells REIT II recorded approximately $11.8 million in intangible lease assets, which are included in real estate assets in the consolidated balance sheet. Wells REIT II recorded approximately $7.6 million in lease origination costs, which are included in deferred lease costs in the consolidated balance sheets.

During the three months ended March 31, 2004, Wells REIT II recorded $50,555 in amortization expense of deferred lease costs in the consolidated statement of operations, and $97,653 in amortization of intangible lease assets and liabilities was recorded as a reduction in rental income in the consolidated statement of operations.

Investments in Bonds and Obligations Under Capital Leases

Wells REIT II has acquired investments in bonds and an offsetting obligation under a capital lease. Wells REIT II records the bonds and obligations under capital leases at the amounts Wells REIT II expects to pay and receive. Because Wells REIT II is obligated to pay the indebtedness evidenced by the bonds, Wells REIT II has recorded these obligations as liabilities; however, since Wells REIT II is also the owner of the bonds, the bonds are carried on Wells REIT II s books as assets. The related offsetting interest amounts are recorded as interest income and interest expense in the period that the amounts accrue, with no net impact on the results of operations of Wells REIT II.

Line of Credit

Wells REIT II s line of credit is recorded at the stated principal amount. Interest is charged to interest expense as it accrues.

Dividends Payable and Distribution Policy

Wells REIT II intends to make distributions each taxable year (not including a return of capital for federal income tax purposes) equal to at least 90% of its taxable income. Wells REIT II intends to pay regular quarterly dividends to stockholders. Dividends will be paid to those stockholders who are stockholders of record as of daily record dates.

Dividends to be distributed to the stockholders are determined by the board of directors of Wells REIT II and are dependent upon a number of factors relating to Wells REIT II, including funds available for payment of dividends, financial condition, the timing of property acquisitions, capital expenditure requirements and annual distribution requirements in order to maintain Wells REIT II s status as a REIT under the Internal Revenue Code.

Offering and Related Costs

Offering costs are charged by the Advisor for costs incurred by the Advisor for raising capital for Wells REIT II. Such costs include legal and accounting fees, printing costs, sales and promotional costs, and other offering costs. Such costs, as well as sales commissions and dealer manager fees associated with the offering of shares, which are approximately 7% and up to 2.5%, respectively, of gross offering proceeds, are accounted for as a reduction of equity.

Minority Interest

Minority interest in loss of consolidated subsidiaries in the consolidated statement of operations represents the net loss allocated to minority interests based on the economic ownership percentage of the consolidated subsidiaries held by third parties throughout the period. Minority interest in the consolidated balance sheets represents the economic equity interests of consolidated subsidiaries that are not owned by Wells REIT II.

Stockholders Equity

The par value of investor proceeds raised from the offering is classified as common stock, with the remainder allocated to additional paid in capital. Wells REIT II s redemption program in place at March 31, 2004 provides that all shares are redeemable upon death without limitation. Under Accounting Series Release No. 268, *Presentation in Financial*

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Statements of Redeemable Preferred Stock, because redemption of these shares is certain to occur and outside the control of Wells REIT II, they are considered to be temporary equity.

On April 21, 2004, Wells REIT II s share redemption program was amended, as discussed in Note 8. The amendment limits all redemptions during any calendar year, including those upon death or qualifying disability, to those that can be funded with proceeds raised in the current calendar year from Wells REIT II s dividend reinvestment plan. As a result of the adoption of the amendment, Wells REIT II has included all shares outstanding, with the exception of those purchased through Wells REIT II s dividend reinvestment plan, as equity rather than temporary equity as of March 31, 2004.

Revenue Recognition

All leases on real estate assets held by Wells REIT II are classified as operating leases, and the related rental income is recognized on a straight-line basis over the terms of the respective leases, unless rental income is dependent upon criteria that cannot be determined at inception of the lease. Tenant reimbursements are recognized as revenue in the period that the related operating cost is incurred, and, therefore contractually earned and billable pursuant to the terms of the underlying lease. Rents paid in advance, which do not qualify for revenue recognition, are deferred to future periods.

Revenues earned relating to lease termination agreements are recognized at the time the tenant loses the right to lease the space and when Wells REIT II has satisfied all obligations under the agreement.

Earnings Per Share

Earnings per share are calculated based on the weighted average number of common shares outstanding during each period. The weighted average number of common shares outstanding is identical for basic and fully diluted earnings per share. Outstanding stock options have been excluded from the diluted earnings per share calculation, as their impact would be anti-dilutive using the treasury stock method, as the exercise price of the options exceeds the fair value of the stock, and Wells REIT II recognized a net loss for the period.

Financial Instruments

Wells REIT II considers its cash, accounts receivable, accounts payable, bonds, obligations under capital leases, and line of credit to meet the definition of financial instruments. At March 31, 2004, the carrying value of Wells REIT II s financial instruments approximated their fair value. The line of credit bears interest based on variable interest rates that periodically adjust to market, which approximates current market rates for similar arrangements.

Income Taxes

Wells REIT II intends to elect to be taxed as a REIT under the Internal Revenue Code of 1986, as amended, and has operated as such beginning with its taxable period ended December 31, 2003. To qualify as a REIT, Wells REIT II must meet certain organizational and operational requirements, including a requirement to distribute at least 90% of Wells REIT II s ordinary taxable income to stockholders. As a REIT, Wells REIT II generally will not be subject to federal income tax. If Wells REIT II fails to qualify as a REIT in any taxable year, it will then be subject to federal income taxes on its taxable income at regular corporate rates and will not be permitted to qualify for treatment as a REIT for federal income tax purposes for four years following the year during which qualification is lost unless the Internal Revenue Service grants Wells REIT II relief under certain statutory provisions. Such an event could materially adversely affect Wells REIT II s net income and net cash available for distribution to stockholders. However, Wells REIT II believes that it is organized and operates in such a manner as to qualify for treatment as a REIT and intends to continue to operate in the foreseeable future in such a manner that Wells REIT II will remain qualified as a REIT for federal income tax purposes. No provision for federal income taxes has been made in the accompanying consolidated financial statements, as Wells REIT II made distributions in excess of taxable income for the period presented and incurred a net loss. Wells REIT II is subject to certain state and local taxes related to the operations of properties in certain locations, which has been provided for in the accompanying consolidated financial statements.

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3. Real Estate Assets

Acquisitions

During the three months ended March 31, 2004, Wells REIT II acquired ownership interests in three properties for an aggregate purchase price of approximately $78.0 million, $5.3 million of which will be paid in a future period as stipulated below, exclusive of related closing costs and acquisition fees paid to the Advisor, as described below.

Weatherford Center Houston

On February 10, 2004, Wells REIT II purchased a 12-story office building containing approximately 260,000 rentable square feet located at 515 South Post Oak Boulevard in Houston, Texas for a purchase price of approximately $39.9 million plus closing costs. The property, which was completed in 1980 and renovated in 1993, is leased to Weatherford International, Ltd. (approximately 96%) and various other office and retail tenants.

New Manchester One

On March 19, 2004, Wells REIT II purchased a 404,000-square-foot single-story distribution facility subject to a ground lease located on an approximate 31-acre tract of land at 9103 Riverside Parkway in Douglasville, Georgia (Phase I) for a purchase price of approximately $19.3 million, of which $14.0 million was paid at closing for Phase I with proceeds drawn from our $175 million bridge facility. The remaining $5.3 million will be funded at certain milestones during construction of an additional 189,000 rentable square feet (Phase II) on the same tract of land. Phase I was completed in December 2003, and the anticipated completion date for Phase II is November 2004.

Fee simple title to the land upon which the New Manchester One building is located is held by the Development Authority of Douglas County (the Development Authority), which issued a Development Authority of Douglas County Taxable Revenue Bond (the Bond) totaling $18 million in connection with the construction of the building. Certain real property tax abatement benefits are available to Wells REIT II because the fee simple title to the property is held by the Development Authority. The property tax abatement benefits will expire in 2011. As part of the transaction, Well REIT II also purchased the Bond. The amount of rent payable under the ground lease and the payments due on the Bond offset each other, and result in no net impact on our operating results. Wells REIT II will acquire fee simple title upon exercise of an option to purchase contained in the ground lease. The purchase price will be approximately equal to the amount then due to Wells REIT II under the Bond. Wells REIT II is not likely to exercise the purchase option until the tax abatement benefits expire.

The New Manchester One Building is entirely leased to JVC Americas Corporation, a wholly owned subsidiary of Victor Company of Japan, Ltd., which is a majority owned subsidiary of Matsushita Electric Co., Ltd.

Republic Drive Buildings

On March 31, 2004, Wells REIT II purchased two single-story engineering buildings containing an aggregate of approximately 169,000 rentable square feet for an aggregate purchase price of approximately $18.9 million plus closing costs. The property is located on an approximate 20-acre tract of land at 333 Republic Drive and 777 Republic Drive, Allen Park, Michigan. The Republic Drive Buildings, which were constructed in 2000, are 100% leased under a net lease to Roush Industries, Inc.

4. Line of Credit

On February 10, 2004, Wells REIT II entered into a non-revolving $175 million, 90-day, secured bridge facility with Bank of America, N.A., the proceeds of which are designated for the acquisition of approved properties. Wells REIT II utilized capacity under the line to finance the three acquisitions above. The agreement contains borrowing arrangements that provide for interest costs based on LIBOR plus a percentage ranging from 2.25% to 5%, based on Wells REIT II s leverage, calculated as Wells REIT II s ratio of total debt to total real estate assets at cost plus cash and cash equivalents. At March 31, 2004, the interest rate was approximately 3.34% and outstanding principal was approximately $37.8 million. Substantially all remaining capacity on the facility was utilized for the Manhattan Towers Property acquisition on April 2,

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2004 (see Note 8). The agreement also contains a provision that Wells REIT II pays a monthly unused fee of 0.5% of the amount of the line not utilized. This line of credit is collateralized by all properties owned by Wells REIT II.

5. Commitments and Contingencies

Commitments Under Existing Lease Agreements

Certain lease agreements include provisions that, at the option of the tenant, Wells REIT II may be obligated to expend certain amounts of capital to expand an existing property or provide other expenditures for the benefit of the tenant, in favor of additional rental revenue. At March 31, 2004, no tenants have exercised such options.

Properties Under Contract

At March 31, 2004, Wells REIT II had a contract to acquire a real estate asset for a purchase price of $79.3 million. In addition, Wells REIT II had signed an agreement related to the completion of construction of Phase II of the New Manchester One facility in the amount of approximately $5.3 million. Wells REIT II has paid $3.2 million in earnest money related to these contracts at March 31, 2004, which are included in prepaid expenses and other assets in the consolidated balance sheet.

6. Related-Party Transactions

Advisory Agreement

Wells REIT II has entered into an Advisory Agreement with the Advisor, which entitles the Advisor to earn specified fees upon the completion of certain services. The Advisory Agreement has a one-year term and automatically renews unless either side gives notice of its intent not to renew. However, Wells REIT II may terminate the Advisory Agreement upon 60 days written notice. If Wells REIT II terminates the Advisory Agreement, Wells REIT II will pay the Advisor all unpaid reimbursements of expenses and all earned but unpaid fees. The Advisory Agreement expires on October 9, 2004.

Organization and Offering Costs

The Advisor pays organization and offering costs (other than selling commissions, the dealer manager fee and the reimbursable due diligence expenses of participating dealers) of Wells REIT II. These costs include Wells REIT II s legal, accounting, printing, and filing fees and other offering expenses, such as the salaries of the Advisor s employees and other costs of the Advisor relating to the preparation of supplemental sales materials and holding educational conferences. Wells REIT II is obligated to reimburse the Advisor for those costs in an amount equal to the lesser of actual costs incurred or 2% of the gross proceeds from the offering and sale of shares of common stock to the public. As of March 31, 2004, the Advisor had incurred organization and offering costs on behalf of Wells REIT II of approximately $8.4 million. However, because Wells REIT II s obligation for organization and offering costs is limited to 2% of gross offering proceeds raised, $1.2 million has been accrued in Wells REIT II s consolidated balance sheet as of March 31, 2004. The remaining $7.2 million will be accrued and payable as Wells REIT II raises additional offering proceeds.

Asset Management Fees

Wells REIT II pays an asset management fee to the Advisor for services related to formulating and implementing strategies to administer, promote, manage, operate, maintain, improve, finance and refinance, market, lease, and dispose of properties. The asset management fee is payable monthly in an amount equal to one-twelfth of 0.75% of the cost of (1) all occupied properties of Wells REIT II and (2) investments in joint ventures. The amount paid in any calendar quarter may not exceed 1.0% of the net asset value of those investments at each quarters end after deducting debt used to acquire or refinance properties. These fees totaled $24,830 for the three months ended March 31, 2004.

Administrative Services Reimbursement

Additionally, Wells REIT II reimburses the Advisor for all costs and expenses the Advisor incurs in fulfilling its duties as the asset portfolio manager. These costs and expenses include wages and salaries and other employee-related expenses of the

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Advisor s employees engaged in the management, administration, operations, and marketing functions. Employee-related expenses include taxes, insurance and benefits relating to such employees, and legal, travel and other out-of-pocket expenses that are directly related to the services they provide. The related expenses are billed to Wells REIT II based on time spent on each entity by administrative personnel. These expenses totaled $52,120 for the three months ended March 31, 2004 and are included in general and administrative expenses in the consolidated statement of operations.

Acquisition Fees

Wells REIT II pays a fee to the Advisor for services related to the acquisition and disposition of investment properties. Wells REIT II pays acquisition fees equal to 2.0% of the aggregate purchase price of all shares Wells REIT II sells. These acquisition fees serve as compensation for services the Advisor renders in connection with the investigation, selection and acquisition of properties. Wells REIT II pays the acquisition fees upon its receipt of proceeds from the shares it sells, but the Advisor is obligated to reimburse Wells REIT II for any unearned acquisition fee upon termination of the Advisory Agreement. Wells REIT II also reimburses the Advisor for expenses it pays to third parties in connection with acquisitions or potential acquisitions. Additionally, when Wells REIT II sells a property, it will pay the Advisor a fee equal to 3.0% of the sales price if the Advisor provided a substantial amount of services in connection with the sale (as determined by the conflicts committee of Wells REIT II s board of directors). This fee may be in addition to real estate commissions paid to third parties. However, for any Wells REIT II property sold, the total real estate commissions (including such disposition fee) may not exceed the lesser of (i) 6.0% of the sales price of each property or (ii) the level of real estate commissions customarily charged in light of the size, type, and location of the property. During the three months ended March 31, 2004, the Advisor earned acquisition fees of approximately $1.2 million with regard to Wells REIT II.

Subordinated Incentive Listing and Liquidation Fees

The Advisor may also earn fees in connection with the listing of Wells REIT II s shares of common stock or a liquidating sale of Wells REIT II s assets. If Wells REIT II lists its shares on a national securities exchange or national over-the-counter market system, the Advisor will be entitled to a fee provided that the market value of Wells REIT II s outstanding stock plus distributions paid prior to listing exceeds the sum of the amount of capital stockholders invested plus the amount that would be required to be paid to stockholders to provide an annualized, non-cumulative return of 8.0%. The fee would equal 10% of that excess and would be offset by any incentive fees previously paid. Further, if Wells REIT II pays this fee following a listing of shares, it will not be obligated to pay any further incentive fees to the Advisor. Furthermore, if Wells REIT II sells properties in a single transaction or a series of related transactions with the intent of liquidating the assets of Wells REIT II and receives proceeds enabling it to distribute to stockholders all of the capital stockholders invested plus an amount sufficient to provide stockholders with an annualized, non-cumulative return of 8.0%, the Advisor will be entitled to an incentive fee. This incentive fee will equal 10% of the net sales proceeds remaining after Wells REIT II has made the distributions providing stockholders a complete return of capital and the 8.0% return. As of March 31 2004, the Advisor has not earned any such fees.

In addition, the Advisor would be entitled to 10% of the amount, if any, by which the sum of the net value of Wells REIT II s properties plus all distributions paid to the termination date exceeded the difference between (A) the sum of (1) the total investments by stockholders (after any redemptions) plus (2) distributions attributable to the sale of properties plus (3) the amount of distributions that would be required to be paid to stockholders to provide an annualized, non-cumulative return of 8.0% and (B) any prior incentive fee paid to the Advisor.

Property Management and Leasing Agreements

Wells REIT II may retain Wells Management, Inc. (Wells Management) to manage and lease some of its properties. If so, Wells REIT II will enter into an agreement with Wells Management to pay a fee equal to what other management companies generally charge for the management of similar properties, which may include reimbursement of costs and expenses Wells Management incurs in managing the properties. Reimbursable costs and expenses include wages and salaries and other expenses of employees engaged in operating, managing, maintaining, and leasing properties. In addition, Wells REIT II may pay Wells Management a separate one-time fee for the initial leasing of newly constructed properties at a market rate, typically equal to one month s rent. No such agreements had been entered into and thus no such fees had been earned as of March 31, 2004.

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Dealer Manager Agreement

Wells REIT II has executed a Dealer Manager Agreement with Wells Investment Securities, Inc. (WIS), whereby WIS, an affiliate of the Advisor, performs the dealer manager function for Wells REIT II. For these services, WIS earns a fee of up to 7% of the gross offering proceeds from the sale of the shares of Wells REIT II, of which substantially all are reallowed to participating broker-dealers. During the three months ended March 31, 2004, Wells REIT II incurred commissions of $4.1 million, of which more than 99% was reallowed to participating broker-dealers.

Additionally, Wells REIT II is required to pay WIS a dealer manager fee of up to 2.5% of the gross offering proceeds from the sale of Wells REIT II s stock at the time the shares are sold. Under the dealer manager agreement, up to 1.5% of the gross offering proceeds may be reallowed by WIS to participating broker-dealers, and some of the fees may be reduced for certain classes of purchasers or for purchasers under the dividend reinvestment plan. Wells REIT II recorded dealer manager fees of approximately $1.5 million during the three months ended March 31, 2004, of which approximately $0.7 million was reallowed to participating broker-dealers.

Conflicts of Interest

The Advisor also is a general partner of or advisor to various other entities including another REIT and several syndicated real estate limited partnerships. As such, there are instances where the Advisor, while serving in the capacity as general partner or advisor for these entities, may be in competition with Wells REIT II in connection with property acquisitions or for tenants in similar geographic markets. The compensation arrangements with the Advisor and its affiliates could influence the Advisor s and its affiliates advice to Wells REIT II.

Additionally, certain members of the board of directors of Wells REIT II also serve on the board of directors of another REIT sponsored by the Advisor. These directors may face situations where decisions that benefit one entity may be detrimental to the other entity.

7. Economic Dependency

Under agreements which have terms of one year or less, Wells REIT II has engaged the Advisor and its affiliates to provide certain services that are essential to Wells REIT II, including asset management services, supervision of the management and leasing of properties owned by Wells REIT II, asset acquisition and disposition decisions, the sale of shares of Wells REIT II s common stock available for issue, as well as other administrative responsibilities for Wells REIT II including accounting services and investor relations. As a result of these relationships, Wells REIT II is dependent upon the Advisor and its affiliates. In the event that these companies were unable to provide Wells REIT II with the respective services, Wells REIT II would be required to find alternative providers of these services.

On or about March 12, 2004, a putative class action complaint (the complaint) relating to Wells Real Estate Fund I, a public limited partnership that offered units from September 6, 1984 through September 5, 1986 (Wells Fund I), was filed by four individuals (the plaintiffs) against Leo F. Wells, III and the Advisor, as well as Wells Investment Securities, Inc., Wells Management Company, Inc., and Wells Fund I (collectively, the Wells Defendants) (Hendry et al. v. Leo F. Wells, III et al., Superior Court of Gwinnett County, Georgia, Civil Action No. 04-A-2791 2). The Wells Defendants received notice of the complaint on or about March 19, 2004. The plaintiffs filed the complaint purportedly on behalf of all limited partners holding B units of Wells Fund I as of January 15, 2003. The complaint alleges, among other things, that (a) during the offering period (September 6, 1984 through September 5, 1986), Mr. Wells, the Advisor, Wells Investment Securities and Wells Fund I negligently or fraudulently made false statements and made material omissions in connection with the initial sale of the B units to investors of Wells Fund I by making false statements and omissions in the Wells Fund I sales literature relating to the distribution of net sale proceeds to holders of B units; (b) Mr. Wells, the Advisor, and Wells Fund I negligently or fraudulently misrepresented and concealed disclosure of, among other things, alleged discrepancies between such statements and the provisions in the partnership agreement for a period of time in order to delay such investors from taking any legal, equitable or other action to protect their investments in Wells Fund I, among other reasons; and (c) Mr. Wells, the Advisor and Wells Fund I breached their fiduciary duties to the limited partners. The plaintiffs seek, among other remedies, the following: rescission of all purported class members purchases of B units and an order for a full refund of all money paid for such units together with interest; judgment against the Wells Defendants, jointly and severally, in an amount to be proven at trial; punitive damages; judicial dissolution of Wells Fund

I and the appointment of a receiver to wind up and terminate the partnership; and an award to plaintiffs of their attorneys fees, costs and expenses.

Due to the uncertainties inherent in the litigation process, it is not possible to predict the ultimate outcome of this matter at this time. However an adverse outcome could adversely affect the ability of the Advisor, Wells Investment Securities, and Mr. Wells to fulfill their duties under the agreements and relationships they have with us.

8. Subsequent Events

Sale of Shares of Common Stock

From April 1, 2004 through April 30, 2004, Wells REIT II had raised approximately $40.9 million through the issuance of approximately 4.1 million shares of common stock of Wells REIT II. As of April 30, 2004, approximately $5.9 billion in shares (589.8 million shares) remained available for sale to the public under the offering, exclusive of shares available under Wells REIT II s dividend reinvestment plan.

Manhattan Towers Property Acquisition

On April 2, 2004, Wells REIT II purchased two six-story office buildings containing approximately 310,000 rentable square feet for a purchase price of approximately $89.9 million plus closing costs. The buildings are located on an approximate 5.1-acre parcel of land at 1230 and 1240 Rosecrans Avenue in Manhattan Beach, California. The property, which was completed in 1985 and renovated in 2001, is leased to Northrop Grumman Space and Mission Systems Corporation (approximately 76%) and various other office and retail tenants (approximately 23%). Approximately 1% of the Manhattan Towers Property is currently vacant.

Declaration of Dividends

On April 21, 2004, Wells REIT II s board of directors increased the dividend rate to a 6.0% annualized rate of return on a $10.00 investment per share from a 5.0% annualized rate, calculated on a daily basis to stockholders of record each day from April 22, 2004, through June 15, 2004. This dividend will be paid in June, along with the dividends earned March 16, 2004, through April 21, 2004.

Line of Credit

On May 10, 2004, Wells REIT II entered into a revolving $350 million, 180-day, secured interim facility agreement with Bank of America, N.A., superseding the $175 million facility agreement and refinancing the remaining outstanding principal balance. In connection with closing the $350 million facility, Wells REIT II paid and expects to pay fees and expenses totaling approximately $3.2 million. The agreement contains borrowing arrangements that provide for interest costs based on LIBOR for one, two, or three month periods, plus 225 basis points or the base rate plus 50 basis points, at Wells REIT II s option. The base rate for any day is the higher of the Federal Funds Rate for such day plus 50 basis points or Bank of America s prime rate for such day. If Bank of America is not able to syndicate an acceptable portion of this line of credit, the terms of the line of credit, including, but not limited to, the interest rate and the amount available under the facility, may change. Like Wells REIT II s initial $175 million facility, this $350 million facility requires that Wells REIT II use 86.5% of gross offering proceeds to repay the facility. Unlike the initial $175 million facility, the $350 million facility permits the use of loan proceeds for any property acquisition (subject to compliance with certain covenants) and for working capital; however, borrowing under the facility is limited to a certain percentage of the value of lender-approved properties.

Under the terms of the $350 million line of credit, Wells REIT II is required to repay outstanding principal and accrued interest within 180 days. During the initial 180-day term, the agreement allows Wells REIT II to borrow up to 70% of the aggregate cost of the subset of lender-approved properties with an aggregate average occupancy rate of 85% (the Borrowing Base). Wells REIT II is able to extend the initial maturity date by an additional 180 days if Wells REIT II seeks an extension and meet the related conditions set forth in the agreement, including reducing the amount outstanding under the facility to 60% of the Borrowing Base. During the extension term, borrowing under the facility is limited to

60% of the Borrowing Base. At May 10, 2004, Wells REIT II was able to borrow up to approximately $2.5 million under the $350 million line of credit.

The agreement also stipulates that Wells REIT II s net distributions, which equal total distributions less the amount reinvested through our dividend reinvestment plan, may not exceed the greater of 90% of Wells REIT II s Funds from Operations for the corresponding period and any equity proceeds not used for other purposes that are otherwise not required to pay down the line. With the obligation to use 86.5% of gross offering proceeds to repay the facility, the equity proceeds that Wells REIT II could use to fund distributions will be largely limited to approximately $14.8 million of available new proceeds raised before entering into the former $175 million bridge facility. Funds from Operations, as defined by the National Association of Real Estate Investment Trusts, generally means net income, computed in accordance with accounting principles generally accepted in the United States (GAAP), excluding extraordinary items (as defined by GAAP) and gains (or losses) from sales of property, plus depreciation and amortization on real estate assets, and after adjustments for unconsolidated partnerships, joint ventures and subsidiaries. The lender also further adjusts the definition of Funds from Operations to add back the amortization of initial loan fees paid to the lender.

Debt covenants of the $350 million line of credit require that Wells REIT II maintain its leverage, i.e., the ratio of total debt to total purchase price of real estate assets plus cash and cash equivalents, at 70% or less at all times during the initial or extended term of the facility. The $350 million facility is secured by mortgages on all lender-approved properties; however, only some of the mortgages are recorded in the property records. However, in the event we are in default under the facility, the lender may elect to record all of the mortgages and foreclose.

Amendment to the Share Redemption Program

On April 21, 2004, Wells REIT II s share redemption program was amended. Wells REIT II s board of directors may amend, suspend or terminate the share redemption program upon 30 days notice. The revised program will go into effect 30 days after notice to the stockholders of Wells REIT II, and is summarized as follows:

Under the revised program, the initial redemption price was increased from $8.40 per share to $9.10 per share, or 91% of the price per share paid for those shares sold for less than $10.00. Higher redemption prices remain in effect for redemptions sought within two years of death. The higher redemption price available upon death will now also be available within two years of an investor s award of disability benefits from the Social Security Administration or, in limited circumstances, from other governmental agencies.

The revised program also contains different limitations on the total amount of redemptions Wells REIT II can make. In addition to redemptions following death, the revised program provides that redemptions following a qualifying disability are also exempt from the cap of 5% of the weighted average number of shares outstanding during the prior calendar year. However, the redemptions during any calendar year, other than redemptions within two years of death or disability, are limited to those that can be funded with 50% of the net proceeds from the sale of shares under our dividend reinvestment plan during that calendar year. All redemptions during any calendar year, including those within two years of death or disability, are limited to those that can be funded from 100% of the net proceeds from the sale of shares under our dividend reinvestment plan during that calendar year.

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REPORT OF INDEPENDENT AUDITORS

Board of Directors and Stockholders

Wells Real Estate Investment Trust II, Inc.

We have audited the accompanying consolidated balance sheet of Wells Real Estate Investment Trust II, Inc. as of December 31, 2003 and the related consolidated statements of loss, stockholder s equity, and cash flows for the period from inception (July 3, 2003) through December 31, 2003. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the 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 audit provides 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 Wells Real Estate Investment Trust II, Inc. at December 31, 2003 and the consolidated results of its operations and its cash flows for the period from inception (July 3, 2003) to December 31, 2003 in conformity with accounting principles generally accepted in the United States.

/s/ ERNST & YOUNG LLP

Atlanta, Georgia

February 18, 2004

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WELLS REAL ESTATE INVESTMENT TRUST II, INC.

CONSOLIDATED BALANCE SHEET

DECEMBER 31, 2003

ASSETS:	
Cash and cash equivalents	$ 156,912
Restricted cash	981,924
Prepaid expenses and other assets	512,633
Total assets	$ 1,651,469
LIABILITIES AND STOCKHOLDER S EQUITY	
LIABILITIES:	
Accrued expenses	$ 563,000
Escrowed investor proceeds	981,924
Total liabilities	1,544,924
COMMITMENTS AND CONTINGENCIES	
MINORITY INTEREST	106,015
STOCKHOLDER S EQUITY:	
Preferred shares, $.01 par value; 100,000,000 shares authorized, no shares issued and outstanding at December 31, 2003	
Common shares, $.01 par value; 900,000,000 shares authorized, 100 shares issued and outstanding at December 31, 2003	1
Additional paid-in capital	999
Accumulated deficit	(470)
Total stockholder s equity	530
Total liabilities and stockholder s equity	$ 1,651,469

See accompanying notes.

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WELLS REAL ESTATE INVESTMENT TRUST II, INC.

CONSOLIDATED STATEMENT OF LOSS

FOR THE PERIOD FROM INCEPTION (JULY 3, 2003) TO DECEMBER 31, 2003

REVENUES:	
EXPENSES:	
General and administrative	$ 94,455
LOSS BEFORE MINORITY INTEREST	$ (94,455)
MINORITY INTEREST IN LOSS OF CONSOLIDATED ENTITIES	$ (93,985)
NET LOSS	$ (470)
EARNINGS PER SHARE:	
Basic and diluted	$ (4.70)
WEIGHTED AVERAGE SHARES OUTSTANDING:	
Basic and diluted	100

See accompanying notes.

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WELLS REAL ESTATE INVESTMENT TRUST II, INC.

CONSOLIDATED STATEMENT OF STOCKHOLDER S EQUITY

FOR THE PERIOD FROM INCEPTION (JULY 3, 2003) TO DECEMBER 31, 2003

	Common Stock		Additional Paid-In Capital	Accumulated Deficit	Total Stockholder s Equity
	Shares	Amount			
BALANCE, (inception) July 3, 2003		$	$	$	$
Issuance of common stock	100	1	999		1,000
Net loss				(470)	(470)
BALANCE, December 31, 2003	100	$ 1	$ 999	$ (470)	$ 530

See accompanying notes.

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WELLS REAL ESTATE INVESTMENT TRUST II, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

FOR THE PERIOD FROM INCEPTION (JULY 3, 2003) TO DECEMBER 31, 2003

CASH FLOWS FROM OPERATING ACTIVITIES:	
Net loss	$ (470)
Adjustments to reconcile net loss to net cash used in operating activities:	
Minority interest in loss of consolidated entities	(93,985)
Changes in assets and liabilities:	
Prepaid expenses and other assets	(512,633)
Accrued expenses	563,000
Total adjustments	(43,618)
Net cash used in operating activities	(44,088)
CASH FLOWS FROM INVESTING ACTIVITIES:	
Net cash provided by (used in) investing activities	
CASH FLOWS FROM FINANCING ACTIVITIES:	
Issuance of common stock	1,000
Limited partner s contribution to Wells OP II	200,000
Net cash provided by financing activities	201,000
NET INCREASE IN CASH AND CASH EQUIVALENTS	156,912
CASH AND CASH EQUIVALENTS, July 3, 2003 (inception)	
CASH AND CASH EQUIVALENTS, December 31, 2003	$ 156,912

See accompanying notes.

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WELLS REAL ESTATE INVESTMENT TRUST II, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE PERIOD FROM INCEPTION (JULY 3, 2003) TO DECEMBER 31, 2003

1. ORGANIZATION

Wells Real Estate Investment Trust II, Inc. (Wells REIT II) was formed on July 3, 2003 as a Maryland corporation that intends to qualify as a real estate investment trust (REIT). Wells REIT II expects to engage in the acquisition and ownership of commercial real properties throughout the United States, including properties that are under construction, are newly constructed or have operating histories. Wells REIT II may invest in office buildings, shopping centers, other commercial and industrial properties or other real estate properties. All such properties may be acquired directly or through joint ventures with real estate limited partnerships sponsored by Wells Capital, Inc. (the Advisor), affiliates of the Advisor, or third parties.

Substantially all of Wells REIT II s business is expected to be conducted through Wells Operating Partnership II, L.P. (Wells OP II), a Delaware limited partnership. Wells OP II was formed on July 3, 2003, and is expected to acquire, develop, own, lease, and operate real properties on behalf of Wells REIT II, either directly, through wholly owned subsidiaries or through joint ventures. Wells REIT II is the general partner in Wells OP II and possesses full legal control and authority over the operations of Wells OP II. On September 9, 2003, the Advisor purchased 20,000 limited partner units in Wells OP II in exchange for $200,000.

On November 26, 2003, Wells REIT II commenced its first public offering of up to 785,000,000 shares of common stock of Wells REIT II pursuant to a Registration Statement filed on Form S-11 under the Securities Act of 1933, with 185,000,000 of those shares being offered through the Wells REIT II Dividend Reinvestment Plan. Subscribers shall be admitted to Wells REIT II upon Wells REIT II s receipt and acceptance of gross offering proceeds of $2,500,000 (the Minimum Offering) and, for subscribers residing in Pennsylvania, receipt and acceptance of a minimum of $200,000,000 in gross offering proceeds from all jurisdictions. As of December 31, 2003 Wells REIT II has sold 100 shares to the Advisor at the initial public offering price of $10 per share and proceeds from the sale of 98,192 shares to the public are restricted until the Minimum Offering is reached.

At December 31, 2003, Wells REIT II has neither purchased nor contracted to purchase any interest in real properties.

Wells REIT II s stock is not listed on a national exchange. However, Wells REIT II s Articles of Incorporation require that, in the event that Wells REIT II s stock is not listed on a national exchange by October 2015, Wells REIT II must either seek stockholder approval of an extension or amendment of this listing deadline or stockholder approval to begin liquidating investments and distributing the resulting proceeds to the stockholders. If Wells REIT II seeks stockholder approval of an extension or amendment to this listing date and does not obtain it, Wells REIT II will then be required to seek stockholder approval to liquidate. If Wells REIT II seeks and does not obtain approval to liquidate, Wells REIT II will not be required to list or liquidate and could continue to operate as before.

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2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

The consolidated financial statements include the accounts of Wells REIT II and any entities for which Wells REIT II has a controlling financial interest. In determining whether a controlling financial interest exists, Wells REIT II considers ownership of voting interests, protective rights and participatory rights of the investors. Any intercompany balances and transactions are eliminated upon consolidation. As of December 31, 2003, Wells REIT II has no investments in other entities, except for its 0.5% interest in Wells OP II, which is included in the consolidated financial statements of Wells REIT II.

Upon formation, Wells REIT II adopted Financial Accounting Standards Board Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46). The interpretation provides additional guidance on the appropriate accounting for variable interest entities. Wells OP II is a variable interest entity (VIE), as that term is defined in FIN 46. Under FIN 46, the primary beneficiary of a VIE is required to consolidate the VIE. Wells REIT II is deemed to be the primary beneficiary of Wells OP II since its activities are deemed to be most closely associated with Wells OP II. Consequently, Wells REIT II has consolidated its interest in Wells OP II in its consolidated balance sheet.

Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Cash and Cash Equivalents

Wells REIT II considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. Cash equivalents may include cash and short term investments. Short term investments are stated at cost, which approximates fair value and may consist of investments in money market accounts.

Restricted Cash and Escrowed Investor Proceeds

Wells REIT II s cash from offering proceeds of $981,924 is restricted until the Minimum Offering is received and accepted.

Prepaid Expenses and Other Assets

Prepaid expenses and other assets include expenses paid during the current period relating to future periods and will be expensed during the period to which the costs relate.

Minority Interest

Minority interest in loss of consolidated entities in the consolidated statement of loss represents the net loss allocated to minority interests based on the economic ownership

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percentage of the consolidated partnerships held by third parties throughout the year and minority interest in the consolidated balance sheet represents the economic equity interests of consolidated partnerships that are not owned by Wells REIT II. Included in minority interest in the consolidated balance sheet and statement of loss is the interest in Wells OP II owned by the Advisor.

Dividends Payable and Distribution Policy

Wells REIT II intends to make distributions each taxable year (not including a return of capital for federal income tax purposes) equal to at least 90% of the taxable income of Wells REIT II. Wells REIT II expects to declare dividends in advance of the quarter to which they relate based on a daily rate and pay the dividends at the end of the quarter.

Dividends to be distributed to stockholders will be determined by the board of directors of Wells REIT II and will be dependent upon a number of factors relating to Wells REIT II, including funds available for payment of dividends, financial condition, the timing of property acquisitions, capital expenditure requirements, and annual distribution requirements in order to maintain Wells REIT II s status as a REIT under the Internal Revenue Code.

Offering and Related Costs

Organization and offering costs (as described in Note 6) of Wells REIT II are incurred or paid by the Advisor on behalf of Wells REIT II. As of December 31, 2003, the Advisor had incurred organization and offering expenses on behalf of Wells REIT II of approximately $3,200,000, which will be reimbursed by Wells REIT II upon the sale of shares to the public under the terms of the Advisory Agreement discussed in Note 6. Upon receipt and acceptance of the Minimum Offering, organizational costs will be expensed, and offering costs will be charged to stockholder s equity.

Earnings Per Share

Earnings per share is calculated based on the weighted average number of common shares outstanding during each period. The weighted average number of common shares outstanding is identical for basic and fully diluted earnings per share. Until Wells REIT II breaks escrow, all shares sold to the public are excluded from the calculation of weighted average shares outstanding.

Financial Instruments

Wells REIT II considers its cash to meet the definition of financial instruments. At December 31, 2003, the carrying value of Wells REIT II s financial instruments approximated their fair value.

Income Taxes

Wells REIT II intends to elect to be taxed as a REIT under the Internal Revenue Code of 1986, as amended, and intends to operate as such beginning with its taxable period ended December 31, 2003. To qualify as a REIT, Wells REIT II must meet certain organizational and operational requirements, including a requirement to distribute at least 90% of Wells REIT II s ordinary taxable income to stockholders. As a REIT, Wells

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REIT II generally will not be subject to federal income tax on taxable income that it distributes to stockholders. If Wells REIT II fails to qualify as a REIT in any taxable year, it will then be subject to federal income taxes on its taxable income at regular corporate rates and will not be permitted to qualify for treatment as a REIT for federal income tax purposes for four years following the year during which qualification is lost unless the Internal Revenue Service grants Wells REIT II relief under certain statutory provisions. Such an event could materially adversely affect Wells REIT II s net income and net cash available for distribution to stockholders. However, Wells REIT II intends to organize and operate in such a manner as to qualify for treatment as a REIT.

Recent Pronouncements

In May 2003, the Financial Accounting Standards Board (FASB) issued Statement No. 150 Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (FAS 150), certain components of which were deferred by the FASB in October 2003 for an indefinite period. This statement establishes standards for classifying and measuring as liabilities certain financial instruments that embody obligations of the issuer and have characteristics of both liabilities and equity. FAS 150 requires, among other things, that a minority interest in a consolidated entity be classified as a liability and reported at settlement value if an unconditional obligation to exercise or redeem the minority interest exists. As Wells OP II is an infinite life partnership and the redemption or conversion of the minority interest is conditioned upon future events, the limited partnership interest in Wells OP II is accounted for as a minority interest in the accompanying consolidated balance sheet. Until further guidance is provided during the deferral period for FAS 150, this interest will continue to be classified as minority interest in Wells REIT II s consolidated balance sheet.

3. COMMITMENTS AND CONTINGENCIES

In the normal course of business, Wells REIT II, the Advisor, or affiliates of the Advisor that Wells REIT II are dependent upon may become subject to litigation or claims.

On August 26, 2003, Wells Investment Securities (WIS), and Leo F. Wells, III, settled an NASD enforcement action against them by entering into a Letter of Acceptance, Waiver and Consent (AWC) with the NASD which contained findings by the NASD including that WIS and Mr. Wells had violated certain of its Conduct Rules related to providing non-cash compensation of more than $100 to associated persons of NASD member firms in connection with their attendance at the annual educational conferences sponsored by WIS in 2001 and 2002, and that WIS and Mr. Wells failed to adhere to all the terms of a written undertaking made in March 2001. WIS consented to a censure and Mr. Wells consented to suspension from acting in a principal capacity with a member firm for one year. WIS and Mr. Wells also agreed to the imposition of a joint and several fine in the amount of $150,000. We do not expect any material impact on our financial position or results of operations as a result of this matter.

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4. STOCKHOLDER S EQUITY

General

Wells REIT II s charter authorizes it to issue 1,000,000,000 shares of capital stock, consisting of 900,000,000 common shares and 100,000,000 preferred shares, each as defined by the charter.

The common shares have a par value of $0.01 per share and entitle the holders to one vote per share on all matters upon which stockholders are entitled to vote, to receive dividends and other distributions as authorized by the board of directors in accordance with the Maryland General Corporation Law and to all rights of a stockholder pursuant to the Maryland General Corporation Law. The common stock has no preferences or preemptive, conversion or exchange rights. As of December 31, 2003, Wells REIT II has issued 100 shares of common stock, and 98,192 shares are issuable upon breaking escrow.

Wells REIT II is authorized to issue one or more series of preferred stock. Prior to the issuance of such shares, the board of directors shall have the power from time to time to classify or reclassify, in one or more series, any unissued shares constituting such series and the designation, preferences, conversion, and other rights, voting powers, restrictions, limitations as to dividends and other distributions, qualifications and terms and conditions of redemption of such shares. As of December 31, 2003, Wells REIT II has issued no shares of preferred stock.

Stock Option Plan

The Stock Option Plan adopted by the board of directors and stockholder of Wells REIT II provides for grants of non-qualified stock options to be made to selected employees of the Advisor and Wells Management Company, Inc. (Wells Management). A total of 750,000 shares have been authorized and reserved for issuance under the Stock Option Plan. At December 31, 2003, no stock options have been granted under the plan; therefore all 750,000 shares are available for option grants, subject to limitations set forth in the charter.

The exercise price per share for the options must be the greater of (1) $11.00 or (2) the Fair Market Value (as defined in the Stock Option Plan) on the date the option is granted. The conflicts committee of Wells REIT II s board of directors, upon recommendation and consultation with the Advisor and Wells Management, will grant options under the plan. The conflicts committee has the authority to set the term and vesting period of the stock options as long as no option has a term greater than five years from the date the stock option is granted. If the conflicts committee determines that the potential benefits of the stock options may be inappropriately diluted or enlarged as a result of certain corporate transactions or events, the conflicts committee may adjust the number and kind of shares or the exercise price with respect to any option. No stock option may be exercised if such exercise would jeopardize Wells REIT II s status as a REIT under the Internal Revenue Code, and no stock option may be granted if the grant, when combined with those issuable upon exercise of outstanding options or warrants granted to Wells REIT II s advisor, directors, officers or any of their affiliates, would exceed 10% of Wells REIT II s issued and outstanding shares. No option may be sold, pledged, assigned or transferred by an employee in any manner other than by will or the laws of descent or distribution.

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Independent Director Stock Option Plan

The Director Stock Option Plan (the Director Plan) adopted by the board of directors and stockholder of Wells REIT II provides for grants of stock to be made to independent non-employee directors of Wells REIT II. A total of 100,000 shares have been authorized and reserved for issuance under the Director Plan. As Wells REIT II has not broken escrow at December 31, 2003, no options have been granted under the plan; therefore all 100,000 shares are available for independent director stock option grants, subject to limitations set forth in the charter.

Options to purchase 2,500 shares of common stock at the greater of $12 per share or the Fair Market Value (as defined in the Director Plan) are granted upon initially becoming an independent director of Wells REIT II, or at the date the stockholders approved the Director Plan. Of these shares, 20% are exercisable immediately on the date of grant. An additional 20% of these shares become exercisable on each anniversary following the date of grant for a period of four years. Additionally, effective on the date of each annual stockholder meeting, beginning in 2004, each independent director will be granted an option to purchase 1,000 additional shares of common stock at the greater of (1) $12 per share or (2) the Fair Market Value. These options are 100% exercisable at the completion of two years of service after the date of grant. All options granted under the Director Plan expire no later than the tenth anniversary of the date of grant and may expire sooner if the independent director dies, is disabled, or ceases to serve as a director. In the event that the potential benefits of the stock options may be inappropriately diluted or enlarged as a result of a certain corporate transaction or event, a corresponding adjustment to the consideration payable with respect to all stock options shall be made. No stock option may be exercised if such exercise would jeopardize Wells REIT II s status as a REIT under the Internal Revenue Code, and no stock option may be granted if the grant, when combined with those issuable upon exercise of outstanding options or warrants granted to Wells REIT II s advisor, directors, officers or any of their affiliates, would exceed 10% of Wells REIT II s issued and outstanding shares. No option may be sold, pledged, assigned or transferred by an independent director in any manner other than by will or the laws of descent or distribution.

Dividend Reinvestment Plan

The dividend reinvestment plan (the DRP) adopted by the board of directors and stockholder of Wells REIT II allows common stockholders to elect to reinvest an amount equal to the dividends declared on their common shares in additional shares of Wells REIT II s common stock in lieu of receiving cash dividends. Under the plan as amended by the board of directors, shares may be purchased by eligible stockholders at the higher of $9.55 per share or 95% of the estimated per share value, as estimated by the Advisor or another firm chosen by the board of directors for that purpose. Participants in the DRP may purchase fractional shares so that 100% of the dividends will be used to acquire shares of the Wells REIT II s stock. Wells REIT II will pay selling commissions of 5.0% in connection with sales under the DRP to the extent it paid commissions on the shares to which the dividends relate. No dealer manager fees will be paid on shares issued under the DRP. The board of directors, by majority vote, may amend or terminate the DRP for any reason upon 10 days prior written notice to the participants of the DRP. Participants may purchase shares under the DRP as long as a registration statement registering such DRP shares remains effective unless all 185,000,000 shares reserved under the DRP have been sold.

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Share Redemption Program

As Wells REIT II s stock is currently not listed on a national exchange, there is no market for Wells REIT II s stock. As a result, there is risk that a stockholder may not be able to sell Wells REIT II s stock at a time or price acceptable to the shareholder. The board of directors of Wells REIT II has approved a share redemption program for stockholders who hold their shares for more than one year, subject to certain limitations and penalties. The share redemption program as amended provides that Wells REIT II may repurchase a stockholder s stock for $8.40 per share. This redemption price will remain fixed until three years after Wells REIT II completes its initial public offering or any subsequent public equity offerings (other than secondary offerings or offerings related to a dividend reinvestment plan, employee benefit plan or the issuance of shares upon redemption of interests in Wells OP II). Thereafter, the redemption price would equal 95% of the per share value of Wells REIT II as estimated by the Advisor or another firm chosen by the board of directors for that purpose. However, redemptions sought upon the death of a stockholder do not require a one-year holding period, and the redemption price is the amount paid for the shares until three years after completion of the above-mentioned offering stage. At that time, the redemption price would be the higher of the amount paid for the shares or 100% of the Advisor s estimated per share net asset value. The shares redeemed under the plan other than upon the death of a stockholder may not exceed the lesser of (i) the amount redeemable from proceeds from the sale of shares through the DRP, or (ii) 5% of the weighted average common shares outstanding during the preceding year. The board of directors may amend or terminate Wells REIT II s share redemption program at any time with 30 days notice. At December 31, 2003, no shares have been redeemed under Wells REIT II s share redemption program.

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5. INCOME TAX BASIS NET LOSS

Wells REIT II s income tax basis net loss for the year ended December 31, 2003 is as follows:

GAAP basis financial statement net loss	$ (470)
Increase (decrease) in net loss resulting from:	
Expenses deductible for financial reporting purposes, not deductible for income tax purposes	470
Income tax basis net loss, prior to dividends paid deduction	$ (0)

6. RELATED-PARTY TRANSACTIONS

Advisory Agreement

Wells REIT II has entered into an Advisory Agreement with the Advisor, which entitles the Advisor to earn specified fees upon the completion of certain services with regard to the investment of funds in real estate projects and sales of properties, among other services.

The Advisor will incur or pay organization and offering costs (other than selling commissions, the dealer manager fee and the reimbursable due diligence expenses of participating dealers) of Wells REIT II. These costs include Wells REIT II s legal, accounting, printing, and filing fees and other offering expenses, such as the salaries of the Advisor s employees and other costs of the Advisor relating to the preparation of supplemental sales materials and holding educational conferences. If Wells REIT II raises $2,500,000 from the sale of capital stock to the public, Wells REIT II is obligated to reimburse the Advisor for those costs in an amount equal to the lesser of actual costs incurred or 2% of the gross proceeds from the offering and sale of shares of common stock to the public. As of December 31, 2003, the Advisor had incurred organization and offering expenses on behalf of Wells REIT II of approximately $3,200,000, for which Wells REIT II will reimburse the Advisor upon the sale of shares to the public.

Change in fair value, net 27,205 46,309 (8,981) 6,525 71,058 Ending Fair Value $134,950 $132,555 $43,828 $20,286 $331,619

During the second quarter of 2011, we sold all remaining securities at the Fund. We recognized $2 million of OTTI on these securities in the year ended December 31, 2011. In addition to the $231 million of real estate securities included in the table above, consolidated Acacia securitization entities owned $15 million of ABS issued by Sequoia securitization entities, and $12 million in commercial loans at December 31, 2011.

Derivative Financial Instruments at Acacia Securitization Entities

At December 31, 2011, consolidated Acacia securitization entities were party to interest rate agreements with a notional value of $1.3 billion and a net aggregate fair value of negative $60 million. Derivative obligations of Acacia entities are payable solely from the assets of those Acacia entities that have entered into the corresponding derivative contracts and are not legal obligations of Redwood. These derivatives are accounted for as trading instruments with all changes in value and any net payments and receipts recognized through market valuation adjustments, net, in our consolidated statements of income.

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Capital Resources and Liquidity

Set forth below is a discussion of our short- and long-term debt and contractual obligations and commitments, as well as a discussion of asset-backed securities issued. For additional discussion of our capital resources and liquidity see *Summary of Financial Condition, Capital Resources, and Liquidity* above.

Debt at Redwood

At December 31, 2011, we had $428 million of short-term debt outstanding. For the year ended December 31, 2011, the average balance of short-term debt outstanding was $57 million, with a weighted average interest rate of 1.82%. For the year ended December 31, 2011, the highest balance of our short-term debt outstanding was $428 million. In the ordinary course of our business, we may utilize short-term recourse debt through several different types of borrowing facilities and use cash borrowings under these facilities to, among other things, fund the acquisition of residential loans we acquire in anticipation of securitization, fund the origination of commercial loans, finance investments in securities and other investments, and otherwise fund our business and operations. At December 31, 2011, we had two residential loan warehouse facilities with a total outstanding debt balance of $307 million (secured by residential loans with an aggregate value in excess of the outstanding debt) and a total borrowing limit of $400 million. Each residential loan financed under one of our residential loan warehouse facilities can only be financed for a maximum number of days (generally less than 12 months), after which the financing expires and must be repaid. We generally intend to repay the short-term financing of a loan under one of those facilities at or prior to the expiration of that financing with the proceeds of a securitization or other sale of that loan, through the proceeds of other short-term borrowings, or with other equity or long-term debt capital.

In addition, at December 31, 2011, we had an aggregate outstanding short-term debt balance of $121 million under four securities repurchase facilities (secured by securities with a fair market value of approximately $180 million). The financing for each security financed under one of our securities repurchase facilities is limited in its initial duration to a maximum number of days (generally 90 days or less). We generally intend to repay the short-term financing of a security under one of these facilities through a renewal of that financing with the same counterparty, through a sale of the security, or with other equity or long-term debt capital. At December 31, 2011, we also had one secured line of credit with no outstanding debt balance and a total borrowing limit of $10 million (secured by securities with a fair market value in excess of $10 million). During the first quarter of 2012, we established two additional securities repurchase facilities with financial institution counterparties.

At December 31, 2010, we had $44 million of short-term debt (collateralized by mortgage-backed securities) that was used to fund the acquisition of mortgage loans that we intended to securitize. This debt matured and was repaid in March 2011, near the time those mortgage loans were securitized.

In 2006 and 2007, we issued a total of $100 million and $50 million of long-term debt, respectively. This debt requires quarterly distributions at a floating rate equal to three-month LIBOR plus 2.25% until the notes are redeemed in whole. Beginning in the first quarter of 2010, we entered into interest rate swaps with aggregate notional values currently totaling $140 million to hedge the variability in our long-term debt interest expense, fixing our gross interest expense yield at 6.75%. These swaps are accounted for as cash flow hedges with all interest income recorded as a component of net interest income and other valuation changes recorded as a component of equity.

Asset-Backed Securities Issued at the Resecuritization Entity

In July 2011, Redwood transferred $365 million of residential securities into a resecuritization trust, with $245 million of ABS issued to third parties. At December 31, 2011, there were $325 million of securities owned at the resecuritization, which were funded with $220 million of ABS issued. Since resecuritization, the ABS issued has paid down $25 million.

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Asset-Backed Securities Issued at Securitization Entities

At December 31, 2011, there were $3.8 billion of loans owned at Sequoia securitization entities, which were funded with $3.7 billion of ABS issued at Sequoia entities. These loans and ABS issued are reported at their unpaid principal balances net of any unamortized premium or discount. To date, credit losses have not yet been incurred on any of the senior securities issued by consolidated Sequoia securitization entities, although we expect that some of these senior securities may incur losses in the future, depending on the magnitude and timing of additional credit losses incurred on the underlying loans. At December 31, 2011, there were $231 million of securities owned by Acacia securitization entities and reported at fair value, which were funded with $209 million of ABS issued by Acacia entities that were also reported at fair value.

The following tables provide detail on the activity for asset-backed securities issued by the Sequoia and Acacia securitization entities we consolidate for financial reporting purposes for the years ended December 31, 2011 and 2010.

Table 31 ABS Issued Activity Securitization Entities

Year Ended December 31, 2011

(In Thousands)	New Sequoia	Legacy Sequoia	Acacia	Total
Balance at beginning of period	$ 123,146	$ 3,335,355	$ 303,077	$ 3,761,578
New issuance, net of discount	641,838	1,345		643,183
Paydowns	(133,646)	(253,667)	(80,006)	(467,319)
Extinguishment of debt		(919)		(919)
Amortization	(387)	(2,642)		(3,029)
Valuation adjustments			(13,690)	(13,690)
Balance at End of Period	$ 630,951	$ 3,079,472	$ 209,381	$ 3,919,804

Year Ended December 31, 2010

(In Thousands)	New Sequoia	Legacy Sequoia	Acacia	Total
Balance at beginning of period	$	$ 3,644,933	$ 297,596	$ 3,942,529
New issuance, net of discount	211,178			211,178
Paydowns	(88,032)	(289,486)	(77,828)	(455,346)
Extinguishment of debt		(16,031)		(16,031)
Amortization		(4,061)		(4,061)
Valuation adjustments			83,309	83,309
Balance at End of Period	$ 123,146	$ 3,335,355	$ 303,077	$ 3,761,578

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The following table presents our contractual obligations and commitments at December 31, 2011, as well as the obligations of the securitization entities that we sponsor and consolidate for financial reporting purposes.

Table 32 Contractual Obligations and Commitments

	Payments Due or Commitment Expiration by Period				
December 31, 2011 (In Millions)	Less Than 1 Year	1 to 3 Years	3 to 5 Years	After 5 Years	Total
Obligations of Redwood					
Short-term debt	$ 428	$	$	$	$ 428
Long-term debt				140	140
Anticipated interest payments on long-term debt	4	9	11	149	173
Accrued interest payable	1				1
Operating leases	2	4	3	2	11
Purchase commitments	460				460
Total Redwood Obligations and Commitments	$ 895	$ 13	$ 14	$ 291	$ 1,213
Obligations of Consolidated Entities					
Consolidated ABS(1)	$	$ 50	$	$ 6,803	$ 6,853
Anticipated interest payments on ABS(2)	127	236	226	1,214	1,803
Accrued interest payable	7				7
Total obligations of Consolidated Entities	134	286	226	8,017	8,663
Total Consolidated Obligations and Commitments	$ 1,029	$ 299	$ 240	$ 8,308	$ 9,876

(1) All consolidated ABS issued are collateralized by real estate loans and securities. Although the stated maturity is as shown, the ABS obligations will pay down as the principal balances of these real estate loans or securities pay down. The amount shown is the principal balance of the ABS issued and not necessarily the value reported in our consolidated financial statements.

(2) The anticipated interest payments on consolidated ABS issued is calculated based on the contractual maturity of the ABS and therefore assumes no prepayments of the principal outstanding at December 31, 2011.

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Potential GAAP Earnings Volatility

We expect quarter-to-quarter GAAP earnings volatility from our business activities. This volatility can occur for a variety of reasons, including the timing and amount of purchases, sales, calls, and repayment of consolidated assets, changes in the fair values of consolidated assets and liabilities, and certain non-recurring events. In addition, the amount or timing of our reported earnings may be impacted by technical accounting issues, some of which are described below.

Changes in Premium Amortization for Loans

The net unamortized premium for loans owned at Sequoia Entities and at Redwood was $36 million at December 31, 2011. The amount of periodic premium amortization expense we recognize is volatile and dependent on a number of factors, including credit performance of the underlying loans, changes in prepayment speeds, and changes in short-term interest rates. Loan premium amortization was $7 million in the both 2011 and 2010.

Changes in Allowance for Loan Losses

For real estate loans classified as held-for-investment, we establish and maintain an allowance for loan losses based on our estimate of credit losses inherent in our loan portfolios at the reporting date. To calculate the allowance for loan losses, we assess inherent losses by determining loss factors (defaults, loss severities on default liquidations, and the timing of default liquidations) that can be specifically applied to each of the consolidated loans or pools of loans.

Changes in actual defaults or our expectations on loss severities and default timing can have a significant effect on periodic income.

Changes in the Fair Value of Residential and Commercial Loans Classified as Held-for-Sale

The majority of unsecuritized residential loans on our consolidated balance sheets are being held for future securitizations and will be sold to non-consolidated entities. At the time of purchase, we may elect the fair value option for these loans or classify them as held-for-sale. For loans for which we have elected the fair value option, changes in fair values are recorded in market valuation adjustments through the consolidated statements of income in the period in which the valuation change occurs. Periodic fluctuations in the values of these investments are inherently volatile and thus can lead to significant period-to-period GAAP earnings volatility.

Loans classified as held-for-sale are carried at the lower of their cost basis or fair value. If the fair value of loans classified as held-for-sale is lower than their cost basis, the difference is reported as a negative market valuation adjustment through our consolidated statements of income.

The fair value of loans is affected by, among other things, changes in interest rates, credit performance, prepayments, and market liquidity. To the extent interest rates change or market liquidity and or credit conditions materially change, the value of these loans could decline below their cost basis, which could have a material effect on reported earnings.

Changes in Yields for Securities

The yields we project on real estate securities can have a significant effect on the periodic interest income we recognize for financial reporting purposes. Yields can vary as a function of credit results, prepayment rates, and interest rates. If estimated future credit losses are less than our prior estimate, credit losses occur later than expected, or prepayment rates are faster than expected (meaning the present value of projected cash flows is greater than previously expected for assets acquired at a discount to principal balance), the yield over the remaining life of the security may be adjusted upwards. If estimated future credit losses exceed our prior expectations, credit losses occur more quickly than expected, or prepayments occur more slowly than expected (meaning the present value of projected cash flows is less than previously expected for assets acquired at a discount to principal balance), the yield over the remaining life of the security may be adjusted downward.

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Changes in the actual maturities of real estate securities may also affect their yields to maturity. Actual maturities are affected by the contractual lives of the associated mortgage collateral, periodic payments of principal, and prepayments of principal. Therefore, actual maturities of AFS securities are generally shorter than stated contractual maturities. Stated contractual maturities are generally greater than ten years. There is no assurance that our assumptions used to estimate future cash flows or the current period s yield for each asset will not change in the near term, and any change could be material.

Changes in Fair Values of Securities

All securities owned at Redwood and consolidated entities are classified as either trading or AFS securities, and in both cases are carried on our consolidated balance sheets at their estimated fair values. For trading securities, changes in fair values are recorded in the consolidated statements of income. Periodic fluctuations in the values of these investments are inherently volatile and thus can lead to significant GAAP earnings volatility each quarter.

For AFS securities, cumulative unrealized gains and losses are recorded as a component of accumulated other comprehensive (loss) income in our consolidated statements of changes in equity. Unrealized gains and losses are not charged against current earnings to the extent they are temporary in nature. Certain factors may require us, however, to recognize these amounts as other-than-temporary impairments and record them through our current earnings. Factors that determine other-than-temporary-impairment include a change in our ability or intent to hold assets, adverse changes to projected cash flows of assets, or the likelihood that declines in the fair values of assets would not return to their previous levels within a reasonable time. Impairments can lead to significant GAAP earnings volatility each quarter.

Changes in Fair Values of Derivative Financial Instruments

We can experience significant earnings volatility from our use of derivatives. We generally use derivatives to manage risks associated with residential loans we own or plan to acquire and securitize, commercial loans we own, variability in interest expense indexed to adjustable rates, and cash flows on assets and liabilities that have different coupon rates (fixed rates versus floating rates, or floating rates based on different indices). The nature of the instruments we use and the accounting treatment for the specific assets, liabilities, and derivatives may therefore lead to volatility in our periodic earnings, even when we are meeting our hedging objectives.

Some of our derivatives are accounted for as trading instruments with all associated changes in value recorded through our consolidated statements of income. Changes in value of the assets and liabilities we manage by using derivatives may not be accounted for similarly. This could lead to reported income and book values in specific periods that do not necessarily reflect the economics of our risk management strategy. Even when the assets and liabilities are similarly accounted for as trading instruments, periodic changes in their values may not coincide as other market factors (e.g., supply and demand) may affect certain instruments and not others at any given time.

Changes in Loss Contingency Reserves

We may be exposed to various loss contingencies, including, without limitation, those described in *Note 14* to the financial statements included in Part IV, Item 15 of this Annual Report on Form 10-K. In accordance with FASB guidance on accounting for contingencies, we review the need for any loss contingency reserves and establish them when, in the opinion of management, it is probable that a matter would result in a liability, and the amount of loss, if any, can be reasonably estimated. The establishment of a loss contingency reserve, the subsequent increase in a reserve or release of reserves previously established, or the recognition of a loss in excess of previously established reserves, can occur as a result of various factors and events that affect management s opinion of whether the standard for establishing, increasing, or continuing to maintain, a reserve has been met. Changes in the loss contingency reserves can lead to significant GAAP earnings volatility each quarter.

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Results of Operations Taxable Income

The following table summarizes our taxable income and distributions to shareholders for the years ended December 31, 2011, 2010, and 2009. For each of these years, we had no undistributed REIT taxable income.

Table 33 Taxable Income

	Years Ended December 31,		
(In Thousands)	2011 est.[(1)]	2010	2009
REIT taxable income (loss)	$ 19,269	$ 3,383	$ (69,819)
Taxable REIT subsidiary loss	(10,675)	(19,346)	(13,739)
Total Estimated Taxable Income (Loss)	$ 8,594	$ (15,963)	$ (83,558)
Distributions to shareholders	$ 78,382	$ 77,942	$ 73,284

(1) Our tax results for the year ended December 31, 2011, are estimates until we file tax returns for this year.

Our estimated total taxable income for the year ended December 31, 2011, was $9 million ($0.11 per share) and included $58 million in realized credit losses on investments. This compared to a total taxable loss for the year ended December 31, 2010, of $16 million ($0.20 per share) that included $100 million in credit losses. For the year ended December 31, 2009, our taxable loss was $84 million ($1.12 per share) and included $224 million in credit losses.

Taxable Income Distribution Requirement

As a REIT, we are required to distribute at least 90% of our taxable income, after the application of federal net operating loss carry forwards (NOLs), to our shareholders. For 2011, our estimated REIT taxable income of $19 million did not exceed our available NOLs, and therefore our minimum dividend distribution requirement was zero. The following table details our federal NOLs and capital loss carry forwards available as of December 31, 2011.

Table 34 Federal Net Operating and Capital Loss Carry Forwards

	Loss Carry Forward Expiration by Period				
(In Thousands)	1 to 3 Years	3 to 5 Years	5 to 15 Years	After 15 Years	Total
REIT Loss Carry Forwards					
Net operating loss	$	$	$	$ (69,819)	$ (69,819)
Capital loss	(81,340)	(17,703)			(99,043)
Total REIT Loss Carry Forwards	$ (81,340)	$ (17,703)	$	$ (69,819)	$ (168,863)
TRS Loss Carry Forwards					
Net operating loss	$	$	$	$ (30,175)	$ (30,175)
Capital loss	(21,423)	(21,039)			(42,462)
Total TRS Loss Carry Forwards	$ (21,423)	$ (21,039)	$	$ (30,175)	$ (72,637)

As of December 31, 2011, we maintained $70 million of NOLs at the REIT level. In order to utilize these carry forwards, taxable income must exceed our dividend distributions. During 2011, we distributed $80 million to shareholders and exceeded our distribution requirement. We do not expect to report any REIT taxable income on our 2011 federal income tax return after the application of a dividends paid deduction. As a result, we do not expect any of our federal NOLs at the REIT level to be utilized in 2011. Federal NOLs at the REIT level do not expire until 2029. Federal NOLs at the TRS level expire between 2030 and 2031.

Federal capital loss carry forwards of $99 million and $42 million at the REIT and TRS, respectively, will expire between 2013 and 2016. In order to utilize these carry forwards, the respective entities must recognize capital gains in excess of capital losses before the expiration dates. Utilization of capital loss carry forwards by the REIT reduces the REIT s taxable income and distribution requirement. Capital loss carry forwards do not reduce the taxability of dividends to shareholders.

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Tax Characteristics of Distributions to Shareholders

For the year ended December 31, 2011, we declared and distributed four regular quarterly dividends totaling $1.00 per share. Under the federal income tax rules applicable to REITs, the taxable portion of any distribution to shareholders in excess of the minimum requirement is determined by i) taxable income of the REIT, exclusive of the dividends paid deduction and NOLs; and, ii) net capital gains recognized by the REIT, exclusive of capital loss carry forwards.

Our 2011 dividend distributions are expected to be characterized for income tax purposes as 25% ordinary income and 75% return of capital. Thus, we expect approximately $19 million of our 2011 dividend distributions to be characterized as ordinary income to shareholders, as this amount represents the taxable income we generated in 2011 prior to the application of a dividends paid deduction and NOLs in accordance with federal income tax rules. Of this amount, none is attributable to net capital gains recognized for tax purposes. The remaining $59 million of dividend distributions are expected to be characterized as a return of capital to shareholders and are generally not taxable. A distribution of capital reduces the tax basis for common shares held by a shareholder at each quarterly distribution date (provided the distribution does not exceed a shareholder s tax basis in our common shares).

In November 2011, our board of directors announced its intention to pay a regular dividend of $0.25 per share, per quarter in 2012.

Differences between Estimated Taxable Income and GAAP Income

Differences between estimated taxable income and GAAP income are largely due to the following: (i) we cannot establish loss reserves for future anticipated events for tax but can for GAAP as realized credit losses are expensed when incurred for tax and these losses are anticipated through lower yields on assets or through loss provisions for GAAP; (ii) the timing, and possibly the amount, of some expenses (e.g., compensation expenses) are different for tax than for GAAP; (iii) since amortization and impairments differ for tax and GAAP, the tax and GAAP gains and losses on sales may differ, resulting in differences in realized gains on sale; (iv) for tax, realized capital gains on sales may be offset by prior capital losses; (v) unrealized gains and losses on market valuation adjustments of securities and derivatives are not recognized for tax until the instrument is sold or extinguished; and, (vi) for tax, we do not consolidate noncontrolling interests or securitization entities as we do under GAAP. As a result of these differences in accounting, our estimated taxable income can vary significantly from our GAAP income during certain reporting periods.

The Redwood REIT s tax basis in its assets and liabilities was $1.9 billion and $0.5 billion, respectively, at December 31, 2011. The Redwood REIT s GAAP basis in its assets and liabilities was $4.9 billion and $3.9 billion, respectively, at December 31, 2011. The primary difference in both the tax and GAAP assets and liabilities is attributable to securitization entities that are consolidated for GAAP reporting purposes but not for tax purposes.

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The tables below reconcile our estimated taxable income to our GAAP income for the years ended December 31, 2011, 2010, and 2009.

Table 35 Differences between Estimated Taxable Income (Loss) and GAAP Net Income

	Year Ended December 31, 2011		
(In Thousands, Except per Share Data)	Tax est.	GAAP	Differences
Interest income	$ 128,353	$ 217,179	$ (88,826)
Interest expense	(16,759)	(99,037)	82,278
Net interest income	111,594	118,142	(6,548)
Provision for loan losses		(16,151)	16,151
Realized credit losses	(57,526)		(57,526)
Market valuation adjustments, net		(40,017)	40,017
Operating expenses	(45,459)	(47,682)	2,223
Realized gains on sales and calls, net		10,946	(10,946)
Provision for income taxes	(15)	(42)	27
Less: Net loss attributable to noncontrolling interest		(1,147)	1,147
Net Income	$ 8,594	$ 26,343	$ (17,750)
Income per share	$ 0.11	$ 0.31	$ (0.20)

	Year Ended December 31, 2010		
(In Thousands, Except per Share Data)	Tax	GAAP	Differences
Interest income	$ 136,750	$ 230,054	$ (93,304)
Interest expense	(8,545)	(84,664)	76,119
Net interest income	128,205	145,390	(17,185)
Provision for loan losses		(24,135)	24,135
Realized credit losses	(99,586)		(99,586)
Market valuation adjustments, net		(19,554)	19,554
Operating expenses	(44,804)	(53,715)	8,911
Realized gains on sales and calls, net	230	63,496	(63,266)
Provision for income taxes	(8)	(280)	272
Less: Net income attributable to noncontrolling interest		1,150	(1,150)
Net (Loss) Income	$ (15,963)	$ 110,052	$ (126,015)
(Loss) income per share	$ (0.20)	$ 1.36	$ (1.56)

	Year Ended December 31, 2009		
(In Thousands, Except per Share Data)	Tax	GAAP	Differences
Interest income	$ 192,922	$ 287,877	$ (94,955)
Interest expense	(4,955)	(132,003)	127,048
Net interest income	187,967	155,874	32,093
Provision for loan losses		(49,573)	49,573

Realized credit losses	(223,903)		(223,903)
Market valuation adjustments, net		(87,628)	87,628
Operating expenses	(54,234)	(46,995)	(7,239)
Realized gains on sales and calls, net	6,625	63,166	(56,541)
(Provision for) benefit from income taxes	(13)	4,268	(4,281)
Less: Net loss attributable to noncontrolling interest		(83)	83
Net (Loss) Income	$ (83,558)	$ 39,195	$ (122,753)
(Loss) income per share	$ (1.12)	$ 0.55	$ (1.67)

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Potential Taxable Income Volatility

We expect period-to-period estimated taxable income volatility for a variety of reasons, including those described below.

Credit Losses on Securities and Loans

To determine estimated taxable income, we are generally not permitted to anticipate, or reserve for, credit losses on investments which are generally purchased at a discount. For tax purposes, we accrue the entire purchase discount on a security into taxable income over the expected life of the security. Estimated taxable income is reduced when actual credit losses occur. For GAAP purposes, we establish a credit reserve and only accrete a portion of the purchase discount, if any, into income and write-down securities that become impaired. Our income recognition is therefore faster for tax as compared to GAAP, especially in the early years of owning a security (when there are generally few credit losses). At December 31, 2011, the cumulative difference between the GAAP and tax amortized cost basis of our residential, commercial, and CDO subordinate securities (excluding our investments in our securitization entities) was $127 million.

As we have no credit reserves or allowances for tax, any future credit losses on securities or loans will have a more significant impact on tax earnings than on GAAP earnings and may create significant taxable income volatility to the extent the level of credit losses fluctuates during reporting periods. During the years ended December 31, 2011 and 2010, we realized $58 million and $100 million, respectively, of credit losses on securities for tax that we had previously provisioned for under GAAP. We anticipate that credit losses will continue to be a significant factor for determining 2012 taxable income. Credit losses are based on our tax basis, which differs materially from our basis for GAAP purposes. We anticipate an additional $138 million of credit losses for tax on securities, based on our projection of principal balance losses and assuming a similar tax basis as we have recently experienced, although the timing of actual losses is difficult to accurately project. At December 31, 2011, for GAAP we had a designated credit reserve of $296 million on our securities, and an allowance for loan losses of $67 million for our consolidated residential and commercial loans.

Recognition of Gains and Losses on Sale

Since amortization and impairments on assets differ for tax and GAAP, the tax and GAAP basis on assets sold or called may differ, resulting in differences in gains and losses on sale or call. In addition, gains realized for tax may be offset by prior capital losses and, thus, not affect taxable income. At December 31, 2011, the REIT had an estimated $99 million in capital loss carry-forwards ($1.26 per share) that can be used to offset future capital gains over the next three to five years. Since our intention is to generally invest in assets for the long-term, it is difficult to anticipate when sales may occur and, thus, when or whether we might exhaust these capital loss carry-forwards.

Prepayments on Securities

As part of our investment in Sequoia securitization entities, we have retained IOs at the time they are issued. Our current tax basis in these securities is $23 million. The return on IOs is sensitive to prepayments and, to the extent prepayments vary period to period, income from these IOs will vary. Typically, fast prepayments reduce yields and slow prepayments increase yields. We are not permitted to recognize a negative yield under tax accounting rules, so during periods of fast prepayments our periodic premium expense for tax purposes can be relatively low and the tax cost basis for these securities may not be significantly reduced. In periods prior to 2008, we did experience fast prepayments on the loans underlying our IOs. More recently, prepayments have been slowing, and our tax basis is now below the fair values for these IOs in the aggregate. Most of our Sequoia securitizations are callable or will become callable over the next two years, although we do not currently anticipate calling any Sequoia securitizations in the foreseeable future. If we do call a Sequoia securitization, the remaining tax basis in the IO is written off, creating an ordinary loss at the call date.

Prepayments also affect the taxable income recognition on other securities we own. We are required to use particular prepayment assumptions for the remaining lives of each security. As actual prepayment speeds vary, the yield we recognize for tax purposes will be adjusted accordingly. Thus, to the extent prepayments differ from our long-term assumptions or vary from period to period, the yield recognized will also vary and this difference could be material for a specific security.

Compensation Expense

The total tax expense for equity award compensation is dependent upon varying factors such as the timing of payments of dividend equivalent rights, the exercise of stock options, the distribution of deferred stock units and preferred stock units, and the cash deferrals to and withdrawals from our Executive Deferred Compensation Plan. For GAAP, the total expense associated with an equity award is determined at the award date and is recognized over the vesting period. For tax, the total expense is recognized at the date of distribution or exercise, not the award date. In addition, some compensation may not be deductible for tax if it exceeds certain levels and is not performance-based. Thus, the total amount of compensation expense, as well as the timing, could be significantly different for tax than for GAAP.

As an example, for GAAP we expense the grant date fair value of PSUs granted over the vesting term of those PSUs (regardless of the degree to which the performance conditions for vesting are ultimately satisfied, if at all), whereas for tax the value of the PSUs that actually vest in accordance with the performance conditions of those awards and are subsequently distributed to the award recipient is recorded as an expense on the date of distribution. If no PSUs under a particular grant ultimately vest, due to the failure to satisfy the performance conditions, no tax expense will be recorded for those PSUs, even though we would have already recorded expense for GAAP equal to the grant date fair value of the PSU awards. Conversely, if performance is such that a number of shares of common stock equal to 200% of the PSU award ultimately vest and are delivered to the award recipient, expense for tax will equal the common stock value on the date of distribution of 200% of the number of PSUs originally granted. This expense for tax could significantly exceed the recorded expense for GAAP.

In addition, since the decision to exercise options or distribute deferred stock units, preferred stock units, or cash out of the Executive Deferred Compensation Plan is an employee s, it can be difficult to project when the tax expense will occur.

Critical Accounting Policies

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates. A discussion of critical accounting policies and the possible effects of changes in estimates on our financial statements is included in Note 3 Summary of Significant Accounting Policies included in Item 8 of this Annual Report on Form 10-K. Management discusses the ongoing development and selection of these critical accounting policies with the audit committee of the board of directors.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risks

We seek to manage the risks inherent in our business including but not limited to credit risk, interest rate risk, prepayment risk, liquidity risk, and fair value risk in a prudent manner designed to enhance our earnings and dividends and preserve our capital. In general, we seek to assume risks that can be quantified from historical experience, to actively manage such risks, and to maintain capital levels consistent with these risks. This section presents a general overview of these risks. Additional information concerning the risks we are managing, how these risks are changing over time, and potential GAAP earnings and taxable income volatility we may experience as a result of these risks is further discussed in Part II, Item 7 of this Annual Report on Form 10-K.

Credit Risk

Integral to our core business is assuming the credit risk of real estate loans primarily through the ownership of residential and commercial loans and securities. Some of our capital base is employed in owning credit enhancement securities that have below investment-grade credit ratings due to their concentrated credit risks with respect to underlying real estate loans and investment-grade securities. We believe that many of the loans underlying these securities are above-average in credit quality as compared to U.S. real estate loans in general (although there may nevertheless be significant credit losses related to these loans). We may also own residential loans that are not securitized.

Credit losses from the loans in securitized loan pools, in general, first reduce the principal value of and economic returns on the lower-rated securities in these pools. Credit losses on real estate loans can occur for many reasons, including: poor origination practices; fraud; faulty appraisals; documentation errors; poor underwriting; legal errors; poor servicing practices; weak economic conditions; decline in the value of homes, businesses, or commercial properties; special hazards; earthquakes and other natural events; over-leveraging of the borrower or on the property; reduction in market rents and occupancies and poor property management practices; changes in legal protections for lenders; reduction in personal incomes; job loss; and personal events such as divorce or health problems. In addition, if the U.S. economy or the housing market weakens further than we have anticipated, our credit losses could increase beyond levels that we have anticipated. Credit losses on real estate loans can vary for reasons not related to the general economy.

With respect to most of the loans securitized by securitization entities sponsored by us and for a portion of the loans underlying residential loan securities we have acquired from securitizations sponsored by others, the interest rate is adjustable. Accordingly, when short-term interest rates rise, required monthly payments from homeowners may rise under the terms of these loans, and this may increase borrowers delinquencies and defaults.

We also own securities backed by negative amortization adjustable-rate loans made to residential borrowers, some of which are prime-quality loans while many are Alt-A quality loans (and a few are subprime loans). We invest in these riskier loan types with the expectation of significantly higher delinquencies and losses as compared to regular amortization loans, but believe these securities offer us the opportunity to generate attractive risk-adjusted returns as a result of attractive pricing and the manner in which these securitizations are structured. Nevertheless, there remains substantial uncertainty about the future performance of these assets.

The commercial loans we credit-enhance are typically fixed-rate loans, the majority of which are interest-only loans. In general, these loans are subordinate to other financings of the same commercial property and not fully amortizing and therefore require balloon payments at maturity. Consequently, we could be exposed to credit losses at the maturity of these loans if the borrower is unable to repay or refinance the borrowing with another third-party lender.

We will experience credit losses on residential and commercial loans and securities, and to the extent the losses are consistent with the amount and timing of our assumptions, we expect to earn attractive returns on our investments. We manage our credit risks by analyzing the extent of the risk we are taking and reviewing whether we believe the appropriate underwriting criteria are met, and we utilize systems and staff to monitor the ongoing credit performance of each loan and security. To the extent we find the credit risks on specific assets are changing adversely, we may be able to take actions (which may include selling the assets) to mitigate potential losses. However, we may not always be successful in analyzing risks, reviewing underwriting criteria, foreseeing adverse changes in credit performance or in effectively mitigating future credit losses and the ability to sell an asset may be limited due to the structure of the asset or the absence of a liquid market for the asset.

In addition to residential and commercial subordinate securities, Redwood and Acacia own senior and other securities issued by securitization entities that are sponsored by others. A risk we face with respect to these securities is that we do not generally control or influence the underwriting, servicing, management, or loss mitigation with respect to these underlying loans.

The Acacia entities and Redwood also own securities backed by subprime and Alt-A residential loans that have substantially higher credit risk characteristics than prime-quality loans. Consequently, we can expect these lower-quality loans to have higher rates of delinquency and loss, and if such losses differ from our assumptions, Acacia, and Redwood could suffer losses.

The Acacia entities also own certain senior securities and subordinate securities purchased from the Sequoia securitization entities we sponsor. If the pools of residential and commercial loans underlying these securities were to experience poor credit results, these securities could suffer decreases in fair value, or could experience principal losses. If any of these events occurs, it would likely reduce our returns from these investments.

We are also exposed to credit risk with respect to our business counterparties. For example, counterparties we acquire loans from, lend to, or invest in, make representations and warranties and covenants to us, and may also indemnify us against certain losses. To the extent we have suffered a loss and are entitled to enforce those agreements to recover damages, if our counterparties are insolvent or unable or unwilling to comply with these agreements we would suffer a loss due to the credit risk associated with our counterparties. As an example, under short-term borrowing facilities and swap and other derivative agreements, we sometimes transfer assets as collateral to our counterparties. To the extent counterparty is not able to return this collateral to us if and when we are entitled its return, we could suffer a loss due to the credit risk associated with that counterparty.

Interest Rate Risk

Changes in interest rates and the shape of the yield curve can affect the cash flows and fair values of our assets, liabilities, and derivative financial instruments and, consequently, affect our earnings and reported equity. Our general strategy with respect to interest rates is to maintain an asset/liability posture (including hedges) on a consolidated basis that assumes some interest rate risks but not to such a degree that the achievement of our long-term goals would likely be affected by changes in interest rates. Accordingly, we are willing to accept short-term volatility of earnings and changes in our reported equity in order to accomplish our goal of achieving attractive long-term returns.

To implement our interest rate risk strategy, we may use derivative financial instruments in an effort to maintain a close match between pledged assets and debt, as well as between the interest rate characteristics of the assets in the securitization entities and the corresponding ABS issued. However, we generally do not attempt to completely hedge changes in interest rates, and at times, we may be subject to more interest rate risk than we generally desire in the long term. Changes in interest rates will have an impact on the values and cash flows of our assets and corresponding liabilities.

Prepayment Risk

We seek to maintain an asset/liability posture that benefits from investments in prepayment-sensitive assets while limiting the risk of adverse prepayment fluctuations to an amount that, in most circumstances, can be absorbed by our capital base while still allowing us to make regular dividend payments.

Prepayments affect GAAP earnings in the near-term primarily through the timing of the amortization of purchase premium and discount and through triggering market valuation adjustments. For example, amortization income from discount assets may not necessarily offset amortization expense from premium assets, and vice-versa. In addition, variations in current and projected prepayment rates for individual assets and changes in interest rates (as they affect projected coupons on ARMs and other assets and thus change effective yield calculations) may cause net premium amortization expense or net discount amortization income to vary substantially from quarter to quarter. Moreover, the timing of premium amortization on assets may not always match the timing of the premium amortization on liabilities even when the underlying assets and liabilities are in the same securitization and pay down at the same rate.

Prepayment risks exist in the assets and associated liabilities consolidated on our balance sheets. In general, discount securities benefit from faster prepayment rates on the underlying real estate loans while premium securities (such as IOs) benefit from slower prepayments on the underlying loans. We note that changes in residential loan prepayment rates could result in GAAP and tax earnings volatility.

With respect to securities backed by residential mortgage loans (and in particular, IOs), changes in prepayment forecasts by market participants could affect the market values of those securities sold by securitization entities, and thus could affect the economics associated with securitizing assets.

Our credit results and risks can also be affected by prepayments. For example, credit risks for the securities we own are reduced each time a loan prepays. All other factors being equal, faster prepayment rates reduce our credit risks on our existing portfolio.

We caution that prepayment rates are difficult to predict or anticipate, and variations in prepayment rates can materially affect our earnings and dividend distribution requirements. ARM prepayment rates, for example, are driven by many factors, one of which is the steepness of the yield curve. As the yield curve flattens (short-term interest rates rise relative to longer-term interest rates), ARM prepayments typically increase. However, for borrowers who have impaired credit or who otherwise do not meet loan underwriting criteria, the ability to refinance (i.e., prepay) a loan even when interest rates decline may be limited.

Fair Value and Liquidity Risks

The residential loans and securities that we acquire are generally funded with a combination of short-term recourse debt and equity or long-term debt and our use of short-term debt to finance these assets might affect our liquidity position. The assets and liabilities at Acacia are accounted for under the fair value option, with all changes in market values being recorded through our income statement. Though this potentially creates earnings volatility, the securities and ABS issued by Acacia entities have no recourse to us that would otherwise affect our liquidity position. In addition, securities that we included in the resecuritization we engaged in during the third quarter of 2011 are legally owned by the resecuritization entity and we are not able to sell these securities as a means of protecting ourselves from any declines in the fair value of these securities.

Most of the real estate loans that we consolidate are accounted for using the held-for-investment GAAP classification and are reported at their amortized cost. Most of these loans have been for legal purposes sold to Sequoia entities and, thus, changes in the fair value of the loans do not have an impact on our liquidity. However, changes in fair values during the accumulation period (while these loans are funded with short-term debt before they are sold to a Sequoia entity) may have a short-term effect on our liquidity. We may also own some real estate loans accounted for as held-for-sale and adverse changes in their value may be recognized through our income statement and may have an impact on our ability to obtain financing for them.

Our consolidated obligations consist primarily of ABS issued. Changes in fair value of ABS issued have no impact on our liquidity. ABS issued by Sequoia and the resecuritization we engaged in during the third quarter of 2011 are reported at amortized cost. We report at fair value the ABS issued by Acacia and also report the underlying securities collateralizing the ABS issued at fair value. In either case, the resulting net equity (assets less liabilities) may not necessarily be reflective of the fair value of our interests in these securitization entities. However, since the ABS issued can only look to the cash flows generated by the assets within that securitization entity for payments of interest and repayments of the principal balance of the ABS, the changes in fair value do not have an effect on Redwood s liquidity. Only to the extent that changes in fair values affect the timing of the cash flows we might receive on our investments in consolidated entities is there an effect to Redwood from changes in fair values of these investments.

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We fund some assets with a combination of short-term debt and equity that is recourse to Redwood. This generally increases our fair value and liquidity risks. We manage these risks by maintaining what we believe to be conservative capital levels under our internal risk-adjusted capital and risk management policies and by ensuring we have a variety of financing facilities available to fund each of our assets. We also manage risk by hedging the loans held for securitization to minimize the fluctuations in value prior to securitization.

Under short-term borrowing facilities and swap and other derivatives agreements, we pledge assets as security for our payment obligations and make various representations and warranties and agree to certain covenants, events of default, and other terms. In addition, our short-term borrowing facilities are generally uncommitted, meaning that each time we request a new borrowing under a facility the lender has the option to decline to extend credit to us. The terms of these facilities and agreements typically include financial covenants (such as covenants to maintain a minimum amount of tangible net worth or stockholders equity and/or a minimum amount of liquid assets), margin requirements (which typically require us to pledge additional collateral if and when the value of previously pledged collateral declines), operating covenants (such as covenants to conduct our business in accordance with applicable laws and regulations and covenants to provide notice of certain events to creditors), representations and warranties (such as representations and warranties relating to characteristics of pledged collateral, our exposure to litigation and/or regulatory enforcement actions and the absence of material adverse changes to our financial condition, our operations, or our business prospects), and events of default (such as a breach of covenant or representation/warranty and cross defaults, under which an event of default is triggered under a credit facility if an event of default or similar event occurs under another credit facility).

Notwithstanding our efforts to manage fair value and liquidity risks, we are exposed to these types of risks due to, among other things, our use of short-term borrowing facilities and our use of interest rate swaps and other derivatives. For example, if there is a decline in value of assets we have pledged to collateralize our obligations under a swap or other derivative or to collateralize our borrowings under a short-term borrowing facility, we would be obligated in response to a margin call to pledge additional collateral, which could occur at a time when we do not have additional collateral available to pledge. As another example, if we breach a covenant or representation/warranty in a short-term borrowing facility, or if a default occurs under one of these facilities or agreements, we could be obligated to repay all outstanding borrowings under that credit facility, which could occur at a time when we do not have cash or other liquid assets in an amount sufficient to satisfy our obligations. Similarly, under a swap or derivative agreement, following a breach or default, we could be obligated to make a termination payment to our counterparty, which could also occur at a time when we do not have cash or other liquid assets in an amount sufficient to satisfy our obligations. In addition, because these borrowing facilities and swap and derivatives agreements generally contain cross-default provisions, if we become obligated to repay borrowings under one facility or to make a termination payment under a swap or derivative agreement, our creditors under other facilities or agreements may exercise their right to require us to make payments or repay the borrowings under the agreements they have with us or under borrowing facilities they have extended to us. To the extent we become obligated to pledge assets or make payments at a time when we do not have sufficient cash or assets available, it could have a material adverse effect on our business and results of operations.

Inflation Risk

Virtually all of our consolidated assets and liabilities are financial in nature. As a result, changes in interest rates and other factors drive our performance more directly than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Separately, inflation or deflation in home prices can affect our credit risk.

Our financial statements are prepared in accordance with GAAP. Our activities and balance sheets are measured with reference to historical cost or fair value without considering inflation.

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Risks Relating to Litigation and Governmental Investigations and Enforcement Actions

Our business exposes us to risks relating to litigation and governmental investigations and enforcement actions. For example, through certain of our wholly-owned subsidiaries we have engaged in securitization transactions relating to residential mortgage loans and other types of assets. In the future we plan to continue to engage in securitization transactions relating to residential mortgage loans and may also engage in other types of securitization transactions or other similar types of transactions. As a result of engaging in this business, we have already been the subject of litigation and have received an inquiry and a subpoena, respectively, from two different governmental authorities in connection with their broad-based investigations of certain aspects of certain securitization markets and issuances. Redwood Asset Management, Inc., one of our subsidiaries, is registered with the SEC as an investment adviser and provides investment advisory services to certain entities that we sponsored that issued collateralized debt obligations (and has, in the past, provided investment advisory services to a limited partnership fund we sponsored). Redwood Asset Management could be exposed to litigation by investors in entities to which it provides investment advisory services or it could be the subject of a governmental investigation or enforcement action, in each case, as a result of the manner in which it conducts its advisory activities. Redwood Residential Acquisition Corporation, one of our subsidiaries, is licensed by various states in connection with its acquisitions of residential mortgage loans originated by others and is required to comply with rules and regulations promulgated by federal and state agencies in connection with the conduct of its business. Redwood Residential Acquisition Corporation could be exposed to litigation by mortgage borrowers or could be the subject of a governmental investigation or enforcement action, in each case, as a result of the manner in which it conducts its business. Similarly, Redwood Commercial Mortgage Corporation is licensed by the State of California to engage in commercial real estate lending and could be exposed to litigation or enforcement actions as a result of the manner in which it conducts its business.

Securitization entities that we sponsored issued ABS backed by residential mortgage loans and other assets held by these entities. As a result of declining property values, the recent economic recession, increased defaults, and other factors, the cash flows from the loans and other assets held by these securitization entities will not be sufficient, in some cases, to repay in full the principal amount of ABS issued by these securitization entities. We are not contractually liable for the principal and interest payments due on the ABS issued by these entities. Nonetheless, third parties who have invested in the ABS issued by these entities could try to hold us liable for any losses they experience, including through claims under federal and state securities laws or claims for breaches of representations and warranties we made in connection with engaging in these securitization transactions. Three lawsuits have been brought by investors in two of our different Sequoia securitizations, with two of these three lawsuits having been brought by members of the Federal Home Loan Bank System namely, the Federal Home Loan Bank of Seattle and the Federal Home Loan Bank of Chicago. These lawsuits are discussed above in Note 14 Commitments and Contingencies Loss Contingencies Litigation within the Notes to Consolidated Financial Statements set forth within Part IV, Item 15 of this Annual Report on Form 10-K and are also discussed above within Part I, Item 3 of this Annual Report on Form 10-K. Defending a lawsuit can consume significant resources and may divert management s attention from our operations. To the extent we are unsuccessful in our defense of any lawsuit, we could suffer losses, which could be material.

In addition to the Federal Home Loan Banks noted above, various other Federal Home Loan Banks that make up the Federal Home Loan Bank System are pursuing litigation against various parties in relation to their respective portfolio holdings of RMBS. We have not been named in litigation brought by these other Federal Home Loan Banks to date, although some of them did purchase Sequoia RMBS at original issuance. As examples, (i) in September and October 2009, the Federal Home Loan Bank of Pittsburgh initiated litigation against various RMBS market participants relating to RMBS held within its portfolio, (ii) in March 2010, the Federal Home Loan Bank of San Francisco initiated litigation against various RMBS market participants relating to RMBS held within its portfolio, (iii) in January 2011, the Federal Home Loan Bank of Atlanta initiated litigation against various RMBS market participants relating to RMBS held within its portfolio, and (iv) in April 2011, the Federal Home Loan Bank of Boston initiated litigation against various RMBS market participants relating to RMBS held within its portfolio. There are a total of twelve Federal Home Loan Banks within the Federal Home Loan Bank System and those that have not yet initiated litigation or demands of the type described above may do so in the future and those that have already initiated litigation

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or demands of the type described above may expand the scope of the litigation or demands that they have initiated to date. Any newly initiated or expanded litigation or demands by the Federal Home Loan Banks may include new or additional demands or litigation against us or our subsidiaries to the extent that Federal Home Loan Banks purchased at issuance or in the secondary market RMBS issued through our Sequoia RMBS platform. Other investors in RMBS and other types of ABS have also initiated various legal actions against participants in the market for these types of ABS and those that invested in RMBS and collateralized debt obligations issued in transactions we sponsored may initiate legal actions against us, particularly if the parties who have already initiated legal actions against us or others are successful, in whole or in part, in the pursuit of their claims.

Various governmental authorities have also initiated investigations, enforcement actions, and litigation with respect to, among other things, the mortgage finance markets, RMBS transactions, and collateralized debt obligation transactions and the market participants who structured, sponsored, marketed, or sold transactions or securities relating to these markets and securities. For example in 2010, Goldman Sachs reached a $550 million settlement relating to civil charges brought by the SEC relating to Goldman Sachs role in structuring and marketing a synthetic collateralized debt obligation transaction referred to as Abacus 2007-AC1. Other examples relating to collateralized debt obligations include: (i) in 2010 the SEC initiated an action against an asset management firm named ICP Asset Management (and certain other related entities and individuals) alleging violations of law by ICP in the conduct of its business as the collateral manager of various collateralized debt obligation transactions and (ii) in October 2011, the SEC charged Citigroup s principal U.S. broker-dealer subsidiary with misleading investors about a $1 billion collateralized debt obligation transaction, which charges were settled pursuant to an agreement under which Citigroup paid a total of $285 million to be distributed to investors in that transaction. Another example relating to RMBS is that in 2010 the Federal Housing Finance Agency (FHFA), which is the federal agency that regulates Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, issued 64 subpoenas to institutions that participated in RMBS transactions in which Fannie Mae or Freddie Mac invested, as part of a financial inquiry that is seeking information to determine whether losses sustained by Fannie Mae and Freddie Mac from these investments are the legal responsibility of others and to ensure that the obligations of the various parties involved have been met. In September 2011, the FHFA filed lawsuits against 17 financial institutions, certain of their officers and various unaffiliated lead underwriters, which suits allege violations of Federal securities laws and common law in the sale of RMBS to Fannie Mae and Freddie Mac.

Our business has included, and continues to include, activities relating to securitization transactions, an area that is the focus of various governmental authorities. Because of our involvement in the securitization business, we could become the subject of governmental investigations, enforcement actions, or lawsuits, and governmental authorities could allege that we violated applicable law or regulation in the conduct of our business. If violations are so alleged, we might not be successful in defending any related action brought against us, and any losses incurred as a result of the resolution of any such action against us could have a material adverse effect on our results of operations in future periods. In any case, regardless of the merits of any allegation or legal action that may be brought against us, or of our success in defending against it, the costs of defending against any such allegation or legal action made or brought against us may be significant or material and could have a material adverse effect on our results of operations in future periods. To the extent that any action is brought against us or other market participants by any governmental authority, regardless of whether that action is successful or not, it could result in non-governmental litigants bringing similar actions against us to the extent the law permits private parties to pursue legal action to address alleged violations of law or regulation.

As part of investigations they have been conducting, we have been required to provide information to two different federal agencies. Within Part I, Item 3 of this Annual Report on Form 10-K, we describe (i) the inquiry we received from the SEC, which inquiry took the form of an order to provide certain information regarding our past business activities with respect to sponsoring collateralized debt obligation transactions, and (ii) the subpoena we received from the National Credit Union Administration relating to certain RMBS transactions we sponsored in the past. We have responded to the order from the SEC and the subpoena from the NCUA. Both the subpoena from the NCUA and the order from the SEC state that they should not be construed as an indication that any violation of law has occurred; however, these regulatory agencies could, in

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the future, allege that we did violate applicable law or regulation in the conduct of our securitization business and, if either of them were to make such an allegation, it is possible that we might not be successful in defending any related action brought against us and any losses incurred as a result of the resolution of any such action against us could have a material adverse effect on our results of operations in future periods. As an example, in June 2011 the NCUA filed federal and state securities law claims in U.S. District Court in Kansas City, Kansas against, among others, certain subsidiaries of J.P. Morgan Chase & Co. and Royal Bank of Scotland Group PLC alleging that the offering documents relating to certain RMBS transactions that they sponsored and/or underwrote contained untrue statements of material fact or omitted to state material facts (and on July 18, 2011 the NCUA filed an additional and similar lawsuit against certain subsidiaries of Royal Bank of Scotland Group PLC and certain other entities in U.S. District Court in Los Angeles, California). At the same time the NCUA filed its June 2011 claims, it announced that it expects to file additional similar lawsuits against other financial institutions. On June 21, 2011, The Wall Street Journal reported that the NCUA is engaged in settlement discussions with financial institutions relating to other RMBS transactions and subsequently the media have reported that the NCUA has indicated that it anticipates filing another five to 10 lawsuits relating to the failure of wholesale credit unions.

There have also recently been several notable proposed settlements by large financial institutions of claims related to RMBS transactions. For example:

In June 2011, Bank of America Corporation and certain of its subsidiaries (collectively referred to as Bank of America) reported that it entered into a proposed settlement agreement and a related agreement with certain institutional investors relating to claims for loan servicing breaches relating to, and breaches of representations and warranties made in connection with, certain securitization transactions that had been sponsored by subsidiaries of Countrywide Financial Corporation (prior to the acquisition of Countrywide Financial by Bank of America). The proposed settlement agreement is subject to satisfaction of certain conditions, including court approval. The proposed settlement agreement provides for the release of claims related to: breaches of representations and warranties in the covered securitization transactions, all past servicing of loans underlying the covered securitization transactions, and all future servicing of loans underlying the covered securitization transactions (to the extent that future servicing complies with newly agreed-to standards). Under the proposed settlement, Bank of America would make an aggregate payment of $8.5 billion, which would be allocated among the covered securitization transactions.

In July 2011, subsidiaries of Wells Fargo & Company (collectively referred to as Wells Fargo) entered into a proposed settlement of a class action lawsuit brought by investors in 28 different RMBS transactions sponsored by Wells Fargo, which class action lawsuit included claims under the federal securities laws that the offering documents for those RMBS transactions contained untrue statements and omitted material facts. In settling these claims, Wells Fargo agreed to a settlement payment to the plaintiff class of approximately $125 million. The proposed settlement was approved by the court in November 2011.

In December 2011, Merrill Lynch & Co., Inc., a subsidiary of Bank of America Corporation (Merrill Lynch), entered into a proposed settlement of a class action lawsuit brought by investors in 18 different RMBS transactions sponsored by subsidiaries of Merrill Lynch, which class action lawsuit included claims under the federal securities laws that the offering documents for those RMBS transactions contained untrue statements and omitted material facts. In settling these claims, Merrill Lynch agreed to a settlement payment to the plaintiff class of approximately $315 million. The proposed settlement was approved by the court in December 2011.

As settlements such as those described above are proposed or entered into, we may analyze them, the nature of the claims and RMBS they relate to, and the circumstances under which they were entered into. In some cases, these settlements may affect the value of third-party issued RMBS that we hold. We also may seek to determine the extent to which these settlements are relevant to the defense of the lawsuits that we have been named in, to other aspects of our business, and to the reporting of our financial results. We may not analyze all future settlements that relate to asset-backed securities, or we may analyze them but not describe them in future public disclosures we make.

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Risks Relating to Short-Term Debt Incurred Under Residential Mortgage Loan Warehouse Facilities and Securities Repurchase Facilities

As described above in Part II, Item 7 of this Annual Report on Form 10-K under the heading Capital Resources and Liquidity, in the ordinary course of our business, we use short-term debt financing obtained through several different types of borrowing facilities to, among other things, fund the acquisition of residential mortgage loans we acquire (including those we acquire in anticipation of securitization), fund the origination of commercial real estate loans and other commercial real estate investments, and finance investments in securities and other investments. We may also use short-term borrowings to fund other aspects of our business and operations.

Residential Loan Warehouse Facilities. One source of our short-debt debt financing is secured borrowings under residential loan warehouse facilities we have established with two different financial institution counterparties. Under these two warehouse facilities, we have an aggregate borrowing limit of $400 million, however, these facilities are uncommitted, which means that any request we make to borrow funds under these facilities may be declined for any reason, even if at the time of the borrowing request we have then-outstanding borrowings that are less than the borrowing limits under these facilities. Short-term financing for residential mortgage loans is obtained under these facilities by our legal transfer of mortgage loans to the counterparty in exchange for cash proceeds (in an amount less than 100% of the principal amount of the transferred mortgage loans), and our covenant to reacquire those loans from the counterparty for the same amount plus a financing charge.

In order to obtain financing for a residential loan under these facilities, the loan must initially (and continuously while the financing remains outstanding) meet certain eligibility criteria, including, without limitation, that the loan is not in a delinquent status. In addition, under these warehouse facilities, residential loans can only be financed for a maximum period, which period would not generally exceed 364 days. While a residential loan is financed under a warehouse facility, to the extent the market value of the loan declines (which market value is generally determined by the counterparty under the facility), we are required to either immediately reacquire the loan or meet a margin requirement to pledge additional collateral, such as cash or additional residential loans, in an amount at least equal to the decline in value.

Because our warehouse facilities are uncommitted, at any given time we may not be able to obtain additional financing under them when we need it, exposing us to, among other things, liquidity risks of the types described above in Part I, Item 1A of this Annual Report on Form 10-K under the heading Risk Factors and above under the heading Market Risks . In addition, with respect to residential loans that at any given time are already being financed through our warehouse facilities, we are exposed to market, credit, liquidity, and other risks of the types described above in Part I, Item 1A of this Annual Report on Form 10-K under the heading Risk Factors and within this Part II, Item 7A of this Annual Report on Form 10-K under the heading Market Risks, if and when those loans become ineligible to be financed, decline in value, or have been financed for the maximum term permitted under the applicable facility.

Under our residential loan warehouse facilities, we also make various representations and warranties and have agreed to certain covenants, events of default, and other terms (including of the type described within this Part II, Item 7A of this Annual Report on Form 10-K under the heading Market Risks Fair Value and Liquidity Risks) that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under these facilities and these facilities being unavailable to use for future financing needs. In particular, the terms of these facilities include financial covenants, cross-default provisions, judgment default provisions, and other events of default (such as, for example, events of default triggered by one of the following: a change in control over Redwood, regulatory enforcement action against Redwood, Redwood s failure to continue to qualify as a REIT for tax purposes, or Redwood s failure to maintain the listing of its common stock on the New York Stock Exchange). Under a cross-default provision, an event of default is triggered (and the warehouse facility becomes unavailable and outstanding amounts borrowed thereunder become due and payable) if an event of default or similar event occurs under another borrowing or credit facility we maintain. Under a judgment default provision, an event of default is triggered (and the warehouse facility becomes unavailable and outstanding amounts borrowed thereunder become due and payable) if a judgment for damages in excess of a specified amount in entered against us in any litigation and we are unable to promptly satisfy the judgment. Financial covenants included in our warehouse facilities include, among others, covenants to maintain (i) a minimum tangible net worth, (ii) a maximum ratio of indebtedness to tangible net worth (and other limitations on indebtedness), (iii) a minimum amount of liquid assets, and (iv) a minimum amount of shareholders equity. Our warehouse facilities could also become unavailable and outstanding amounts borrowed thereunder could become immediately due and payable if there is a material adverse change in our business. If we breach or trigger the representations and warranties, covenants, events of default, or other terms of our warehouse facilities, we are exposed to liquidity and other risks, including of the type described above in Part I, Item 1A of this Annual Report on Form 10-K under the heading Risk Factors and within this Part II, Item 7A of this Annual Report on Form 10-K under the heading Market Risks .

In addition to the two residential loan warehouse facilities described above, in the ordinary course of business we are seeking, and currently expect, to establish additional warehouse facilities that may be of a similar size and may have similar or more restrictive terms. In the event a counterparty to one or more of our warehouse facilities becomes insolvent or unable or unwilling to perform it obligations under the facility, we may be unable to access short-term financing we need or fail to recover the full value of our residential mortgage loans financed.

Securities Repurchase Facilities. Another source of our short-debt debt financing for us is through securities repurchase facilities we have established with various different financial institution counterparties. Under these facilities, we do not have an aggregate borrowing limit, however, these facilities are uncommitted, which means that any request we make to borrow funds under these facilities may be declined for any reason. Short-term financing for securities is obtained under these facilities by our legal transfer of securities to the counterparty in exchange for cash proceeds (in an amount less than 100% of the fair value of the transferred securities), and our promise to reacquire those securities from the counterparty for the same amount plus a financing charge.

Under these securities repurchase facilities, securities are financed for a fixed period, which would not generally exceed 90 days. While a security is financed under a securities repurchase facility, to the extent the value of the security declines (which value is generally determined by the counterparty under the facility), we are required to either immediately reacquire the security or meet a margin requirement to pledge additional collateral, such as cash or U.S. Treasury securities, in an amount at least equal to the decline in value.

At the end of a the fixed period applicable to the financing of a security under a securities repurchase facility, if we intend to continue to obtain financing for that security we would typically request the same counterparty to renew the financing for an additional fixed period. If the same counterparty does not renew the financing, it may be difficult for us to obtain financing for that security under one of our other securities repurchase facilities, due to the fact that the financial institution counterparties to our securities repurchase facilities generally only provide financing for securities that we purchased from them or one of their affiliates. Because our securities repurchase facilities are uncommitted, at any given time we may not be able to obtain additional financing under them when we need it, exposing us to, among other things, liquidity risks of the types described in Part I, Item 1A of this Annual Report on Form 10-K under the heading Risk Factors and within this Part II, Item 7A of this Annual Report on Form 10-K under the heading Market Risks . In addition, with respect to securities that at any given time are already being financed through our securities repurchase facilities, we are exposed to market, credit, liquidity, and other risks of the types described in Part I, Item 1A of this Annual Report on Form 10-K under the heading Risk Factors and under the heading Market Risks, if and when those securities decline in value, or have been financed for the maximum term permitted under the applicable facility.

Under our securities repurchase facilities, we also make various representations and warranties and have agreed to certain covenants, events of default, and other terms (including of the type described within this Part II, Item 7A of this Annual Report on Form 10-K under the heading Market Risks Fair Value and Liquidity Risks) that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under these facilities and these facilities being unavailable to use for future financing needs. In particular, the terms of these facilities include financial covenants, cross-default provisions, judgment default provisions, and other events of default (including of the type described within this Part II, Item 7A of this Annual Report on Form 10-K under the heading Residential Loan Warehouse Facilities).

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Financial covenants included in our repurchase facilities include, among others, covenants to maintain (i) a minimum tangible net worth, (ii) a maximum ratio of indebtedness to shareholders equity, (iii) a minimum amount of liquid assets, and (iv) a minimum amount of shareholders equity. Our securities repurchase facilities could also become unavailable and outstanding amounts borrowed thereunder could become immediately due and payable if there is a material adverse change in our business. If we breach or trigger the representations and warranties, covenants, events of default, or other terms of our securities repurchase facilities, we are exposed to liquidity and other risks, including of the type described in Part I, Item 1A of this Annual Report on Form 10-K under the heading Risk Factors and within this Part II, Item 7A of this Annual Report on Form 10-K under the heading Market Risks .

In the ordinary course of business we may seek to establish additional securities repurchase facilities that may have similar or more restrictive terms. In the event a counterparty to one or more of our securities repurchase facilities becomes insolvent or unable or unwilling to perform it obligations under the facility, we may be unable to access the short-term financing we need or fail to recover the full value of our securities financed.

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Quantitative Information on Market Risk

Our future earnings are sensitive to a number of market risk factors and changes in these factors may have a variety of secondary effects that, in turn, will also impact our earnings. To supplement this discussion on the market risk we face, the following table incorporates information that may be useful in analyzing certain market risks that may affect our consolidated balance sheets at December 31, 2011. The table presents principal cash flows and related average interest rates by year of repayment. The forward curve (future interest rates as implied by the yield structure of debt markets) at December 31, 2011, was used to project the average coupon rates for each year presented. The timing of principal cash flows includes assumptions on the prepayment speeds of assets based on their recent prepayment performance and future prepayment performance consistent with the forward curve. Our future results depend greatly on the credit performance of the underlying loans (this table assumes no credit losses), future interest rates, prepayments, and our ability to invest our existing cash and future cash flow.

(1) Percentage number under fair value in thousands of dollars represents fair value as a percentage of principal value.

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(1) Percentage number under fair value in thousands of dollars represents fair value as a percentage of principal value.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The Consolidated Financial Statements of Redwood Trust, Inc. and Notes thereto, together with the Reports of Independent Registered Public Accounting Firm thereon, are set forth on pages F-1 through F-64 of this Annual Report on Form 10-K and incorporated herein by reference.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

We have adopted and maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed on our reports under the Securities Exchange Act of 1934, as amended (the Exchange Act) is recorded, processed, summarized, and reported within the time periods specified in the U.S. Securities and Exchange Commission s rules and forms and that the information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Rule 13a-15(b) of the Exchange Act, we have carried out an evaluation, under the supervision and with the participation of management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the quarter covered by this report. Based on the foregoing, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective at a reasonable assurance level.

There have been no changes in our internal control over financial reporting that occurred during the quarter ended December 31, 2011, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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MANAGEMENT S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of Redwood Trust, Inc., together with its consolidated subsidiaries (the company, or Redwood), is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control over financial reporting is a process designed under the supervision of our chief executive officer and chief financial officer to provide reasonable assurance regarding the reliability of financial reporting and the preparation of our financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles (GAAP).

As of the end of our 2011 fiscal year, management conducted an assessment of the effectiveness of our internal control over financial reporting based on the framework established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has determined that the company s internal control over financial reporting as of December 31, 2011, was effective.

Our internal control over financial reporting includes policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures are being made only in accordance with authorizations of management and the board of directors of Redwood; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

The company s internal control over financial reporting as of December 31, 2011, has been audited by Grant Thornton LLP, an independent registered public accounting firm, as stated in their report appearing on page F-3, which expresses an unqualified opinion on the effectiveness of the company s internal control over financial reporting as of December 31, 2011.

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ITEM 9B. OTHER INFORMATION

There is no information required to be disclosed in a report on Form 8-K during the fourth quarter of the year covered by this Annual Report on Form 10-K that has not been so reported.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by Item 10 is incorporated herein by reference to the definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

ITEM 11. EXECUTIVE COMPENSATION

Certain Matters Relating to 2011 Executive Compensation

2011 Annual Bonuses. In accordance with its previously disclosed policy and practice, in meetings during December 2011 and January 2012, the Compensation Committee of our Board of Directors made determinations regarding the 2011 annual bonuses of executive officers of Redwood. These determinations were subject to completion of the audit of Redwood s 2011 Consolidated Financial Statements (which occurred on February 23, 2012). The 2011 annual bonuses of the following executive officers of Redwood are set forth in the table below:

Plan Category	Company Performance Component of 2011 Annual Bonus	Individual Performance Component of 2011 Annual Bonus	Total 2011 Annual Bonus
Martin S. Hughes, Chief Executive Officer	$	$ 288,750	$ 288,750
Brett D. Nicholas, President	$	$ 187,500	$ 187,500
Diane L. Merdian, Chief Financial Officer	$	$ 100,000	$ 100,000
Fred Matera, Chief Investment Officer	$	$ 100,000	$ 100,000
John Isbrandsten, Managing Director	$	$ 100,000	$ 100,000

As required by SEC regulations, further disclosure regarding the determination of these 2011 annual bonuses will be included within Redwood s 2012 Proxy Statement.

Other Information. The other information required by Item 11 is incorporated herein by reference to the definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by Item 12 is incorporated herein by reference to the definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by Item 13 is incorporated herein by reference to the definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by Item 14 is incorporated herein by reference to the definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

Documents filed as part of this report:

(1) Consolidated Financial Statements and Notes thereto
(2) Schedules to Consolidated Financial Statements:
All Consolidated Financial Statements schedules not included have been omitted because they are either inapplicable or the information required is provided in the Company s Consolidated Financial Statements and Notes thereto, included in Part II, Item 8, of this Annual Report on Form 10-K.

(3) Exhibits:

Exhibit Number	Exhibit
3.1	Articles of Amendment and Restatement of the Registrant, effective July 6, 1994 (incorporated by reference to the Registrant s Quarterly Report on Form 10-Q, Exhibit 3.1, filed on August 6, 2008)
3.1.1	Articles Supplementary of the Registrant, effective August 10, 1994 (incorporated by reference to the Registrant s Quarterly Report on Form 10-Q, Exhibit 3.1.1, filed on August 6, 2008)
3.1.2	Articles Supplementary of the Registrant, effective August 11, 1995 (incorporated by reference to the Registrant s Quarterly Report on Form 10-Q, Exhibit 3.1.2, filed on August 6, 2008)
3.1.3	Articles Supplementary of the Registrant, effective August 9, 1996 (incorporated by reference to the Registrant s Quarterly Report on Form 10-Q, Exhibit 3.1.3, filed on August 6, 2008)
3.1.4	Certificate of Amendment of the Registrant, effective June 30, 1998 (incorporated by reference to the Registrant s Quarterly Report on Form 10-Q, Exhibit 3.1.4, filed on August 6, 2008)
3.1.5	Articles Supplementary of the Registrant, effective April 7, 2003 (incorporated by reference to the Registrant s Quarterly Report on Form 10-Q, Exhibit 3.1.5, filed on August 6, 2008)
3.1.6	Articles Supplementary of the Registrant, effective June 12, 2008 (incorporated by reference to the Registrant s Quarterly Report on Form 10-Q, Exhibit 3.1.6, filed on August 6, 2008)
3.1.7	Articles of Amendment effective May 19, 2009 (incorporated by reference to the Registrant s Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2009)
3.1.8	Articles of Amendment effective May 24, 2011 (incorporated by reference to the Registrant s Current Report on Form 8-K, Exhibit 3.1, filed on May 20, 2011)
3.2	Amended and Restated Bylaws, as adopted on March 5, 2008 (incorporated by reference to Registrant s Current Report on Form 8-K, Exhibit 3.1, filed on March 11, 2008)
4.1	Form of Common Stock Certificate (incorporated by reference to the Registrant s Registration Statement on Form S-11 (No. 333-08363), Exhibit 4.3, filed on August 6, 1996)
4.2	Indenture dated as of October 1, 2001 between Sequoia Mortgage Trust 5 (a wholly-owned consolidated subsidiary of the Registrant) and Bankers Trust Company of California, N.A., as Trustee (incorporated by reference to Sequoia Mortgage Funding Corporation s Current Report on Form 8-K, Exhibit 99.1, filed on November 15, 2001)
4.3	Indenture dated as April 1, 2002 between Sequoia Mortgage Trust 6 (a wholly-owned consolidated subsidiary of the Registrant) and Deutsche Bank National Trust Company, as

	Trustee (incorporated by reference to Sequoia Mortgage Funding Corporation s Current Report on Form 8-K, Exhibit 99.1, filed on May 13, 2002)
4.4	Junior Subordinated Indenture dated as of December 12, 2006 between Registrant and The Bank of New York Trust Company, National Association, as Trustee (incorporated by reference to Registrant s Current Report on Form 8-K, Exhibit 1.4, filed on December 12, 2006)

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Exhibit Number	Exhibit
4.5	Amended and Restated Trust Agreement dated December 12, 2006 among Registrant, The Bank of New York Trust Company, National Association, The Bank of New York (Delaware), the Administrative Trustees (as named therein) and the several holders of the Preferred Securities from time to time (incorporated by reference to Registrant s Current Report on Form 8-K, Exhibit 1.3, filed on December 12, 2006)
4.6	Purchase Agreement dated December 12, 2006 among Registrant, Redwood Capital Trust I and Merrill Lynch International (incorporated by reference to Registrant s Current Report on Form 8-K, Exhibit 1.1, filed on December 12, 2006)
4.7	Purchase Agreement dated December 12, 2006 among Registrant, Redwood Capital Trust I and Bear, Stearns & Co. Inc. (incorporated by reference to Registrant s Current Report on Form 8-K, Exhibit 1.2, filed on December 12, 2006)
4.8	Subordinated Indenture dated as of May 23, 2007 between Registrant and Wilmington Trust Company (incorporated by reference to Registrant s Current Report on Form 8-K, Exhibit 1.2, filed on May 23, 2007)
4.9	Purchase Agreement dated May 23, 2007 between Registrant and Obsidian CDO Warehouse, LLC (incorporated by reference to Registrant s Current Report on Form 8-K, Exhibit 1.1, filed on May 23, 2007)
9.1	Waiver Agreement dated as of November 15, 2007 between Registrant and Davis Selected Advisors, LP (incorporated by reference to the Registrant s Annual Report on Form 10-K, Exhibit 9.1, filed on March 5, 2008)
9.2	Amendment of Waiver Agreement dated as of January 16, 2008 between Registrant and Davis selected Advisors, LP (incorporated by reference to the Registrant s Annual Report on Form 10-K, Exhibit 9.2, filed on March 5, 2008)
10.1*	Amended and Restated 1994 Executive and Non-Employee Director Stock Option Plan, amended January 24, 2002 (incorporated by reference to the Registrant s Quarterly Report on Form 10-Q, Exhibit 10.14.5, filed on May 15, 2002)
10.2*	2002 Incentive Plan, amended through May 18, 2010 (incorporated by reference to Registrant s Current Report on Form 8-K, Exhibit 10.1, filed on May 19, 2010)
10.3*	Form of Employee Incentive Stock Option Grant Agreement under 2002 Incentive Plan (incorporated by reference to the Registrant s Annual Report on Form 10-K, Exhibit 10.8.1, filed on March 16, 2005)
10.4*	Form of Employee Non-Qualified Stock Option Grant Agreement under 2002 Incentive Plan (incorporated by reference to the Registrant s Annual Report on Form 10-K, Exhibit 10.8.2, filed on filed on March 16, 2005)
10.5*	Form of Amendment to Employee Non-Qualified Stock Option Grant Agreement under 2002 Incentive Plan (incorporated by reference to the Registrant s Current Report on Form 8-K, Exhibit 10.2, filed on November 17, 2005)
10.6*	Form of Restricted Stock Award Agreement under 2002 Incentive Plan Pre-December 2011 (incorporated by reference to the Registrant s Annual Report on Form 10-K, Exhibit 10.8.3, filed on March 16, 2005)
10.7*	Form of Deferred Stock Unit Award Agreement under 2002 Incentive Plan Pre-December 2011 (incorporated by reference to the Registrant s Current Report on Form 8-K, Exhibit 10.1, filed on December 2, 2010)
10.8*	Form of Performance Stock Unit Award Agreement under 2002 Incentive Plan Pre-December 2011 (incorporated by reference to the Registrant s Current Report on Form 8-K, Exhibit 10.2,

filed on December 2, 2010)

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Exhibit Number	Exhibit
10.9*	Form of Restricted Stock Award Agreement under 2002 Incentive Plan (incorporated by reference to the Registrant s Current Report on Form 8-K, Exhibit 10.3, filed on December 8, 2011)
10.10*	Form of Deferred Stock Unit Award Agreement under 2002 Incentive Plan (incorporated by reference to the Registrant s Current Report on Form 8-K, Exhibit 10.1, filed on December 8, 2011)
10.11*	Form of Performance Stock Unit Award Agreement under 2002 Incentive Plan (incorporated by reference to the Registrant s Current Report on Form 8-K, Exhibit 10.2, filed on December 8, 2011)
10.12*	2002 Employee Stock Purchase Plan, as amended on May 19, 2009 (incorporated by reference to the Registrant s Current Report on Form 8-K, Exhibit 10.1, filed on May 21, 2009)
10.13*	Executive Deferred Compensation Plan, as amended and restated on December 10, 2008 (incorporated by reference to the Registrant s Current Report on Form 8-K, Exhibit 10.1, filed on January 14, 2009)
10.14	Direct Stock Purchase and Dividend Reinvestment Plan (incorporated by reference to the Plan text included in the Registrant s Prospectus Supplement filed on November 4, 2010)
10.15*	Summary of Redwood Trust, Inc. Compensation Arrangements for Non-Employee Directors (incorporated by reference to the Director Compensation section of the Registrant s Proxy Statement filed on April 4, 2011)
10.16*	Revised Form of Indemnification Agreement for Directors and Executive Officers (incorporated by reference to the Registrant s Current Report on Form 8-K, Exhibit 99.3, filed on November 16, 2009)
10.17	Office Building Lease, dated February, 27, 2003 (incorporated by reference to the Registrant s Annual Report on Form 10-K, Exhibit 10.30.2, filed on March 12, 2004)
10.18	Office Building Lease (second floor), dated July 31, 2006 (incorporated by reference to the Registrant s Quarterly Report on Form 10-Q, Exhibit 10.1, filed November 2, 2006)
10.19	Second Amendment to Lease, dated July 31, 2006 (incorporated by reference to the Registrant s Quarterly Report on Form 10-Q, Exhibit 10.3, filed November 2, 2006)
10.20	Office Building Lease, effective as of and dated as of June 1, 2012 (incorporated by reference to the Registrant s Quarterly Report on Form 10-Q, Exhibit 10.1, filed November 3, 2011)
10.21*	Amended and Restated Employment Agreement, dated as of March 31, 2009, by and between George E. Bull, III and the Registrant (incorporated by reference to the Registrant s Quarterly Report on Form 10-Q, Exhibit 10.1, filed on May 5, 2009)
10.22*	Amended and Restated Employment Agreement, dated as of March 31, 2009, by and between Martin S. Hughes and the Registrant (incorporated by reference to the Registrant s Quarterly Report on Form 10-Q, Exhibit 10.2, filed on May 5, 2009)
10.23*	Amended and Restated Employment Agreement, dated as of March 31, 2009, by and between Brett D. Nicholas and the Registrant (incorporated by reference to the Registrant s Quarterly Report on Form 10-Q, Exhibit 10.3, filed on May 5, 2009)
10.24*	Amended and Restated Employment Agreement, dated as of March 31, 2009, by and between Harold F. Zagunis and the Registrant (incorporated by reference to the Registrant s Quarterly Report on Form 10-Q, Exhibit 10.4, filed on May 5, 2009)
10.25*	First Amendment to Amended and Restated Employment Agreement, by and between Redwood Trust, Inc. and Martin S. Hughes, dated as of March 17, 2010 (incorporated by reference to Registrant s Current Report on Form 8-K, Exhibit 10.1, filed on March 18, 2010)

10.26*	First Amendment to Amended and Restated Employment Agreement, by and between Redwood Trust, Inc. and Brett D. Nicholas, dated as of March 17, 2010 (incorporated by reference to Registrant s Current Report on Form 8-K, Exhibit 10.2, filed on March 18, 2010)

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Exhibit Number	Exhibit
10.27*	Second Amendment to Amended and Restated Employment Agreement, by and between Redwood Trust, Inc. and Martin S. Hughes, dated as of February 24, 2011 (incorporated by reference to Registrant s Annual Report on Form 10-K, Exhibit 10.23, filed on February 24, 2011)
10.28*	Second Amendment to Amended and Restated Employment Agreement, by and between Redwood Trust, Inc. and Brett D. Nicholas, dated as of February 24, 2011 (incorporated by reference to Registrant s Annual Report on Form 10-K, Exhibit 10.24, filed on February 24, 2011)
10.29*	First Amendment to Amended and Restated Employment Agreement, by and between Redwood Trust, Inc. and Harold F. Zagunis, dated as of February 24, 2011 (incorporated by reference to Registrant s Annual Report on Form 10-K, Exhibit 10.25, filed on February 24, 2011)
10.30*	Transition Agreement, dated as of December 10, 2008, between Douglas B. Hansen and the Registrant (incorporated by reference to the Registrant s Annual Report on Form 10-K, Exhibit 10.27, filed on February 26, 2009)
10.31*	Transition Agreement, dated as of March 17, 2010, between George E. Bull, III and the Registrant (incorporated by reference to the Registrant s Quarterly Report on Form 10-Q, Exhibit 10.3, filed on May 5, 2010)
21	List of Subsidiaries (filed herewith)
23	Consent of Grant Thornton LLP (filed herewith)
31.1	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith)
31.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith)
32.1	Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)
32.2	Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)
101	Pursuant to Rule 405 of Regulation S-T, the following financial information from the Company s Annual Report on Form 10-K for the period ended December 31, 2011, is furnished in XBRL-formatted interactive data files: (i) Consolidated Balance Sheets at December 31, 2011 and 2010; Consolidated Statements of Income for the years ended December 31, 2011, 2010; and 2009 (ii) Statements of Consolidated Comprehensive (Loss) Income for the years ended December 31, 2011, 2010, and 2009; (iii) Consolidated Statements of Changes in Equity for the years ended December 31, 2011, 2010, and 2009; (iv) Consolidated Statements of Cash Flows for the years ended December 31, 2011, 2010, and 2009; (v) Notes to Consolidated Financial Statements.

* Indicates exhibits that include management contracts or compensatory plan or arrangements.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, hereunto duly authorized.

REDWOOD TRUST
By:

Date: February 27, 2012

/s/ Martin S. Hughes
Martin S. Hughes
Chief Executive Officer

Pursuant to the requirements the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Martin S. Hughes Martin S. Hughes	Director and Chief Executive Officer (Principal Executive Officer)	February 27, 2012
/s/ Diane L. Merdian Diane L. Merdian	Chief Financial Officer (Principal Financial Officer)	February 27, 2012
/s/ Christopher J. Abate Christopher J. Abate	Managing Director and Controller (Principal Accounting Officer)	February 27, 2012
/s/ George E. Bull, III George E. Bull, III	Director, Chairman of the Board	February 27, 2012
/s/ Richard D. Baum Richard D. Baum	Director	February 27, 2012
/s/ Thomas C. Brown Thomas C. Brown	Director	February 27, 2012
/s/ Mariann Byerwalter Mariann Byerwalter	Director	February 27, 2012
/s/ Douglas B. Hansen Douglas B. Hansen	Director	February 27, 2012
/s/ Greg H. Kubicek Greg H. Kubicek	Director	February 27, 2012
/s/ Jeffrey T. Pero Jeffrey T. Pero	Director	February 27, 2012
/s/ Georganne C. Proctor Georganne C. Proctor	Director	February 27, 2012
/s/ Charles J. Toeniskoetter Charles J. Toeniskoetter	Director	February 27, 2012

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REDWOOD TRUST, INC.

CONSOLIDATED FINANCIAL STATEMENTS, REPORTS OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

For Inclusion in Annual Report on Form 10-K Filed With Securities and Exchange Commission

December 31, 2011

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
Redwood Trust, Inc.

We have audited Redwood Trust, Inc. s (a Maryland Corporation) internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Redwood Trust, Inc. s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on Redwood Trust, Inc. s internal control over financial reporting based on our audit.

We conducted our audit 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 effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Redwood Trust, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control Integrated Framework issued by COSO.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Redwood Trust, Inc. and its subsidiaries as of December 31, 2011 and 2010 and the related consolidated statements of income, comprehensive (loss) income, changes in equity, and cash flows for each of the three years in the period ended December 31, 2011 and our report dated February 27, 2012 expressed an unqualified opinion.

/s/ GRANT THORNTON LLP

Irvine, CA
February 27, 2012

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
Redwood Trust, Inc.

We have audited the accompanying consolidated balance sheets of Redwood Trust, Inc. (a Maryland corporation) and its subsidiaries (the Company) as of December 31, 2011 and 2010, and the related consolidated statements of income, comprehensive (loss) income, changes in equity, and cash flows for each of the three years in the period ended December 31, 2011. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Redwood Trust, Inc. and its subsidiaries as of December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2011 in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company s internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated February 27, 2012 expressed an unqualified opinion.

/s/ GRANT THORNTON LLP

Irvine, CA
February 27, 2012

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data)	December 31, 2011	December 31, 2010
ASSETS		
Residential loans, held-for-sale	$395,237	$1,855
Residential loans, held-for-investment	3,799,648	3,795,240
Commercial loans (includes $12,129 and $19,850 at fair value)	169,855	50,386
Real estate securities, at fair value	981,837	1,154,836
Cash and cash equivalents	267,176	46,937
Total earning assets	5,613,753	5,049,254
Restricted cash	14,987	24,524
Accrued interest receivable	15,840	13,782
Derivative assets	2,373	8,051
Deferred tax asset		3,487
Deferred securities issuance costs	8,083	5,928
Other assets	88,262	38,662
Total Assets[(1)]	$5,743,298	$5,143,688
LIABILITIES AND EQUITY		
Liabilities		
Short-term debt	$428,056	$44,137
Accrued interest payable	8,134	5,930
Derivative liabilities	127,564	83,115
Accrued expenses and other liabilities	8,105	14,305
Dividends payable		19,531
Asset-backed securities issued (includes $209,381 and $303,077 at fair value)	4,139,355	3,761,578
Long-term debt	139,500	139,500
Total liabilities[(1)]	4,850,714	4,068,096
Equity		
Common stock, par value $0.01 per share, 125,000,000 shares authorized; 78,555,908 and 78,124,668 issued and outstanding	786	781
Additional paid-in capital	1,697,979	1,689,851
Accumulated other comprehensive (loss) income	(13,151)	112,339
Cumulative earnings	501,283	474,940
Cumulative distributions to stockholders	(1,294,313)	(1,213,158)
Total stockholders equity	892,584	1,064,753
Noncontrolling interest		10,839
Total equity	892,584	1,075,592
Total Liabilities and Equity	$5,743,298	$5,143,688

(1)

Our consolidated balance sheets include assets of consolidated variable interest entities (VIEs) that can only be used to settle obligations of these VIEs and liabilities of consolidated VIEs for which creditors do not have recourse to the primary beneficiary (Redwood Trust, Inc.). At December 31, 2011 and 2010, assets of consolidated VIEs totaled $4,408,350 and $3,941,212, respectively, and liabilities of consolidated VIEs totaled $4,209,124 and $3,837,929, respectively. See *Note 4* for further discussion.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31,		
(In Thousands, Except Share Data)	2011	2010	2009
Interest Income			
Residential loans	$81,116	$65,405	$99,327
Commercial loans	8,835	1,864	1,292
Real estate securities	127,179	162,531	186,725
Other investments		15	167
Cash and cash equivalents	49	239	366
Total interest income	217,179	230,054	287,877
Interest Expense			
Short-term debt	(1,031)	(81)	
Asset-backed securities issued	(88,492)	(76,319)	(126,218)
Long-term debt	(9,514)	(8,264)	(5,785)
Total interest expense	(99,037)	(84,664)	(132,003)
Net Interest Income	118,142	145,390	155,874
Provision for loan losses	(16,151)	(24,135)	(49,573)
Market valuation adjustments	(30,545)	(9,667)	(13,870)
Other-than-temporary impairments(1)	(9,472)	(9,887)	(73,758)
Market valuation adjustments, net	(40,017)	(19,554)	(87,628)
Net Interest Income After Provision and Market Valuation Adjustments	61,974	101,701	18,673
Operating expenses	(47,682)	(53,715)	(46,995)
Realized gains on sales and calls, net	10,946	63,496	63,166
Net income before provision for income taxes	25,238	111,482	34,844
(Provision for) benefit from income taxes	(42)	(280)	4,268
Net income	25,196	111,202	39,112
Less: Net (loss) income attributable to noncontrolling interest	(1,147)	1,150	(83)
Net Income Attributable to Redwood Trust, Inc.	$26,343	$110,052	$39,195
Basic earnings per common share	$0.31	$1.37	$0.56
Diluted earnings per common share	$0.31	$1.36	$0.55
Regular dividends declared per common share	$1.00	$1.00	$1.00
Basic weighted average shares outstanding	78,299,510	77,841,634	68,458,009
Diluted weighted average shares outstanding	78,299,510	78,810,949	68,990,891

(1) For the year ended December 31, 2011, other-than-temporary impairments were $15,106, of which $5,634 were recognized in Accumulated Other Comprehensive (Loss) Income. For the year ended December 31, 2010, other-than-temporary impairments were $18,216, of which $8,329 were recognized in Accumulated Other Comprehensive (Loss) Income. For the year ended December 31, 2009, other-than-temporary impairments were $97,165, of which $23,407 were recognized in Accumulated Other Comprehensive (Loss) Income.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

STATEMENTS OF CONSOLIDATED COMPREHENSIVE (LOSS) INCOME

	Years Ended December 31,		
(In Thousands, Except Share Data)	2011	2010	2009
Net Income	$26,343	$110,052	$39,195
Other comprehensive (loss) income:			
Net unrealized (loss) gain on available-for-sale securities	(88,502)	45,971	138,944
Reclassification of other-than-temporary impairments to net income	5,048	10,672	40,432
Net unrealized loss on interest rate agreements	(42,115)	(10,391)	
Reclassification of unrealized loss on interest rate agreements to net income	4,243	3,678	4,458
Total other comprehensive (loss) income	(121,326)	49,930	183,834
Total comprehensive (loss) income	(94,983)	159,982	223,029
Less: Comprehensive loss attributable to noncontrolling interest	(4,164)	(2,451)	(2,475)
Comprehensive (Loss) Income Attributable to Redwood Trust, Inc.	$(99,147)	$157,531	$220,554

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

For the Year Ended December 31, 2011

Thousands, Except Share Data)	Common Stock Shares	Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Cumulative Earnings	Cumulative Distributions to Stockholders	Noncontrolling Interest	Total
cember 31, 2010	78,124,668	$781	$1,689,851	$112,339	$474,940	$(1,213,158)	$10,839	$1,075,59
t income (loss)					26,343		(1,147)	25,196
her comprehensive (loss) income				(125,490)			4,164	(121,326
uance of common stock:								
vidend reinvestment & stock rchase plans	708,664	7	8,784					8,791
ployee stock purchase and entive plans	374,662	4	(2,782)					(2,778
n-cash equity award npensation			9,108					9,108
are repurchases	(652,086)	(6)	(6,982)					(6,988
tributions to noncontrolling erest, net							(14,112)	(14,112
mmon dividends declared						(81,155)		(81,155
consolidation elimination							256	256
cember 31, 2011	78,555,908	$786	$1,697,979	$(13,151)	$501,283	$(1,294,313)	$	$892,584

For the Year Ended December 31, 2010

In Thousands, Except Share Data)	Common Stock Shares	Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Cumulative Earnings	Cumulative Distributions to Stockholders	Noncontrolling Interest	Total
December 31, 2009	77,737,130	$777	$1,674,367	$64,860	$364,888	$(1,133,171)	$17,370	$989,091
Net income					110,052		1,150	111,202
Other comprehensive income				47,479			2,451	49,930
ssuance of common stock:								
Dividend reinvestment & stock urchase plans	267,313	3	4,031					4,034

mployee stock purchase and ncentive plans	120,225	1	(69)					(68)
Ion-cash equity award ompensation			11,522					11,522
Distributions to noncontrolling nterest, net							(10,132)	(10,132)
Common dividends declared						(79,987)		(79,987)
December 31, 2010	78,124,668	$781	$1,689,851	$112,339	$474,940	$(1,213,158)	$10,839	$1,075,592

For the Year Ended December 31, 2009

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
(In Thousands, Except Share Data)	2011	2010	2009
Cash Flows From Operating Activities:			
Net income attributable to Redwood Trust, Inc.	$26,343	$110,052	$39,195
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization of premiums, discounts, and debt issuance costs, net	(31,851)	(35,758)	(5,474)
Depreciation and amortization of non-financial assets	1,713	885	1,282
Provision for loan losses	16,151	24,135	49,573
Non-cash equity award compensation	9,108	11,522	6,171
Market valuation adjustments, net	40,017	19,554	87,628
Realized gains on sales and calls, net	(10,946)	(63,496)	(63,166)
Net change in:			
Accrued interest receivable	(2,729)	3,687	14,326
Deferred tax asset	3,487	1,323	(1,202)
Other assets	(43,106)	3,936	40,623
Accrued interest payable	15,823	11,576	(10,585)
Accrued expenses and other liabilities	(6,200)	(57,523)	51,710
Net cash provided by operating activities	17,810	29,893	210,081
Cash Flows From Investing Activities:			
Purchases of loans held-for-investment	(960,014)	(525,349)	
Principal payments on loans held-for-investment	409,009	373,982	393,422
Proceeds from sales of loans held-for-sale	2,092		
Purchases of available-for-sale securities	(128,566)	(261,657)	(743,030)
Proceeds from sales of available-for-sale securities	72,666	249,802	196,001
Principal payments on available-for-sale securities	112,144	145,054	138,016
Purchases of trading securities		(17,137)	(9,809)
Proceeds from sales of trading securities	13,588	7,855	4,256
Principal payments on trading securities	53,990	60,255	89,174
Principal payments on other investments		12,646	33,082
Net decrease in restricted cash	9,537	69,782	(40,698)
Net cash (used in) provided by investing activities	(415,554)	115,233	60,414
Cash Flows From Financing Activities:			
Proceeds from borrowings on short-term debt	697,499	68,214	
Repayments on short-term debt	(313,580)	(24,077)	
Proceeds from issuance of asset-backed securities	887,974	211,178	
Repurchase of asset-backed securities issued		(8,758)	
Repayments on asset-backed securities issued	(492,561)	(455,345)	(520,755)
Deferred securities issuance costs	(4,503)	(1,563)	

Repurchase of long-term debt		(270)	(3,455)
Net settlements of derivatives	(39,926)	(45,482)	(59,703)
Net proceeds from issuance of common stock	6,013	3,966	519,249
Net payments on repurchase of common stock	(6,988)		(4)
Dividends paid	(100,686)	(79,888)	(81,771)
Change in noncontrolling interests	(15,259)	(8,982)	(7,718)
Net cash provided by (used in) financing activities	617,983	(341,007)	(154,157)
Net increase (decrease) in cash and cash equivalents	220,239	(195,881)	116,338
Cash and cash equivalents at beginning of period	46,937	242,818	126,480
Cash and cash equivalents at end of period	$267,176	$46,937	$242,818
Supplemental Disclosures:			
Cash paid for interest	$106,757	$69,787	$142,580
Cash paid for taxes	$51	$215	$122
Dividends declared but not paid at end of period	$	$19,531	$19,434
Transfers from loans held-for-investment to loans held-for-sale	$393,304	$	$
Transfers from residential loans to real estate owned	$11,258	$20,437	$28,535

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 1. Redwood Trust

Redwood Trust, Inc., together with its subsidiaries (Redwood, we, or us), invests in, finances, and manages real estate assets. We invest in residential and commercial loans and in asset-backed securities backed by real estate loans. We seek to invest in assets that have the potential to generate sufficient long-term cash flow returns to support our goal of distributing an attractive level of dividends per share to shareholders over time. For tax purposes, we are structured as a real estate investment trust (REIT).

Redwood was incorporated in the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. Our executive offices are located at One Belvedere Place, Suite 300, Mill Valley, California 94941.

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at December 31, 2011 and 2010, and for the years ended December 31, 2011, 2010, and 2009. These consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) in the United States of America as prescribed by the Financial Accounting Standards Board s (FASB) Accounting Standards Codification (ASC) and using the Securities and Exchange Commission s (SEC) instructions to Form 10-K.

Organization

Our consolidated financial statements include the accounts of Redwood, its direct and indirect wholly owned subsidiaries, and other entities in which we have a controlling financial interest. All significant intercompany balances and transactions have been eliminated. A number of Redwood s consolidated subsidiaries are qualifying REIT subsidiaries and the remainder are taxable subsidiaries. References to the Redwood REIT include Redwood and its qualifying REIT subsidiaries, excluding taxable subsidiaries.

We sponsor two securitization programs. Our Sequoia program is used for the securitization of residential mortgage loans. References to Sequoia refer collectively to all the consolidated Sequoia securitization entities. Our Acacia program was used for the securitization of mortgage-backed securities and other types of financial assets. References to Acacia refer collectively to all the consolidated Acacia securitization entities.

Principles of Consolidation

We apply FASB guidance to determine whether we must consolidate transferred financial assets and variable interest entities (VIEs) for financial reporting purposes. We currently consolidate the assets and liabilities of the Sequoia and the Acacia securitization entities where we maintain an ongoing involvement, as well as an entity formed in connection with a resecuritization transaction we engaged in during the third quarter of 2011. Prior to the fourth quarter of 2011, we also consolidated the assets, liabilities, and noncontrolling interests of the Opportunity Fund (Fund) that we managed. Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities.

For financial reporting purposes, the underlying loans and securities owned at the Sequoia, Acacia, and resecuritization entities are shown under residential and commercial loans and real estate securities on our consolidated balance sheets. The asset-backed securities (ABS) issued to third parties by these entities are shown under ABS issued. In our consolidated statements of income, we record interest income on the loans and securities owned by consolidated Sequoia, Acacia, and resecuritization entities and interest expense on the ABS issued by these entities. The real estate securities owned at the Fund were shown on our consolidated balance sheets under real estate securities and the portion of the Fund owned by third parties was shown under noncontrolling interest. In our consolidated statements of income, we recorded interest income on the securities owned at the Fund.

See *Note 4* for further discussion on principles of consolidation.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 3. Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements requires us to make a number of significant estimates. These include estimates of fair value of certain assets and liabilities, amount and timing of credit losses, prepayment rates, and other estimates that affect the reported amounts of certain assets and liabilities as of the date of the consolidated financial statements and the reported amounts of certain revenues and expenses during the reported period. It is likely that changes in these estimates (e.g., valuation changes due to supply and demand, credit performance, prepayments, interest rates, or other reasons) will occur in the near term. Our estimates are inherently subjective in nature and actual results could differ from our estimates and the differences could be material.

Fair Value Measurements

Our financial statements include assets and liabilities that are measured at their estimated fair values in accordance with GAAP. A fair value measurement represents the price at which an orderly transaction would occur between willing market participants at the measurement date. We develop fair values for financial assets or liabilities based on available inputs and pricing that is observed in the marketplace. Examples of market information that we attempt to obtain include the following:

Quoted prices for the same or similar securities;
Relevant reports issued by analysts and rating agencies;
The current level of interest rates and any directional movements in relevant indices, such as credit risk indices;
Information about the performance of the underlying mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates;
Indicative prices or yields from broker/dealers; and,
Other relevant observable inputs, including nonperformance risk and liquidity premiums.

After considering all available indications of the appropriate rate of return that market participants would require, we consider the reasonableness of the range indicated by the results to determine an estimate that is most representative of fair value.

The markets for many of the real estate securities that we invest in and issue are generally illiquid. Establishing fair values for illiquid assets and liabilities is inherently subjective and is often dependent upon our estimates and modeling assumptions. If we determine that either the volume and/or level of trading activity for an asset or liability has significantly decreased from normal market conditions, or price quotations or observable inputs are not associated with orderly transactions, the market inputs that we obtain might not be relevant. For example, broker or pricing service quotes might not be relevant if an active market does not exist for the financial asset or liability. The nature of the quote (for example, whether the quote is an indicative price or a binding offer) is also evaluated.

In circumstances where relevant market inputs cannot be obtained, increased analysis and management judgment are required to estimate fair value. This generally requires us to establish the use of our internal assumptions about future cash flows and appropriate risk-adjusted discount rates. Regardless of the valuation inputs we apply, the objective of fair value measurement is unchanged from what it would be if markets were operating at normal activity levels and/or transactions were orderly; that is, to determine the current exit price.

See *Note 5* for further discussion on fair value measurements.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 3. Summary of Significant Accounting Policies (continued)

Fair Value Option

We have the option to measure eligible financial assets, financial liabilities, and commitments at fair value on an instrument-by-instrument basis. This option is available when we first recognize a financial asset or financial liability or enter into a firm commitment. Subsequent changes in the fair value of assets, liabilities, and commitments where we have elected the fair value option are recorded in our consolidated statements of income.

Our decision to apply the fair value option for new financial instruments is generally based upon our funding strategy for the specific financial asset acquired. For example, securities that we anticipate funding with equity will generally be accounted for as available-for-sale (AFS) securities. Securities that we anticipate funding with a combination of debt and equity or those financed through the issuance of asset-backed liabilities will generally be accounted for in a manner consistent with the associated liabilities. Additionally, we may elect to apply the fair value option for financial instruments that may not perform similarly to our traditional real estate investments or are particularly volatile or complex.

See *Note 5* for further discussion on the fair value option.

Real Estate Loans

Residential and Commercial Loans   Fair Value

Residential and commercial loans at fair value include loans where we have elected the fair value option. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Changes in fair value are recurring and are reported through our consolidated statements of income in market valuation adjustments, net.

Residential and Commercial Loans   Held-for-Sale

Residential and commercial loans held-for-sale include loans that we are marketing for sale to third parties, including transfers to securitization entities that we plan to sponsor and expect to be accounted for as sales for financial reporting purposes. These loans are carried at the lower of their cost or fair value, as measured on an individual basis or, in the case of the loans we intend to pool for securitization based upon similar underwriting characteristics, on an aggregate basis. If the fair value of a loan, or pool of loans, held-for-sale is lower than its amortized cost basis, this difference is reported as a negative market valuation adjustment through our consolidated statements of income. Coupon interest for loans held-for-sale is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Gains or losses on the sale of residential or commercial loans are based on the specific identification method for loans measured on an individual basis or in aggregate for those loans measured on a pool basis.

Residential and Commercial Loans Held-for-Investment

Loans held-for-investment include residential loans owned at Sequoia entities and residential and commercial loans owned at Redwood. These loans are carried at their unpaid principal balances adjusted for net unamortized premiums or discounts and net of any allowance for loan losses. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due or when a loan has been individually impaired, at which point the loan is placed on nonaccrual status. Interest previously accrued for loans that have become greater than 90 days past due or individually impaired is reserved for in the allowance for loan losses. Loans delinquent more than 90 days or in foreclosure are characterized as seriously delinquent. Cash principal and interest that is advanced from servicers subsequent to a loan becoming greater than 90 days past due or individually impaired is used to reduce the outstanding loan principal balance. When a seriously delinquent loan previously placed on nonaccrual status has cured, meaning all delinquent principal and interest have been remitted by the borrower, the loan is placed back on

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 3. Summary of Significant Accounting Policies (continued)

accrual status. Loans that have been individually impaired are placed back on accrual status once the loan is considered reperforming. A loan is considered reperforming when the loan has been current for at least 12 months.

We use the interest method to determine an effective yield to amortize the premium or discount on real estate loans held-for-investment. For residential loans acquired prior to July 1, 2004, we use coupon interest rates as they change over time and anticipated principal payments to determine periodic amortization. For loans acquired after July 1, 2004, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments, if any, to determine periodic amortization.

We reclassify loans held-for-investment as loans held-for-sale if we determine that these loans will be sold or transferred to third parties. This may occur, for example, if we exercise our right to call ABS issued by a Sequoia securitization trust and decide to subsequently sell the underlying loans to third parties.

See *Note 6* for further discussion on residential loans. See *Note 7* for further discussion on commercial loans.

Residential Loans Allowance for Loan Losses

For residential loans classified as held-for-investment, we establish and maintain an allowance for loan losses based on our estimate of credit losses inherent in our loan portfolios at the reporting date. To calculate the allowance for loan losses, we assess inherent losses by determining loss factors (defaults, the timing of defaults, and loss severities upon defaults) that can be specifically applied to each loan or pools of loans.

We consider the following factors in evaluating the allowance for loan losses:

Ongoing analyses of loans, including, but not limited to, the age of loans and year of origination, underwriting standards, business climate, economic conditions, and other observable data;
Historical loss rates and past performance of similar loans;
Relevant environmental factors;
Relevant market research and publicly available third-party reference loss rates;
Trends in delinquencies and charge-offs;
Effects and changes in credit concentrations;
Information supporting a borrower s ability to meet obligations;
Ongoing evaluations of fair values of collateral using current appraisals and other valuations; and,
Discounted cash flow analyses.

Once we determine the amount of defaults, the timing of the defaults, and severity of losses upon the defaults, we estimate expected losses for each individual loan or pool of loans over its expected life. We then estimate the timing of these losses and the losses probable to occur over an appropriate loss confirmation period. This period is defined as the range of time between the occurrence of a credit loss (such as the initial deterioration of the borrower s financial condition) and the confirmation of that loss (the actual impairment or charge-off of the loan). The losses expected to occur within the estimated loss confirmation period are the basis of our allowance for loan losses, since we believe these losses exist at the reported date of the financial statements. We re-evaluate the adequacy of our allowance for loan losses quarterly.

As part of the loss mitigation efforts undertaken by servicers of residential loans owned by Sequoia securitization entities, a growing number of loan modifications have been completed to help make mortgage

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Note 3. Summary of Significant Accounting Policies (continued)

loans more affordable for certain borrowers. Loan modifications may include, but are not limited to: (i) conversion of a floating rate mortgage loan into a fixed rate mortgage loan; (ii) reduction in the contractual interest rate of a mortgage loan; (iii) forgiveness of a portion of the contractual interest and/or principal amounts owed on a mortgage loan; and, (iv) extension of the contractual maturity of a mortgage loan. We evaluate all loan modifications performed by servicers to determine if they constitute troubled debt restructurings (TDRs) according to GAAP. If a loan is determined to be a TDR, it is removed from the general loan pools used for calculating allowances for loan losses and assessed for impairment on an individual basis based upon any adverse change in the expected future cash flows resulting from the modification. This difference is recorded to the provision for loan losses in our consolidated statements of income.

When foreclosed property is received in full satisfaction for a defaulted loan, we estimate the fair value of the property, based on estimated net proceeds from the sale of the property (including accrued but unpaid interest and other costs). To the extent that the fair value of the property is below the recorded investment of the loan, we record a charge against the allowance for loan losses for the difference. Foreclosed property is subsequently recorded as real estate owned (REO), a component of other assets on our consolidated balance sheets. Actual losses incurred on loans liquidated through a short-sale are also charged against the allowance for loan losses.

Repurchase Reserves

We do not currently maintain a loan repurchase reserve and management is not aware of any outstanding repurchase claims against Redwood that would require the establishment of such a reserve. We do not originate residential loans and believe that risk of loss due to loan repurchases (i.e., due to breach of representations and warranties) would generally be a contingency to the companies from whom we acquired the loans and therefore would be covered by our recourse to those companies.

In circumstances where we believe that there is a risk of loss due to a loan repurchase demand (i.e., due to an allegation of a breach of representations and warranties) and we do not believe that full recourse to the company from whom we acquired the loan exists or is enforceable, we will review the need for any loan repurchase reserve in accordance with FASB guidance on accounting for contingencies and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability and the amount of loss, if any, can be reasonably estimated.

See *Note 6* for further discussion on the allowance for loan losses for residential loans.

Commercial Loans Allowance for Loan Losses

For commercial loans classified as held-for-investment, we establish and maintain a general allowance for loan losses inherent in our portfolio at the reporting date and, where appropriate, a specific allowance for loan losses for loans we have determined to be impaired at the reporting date. An individual loan is considered impaired when it is deemed probable that we will not be able to collect all amounts due according to the contractual terms of the loan.

Our methodology for assessing the adequacy the allowance for loan losses begins with a formal review of each commercial loan in the portfolio and the assignment of an internal impairment status. Reviews are performed at least quarterly. We consider the following factors in evaluating each loan:

Loan to value ratios upon origination or acquisition of the loan;

Ongoing analysis of the most recent financial information for each loan and associated properties, including net operating income, debt service coverage ratios, occupancy rates, rent rolls, as well as any other loss factors we consider relevant, such as, but not limited to, specific loan trigger events that would indicate an adverse change in expected cash flows or payment delinquency;

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 3. Summary of Significant Accounting Policies (continued)

Ongoing analysis of economic trends, both macroeconomic as well as those directly affecting the properties associated with our loans, and the supply and demand of competing projects in the sub-market in which the subject property is located; and,

Ongoing evaluation of each commercial loan sponsor s ability to ensure that properties associated with the loan are managed and operated sufficiently.

Loan reviews are completed by asset management and finance personnel and reviewed and approved by senior management.

Based on the assigned impairment status, a loan is categorized as Pass, Watch List, or Workout. Pass loans are defined as loans that are performing in accordance with the contractual terms of the loan agreement. Watch List loans are defined as performing loans for which the timing of cost recovery is under review. Workout loans are defined as loans that have an established credit impairment that may lead to a realized loss. Workout loans are typically assessed for impairment on an individual basis. Where an individual loan is impaired, we record an allowance to reduce the carrying value of the loan to the updated present value of expected future cash flows discounted at the loan s effective rate with a corresponding charge to our consolidated statement of income.

For all loans that are not individually impaired, we assess the portfolio in aggregate for loan losses based on our expectation of credit losses inherent in our portfolio at the reporting date. Our expectation of credit losses is informed by, among other things:

Historical loss rates and past performance of similar loans in our own portfolio, if any;

Publicly available third-party reference loss rates on similar loans; and,

Trends in delinquencies and charge-offs in our own portfolio and among industry participants.

See *Note 7* for further discussion on the allowance for loan losses for commercial loans.

Real Estate Securities, at Fair Value

We classify our real estate securities as trading or available-for-sale securities. We use the prime or non-prime designation to categorize our residential securities based upon the general credit characteristics of the residential loans underlying each security at the time of origination. For example, prime residential loans are generally characterized by lower LTV ratios, and are made to borrowers with higher Fair Isaac Corporation (FICO) scores. Non-prime residential loans are generally characterized by higher LTV ratios and may have been made to borrowers with lower credit scores or impaired credit histories (while exhibiting the ability to repay their loans). Regardless of whether or not the loans backing a mortgage-backed security were designated as prime or non-prime at origination, there is a risk that the borrower may not be able to repay the loan.

Trading Securities

Trading securities include residential, commercial, and collateralized debt obligation (CDO) securities. Trading securities are carried at their estimated fair values. Coupon interest is recognized as interest income when earned and deemed collectible. All changes in fair value are reported through our consolidated statements of income in market valuation adjustments, net.

We primarily denote trading securities as those securities where we have adopted the fair value option. We currently account for certain securities at Redwood and all securities at Acacia entities as trading securities, at fair value.

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Note 3. Summary of Significant Accounting Policies (continued)

Available-for-Sale (AFS) Securities

AFS securities include certain residential, commercial, and CDO securities. AFS securities are carried at their estimated fair values with cumulative unrealized gains and losses reported as a component of accumulated other comprehensive income in our consolidated statements of equity. Coupon interest is recognized as interest income when earned and deemed collectible, and the interest method is used to determine an effective yield to amortize purchase premiums, discounts, and fees associated with these securities into income over time. This requires us to project cash flows over the remaining life of each security and make assumptions with regards to interest rates, prepayment rates, the timing and amount of credit losses, and other factors. We review our cash flow projections on an ongoing basis and monitor these projections based on input and analyses received from external sources, internal models, and our own judgment and experience.

For an AFS security where its fair value has declined below its amortized cost basis, we evaluate the security for other-than-temporary impairment (OTTI). If we either (i) intend to sell the impaired security; (ii) will more likely than not be required to sell the impaired security before it recovers in value; or, (iii) do not expect to recover the impaired security s amortized cost basis even if we do not intend to sell the security the impairment is deemed an OTTI and we record the entire difference between the security s fair value and its amortized cost in our consolidated statements of income. Conversely, if none of these three conditions is met, we analyze the expected cash flows, or cost recovery of the security, to determine what, if any, OTTI is recognized through our consolidated statements of income. This analysis includes an assessment of any changes in the regulatory and/or economic environment that might affect the performance of the security.

If we conclude through our analysis that there has been no significant adverse change in our cash flow assumptions for the security, then the impairment is deemed temporary in nature and the associated difference between the security s fair value and its amortized cost basis is recorded as an unrealized loss through accumulated other comprehensive income, a component of equity. Alternatively, if we conclude that there has been a significant adverse change in our cash flow assumptions for the security, then the impairment is deemed an OTTI and we perform an additional analysis to determine what portion of OTTI, if any, should be recorded through our consolidated statements of income. This analysis entails discounting the security s cash flows to a present value using the prior period yield for the security to determine an expected recoverable value. The difference between this expected recoverable value and the amortized cost basis of the security is deemed to be the credit component of the OTTI that is recorded in our consolidated statements of income. The amortized cost of the security is then adjusted to the expected recoverable value, and the difference between this expected recoverable value and the fair value is deemed to be the non-credit component of the OTTI that is recorded to accumulated other comprehensive (loss) income. Future amortization and accretion for the security is computed based upon the new amortized cost basis.

See *Note 8* for further discussion on real estate securities.

Other Investments

Other investments included a guaranteed investment contract (GIC) entered into by an Acacia securitization entity that we consolidate for financial reporting purposes. The GIC represented a deposit certificate issued by an investment bank and served as collateral to cover realized losses on credit default swaps (CDS) entered into by this same Acacia entity. As of December 31, 2010, the GIC had been drawn down completely to cover credit losses and principal reductions on the referenced securities. We accounted for this investment at its estimated fair value. Changes in fair value were reported through our consolidated statements of income through market valuation adjustments, net. Interest income was reported through our consolidated statements of income through interest income, other investments.

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Note 3. Summary of Significant Accounting Policies (continued)

Cash and Cash Equivalents

Cash and cash equivalents include non-restricted cash and highly liquid investments with original maturities of three months or less. At December 31, 2011, we did not have any significant concentrations of credit risk arising from cash deposits as all of our cash and cash equivalents were invested in FDIC-insured bank products.

Restricted Cash

Restricted cash primarily includes principal and interest payments that are collateral for, or payable to, owners of ABS issued by consolidated securitization entities. Restricted cash may also include cash retained in the Acacia or Sequoia securitization entities or in the resecuritization entity prior to the payments on or redemptions of outstanding ABS issued. At December 31, 2011, we did not have any significant concentrations of credit risk arising from restricted cash deposits as all of our restricted cash was held in custodial accounts or FDIC-insured bank products.

Accrued Interest Receivable

Accrued interest receivable includes interest that is due and payable to us. Cash interest is generally received within thirty days of recording the receivable. For financial assets where we have elected the fair value option, the associated accrued interest on these assets is measured at fair value. For financial assets where we have not elected the fair value option, the associated accrued interest carrying values approximate fair values.

Derivative Financial Instruments

Derivative financial instruments we currently utilize include contractual interest rate agreements, financial futures contracts, and To Be Announced (TBA) contracts. All derivative financial instruments are recorded at fair value in our consolidated balance sheets. Derivatives with a positive fair value to us are reported as an asset and derivatives with a negative fair value to us are reported as a liability. We classify each of our derivative financial instruments as either (i) a trading instrument (no specific hedging designation for financial reporting purposes) or (ii) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge).

Changes in the fair values of derivatives accounted for as trading instruments, including any associated interest income or expense, are recorded in our consolidated statements of income through market valuation adjustments, net. Changes in the fair values of derivatives accounted for as cash flow hedges, to the extent they are effective, are recorded in accumulated other comprehensive (loss) income, a component of equity. Interest income or expense, and any ineffectiveness associated with these derivatives, are recorded as a component of net interest income in our consolidated statements of income. We measure the effective portion of cash flow hedges by comparing the change in fair value of the expected future variable cash flows of the derivative hedging instruments with the change in fair value of the expected future variable cash flows of the hedged liability.

We will discontinue cash flow hedge accounting if (i) we determine that the hedging derivative is no longer expected to be effective in offsetting changes in the cash flows of the designated hedged item; (ii) the derivative expires or is sold, terminated, or exercised; (iii) the derivative is de-designated as a cash flow hedge; or, (iv) it is probable that a forecasted transaction associated with the hedged item will not occur by the end of the originally specified time period. To the extent we de-designate a cash flow hedging relationship and the associated hedged item continues to exist, any unrealized gain or loss of the cash flow hedge at the time of de-designation remains in accumulated other comprehensive (loss) income and is amortized using the straight-line method through interest expense over the remaining life of the hedged liability.

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Note 3. Summary of Significant Accounting Policies (continued)

Interest Rate Agreements

Interest rate agreement derivatives that we currently utilize include interest rate swaps and caps. Interest rate swaps are derivative contracts in which (i) one party exchanges a stream of fixed interest payments for another party s stream of variable interest cash flows; or, (ii) each party exchanges variable interest cash flows that are referenced to different indices. Interest rate caps are derivative contracts in which the buyer receives payments at the end of each period in which the interest rate exceeds an agreed upon strike price. We enter into interest rate swaps and caps primarily to reduce significant changes in our income or equity caused by interest rate volatility. Certain of these interest rate agreements may be designated as cash flow hedges.

Financial Futures and TBA Contracts

We currently utilize TBA contracts and financial futures contracts such as Eurodollar futures and Treasury futures. Eurodollar futures contracts, unlike our other derivatives, have maturities of only three months. Therefore, in order to achieve the desired interest rate offset necessary to manage our risk, consecutively maturing contracts are required, resulting in a stated notional amount higher than would be needed with our other derivatives. TBA contracts are forward commitments to purchase U.S. government agency mortgage-backed securities to be issued in the future. Financial futures are futures contracts on short-term benchmark interest rates. We purchase or sell these hedging instruments to offset to varying degrees changes in the values of mortgage products for which we have exposure. We account for these derivatives as trading instruments and record any changes in value (including any associated interest income or expense) in our consolidated statements of income through market valuation adjustments, net.

Credit Derivatives

Credit derivatives that we have historically utilized include CDS, which are agreements to pay (receive) credit event protection based on a financial index or specific security in exchange for receiving (paying) a fixed-rate fee or premium over the term of the contract. These instruments enable us, or our consolidated securitization entities, to synthetically assume the credit risk of a reference security or index of securities. The estimated fair values of these contracts fluctuate for a variety of reasons, such as the likelihood or occurrence of a qualifying credit event (e.g., an interest shortfall, a failure to pay principal, or a distressed rating downgrade), the market perception of default risk and counterparty risk, and supply and demand changes. We do not designate any credit derivatives as cash flow hedges.

See *Note 9* for further discussion on derivative financial instruments.

Deferred Tax Assets

Our deferred tax assets are generated by temporary differences in GAAP and taxable income at our taxable subsidiaries. These differences generally reflect differing accounting treatments for tax and GAAP, such as accounting for discount and premium amortization, credit losses, equity awards, asset impairments, and certain valuation estimates. As a result of these differences, we may recognize taxable income in periods prior to when we recognize income for GAAP. When this occurs, we pay the tax liability and establish a deferred tax asset for GAAP. As the income is subsequently realized in future periods under GAAP, the deferred tax asset is reduced.

See *Note 18* for further discussion on deferred tax assets.

Deferred Securities Issuance Costs

Securities issuance costs are expenses associated with the issuance of long-term debt, the resecuritization we engaged in during the third quarter of 2011, and the ABS from the Sequoia securitization entities we sponsor. These expenses typically include underwriting, rating agency, legal, accounting, and other fees. ABS issuance costs associated with liabilities accounted for under the fair value option are expensed as incurred.

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Note 3. Summary of Significant Accounting Policies (continued)

ABS issuance costs associated with liabilities reported at cost are deferred. Deferred ABS issuance costs are reported on our consolidated balance sheets as deferred charges (an asset) and are amortized as an adjustment to interest expense using the interest method, based upon the actual and estimated repayment schedules of the related debt and ABS issued.

Other Assets

Other assets include REO, margin receivable, fixed assets, principal receivable, and other prepaid expenses. REO property acquired through, or in lieu of, loan foreclosure is initially recorded at fair value, and subsequently reported at the lower of carrying amount or fair value (less estimated cost to sell). Changes in the fair value of an REO property that has a fair value at or below its carrying amount are recorded in our consolidated statements of income as a component of market valuation adjustments, net. Margin receivable reflects cash collateral Redwood has posted with our various derivative and lending counterparties as required to satisfy the minimum margin requirements.

See *Note 10* for further discussion on other assets.

Short-Term Debt

Short-term debt includes borrowings under master repurchase agreements, bank warehouse facilities, and other forms of borrowings that expire within one year with various counterparties. These facilities may be unsecured or collateralized by cash, loans, or securities.

See *Note 11* for further discussion on short-term debt.

Accrued Interest Payable

Accrued interest payable includes interest that is due and payable to third parties. Interest is generally paid within one to three months of recording the payable, based upon our remittance requirements. For borrowings where we have elected the fair value option, the associated accrued interest on these liabilities is measured at fair value. For financial liabilities where we have not elected the fair value option, the associated accrued interest carrying values approximate fair values.

Asset-Backed Securities Issued

The majority of the liabilities reported on our consolidated balance sheets represent ABS issued by bankruptcy-remote entities sponsored by Redwood. Sequoia, Acacia, and the resecuritization assets are held in the custody of securitization trustees and are not owned by Redwood. These trustees collect principal and interest payments (less servicing and related fees) from the assets and make corresponding principal and interest payments to the ABS investors.

Sequoia ABS Issued

Sequoia ABS issued are carried at their unpaid principal balances net of any unamortized discount or premium.

Acacia ABS Issued

Acacia ABS issued are accounted for under the fair value option and carried at their estimated fair values. Changes in fair value (gains or losses) are reported in our consolidated statements of income through market valuation adjustments, net.

Resecuritization ABS Issued

Resecuritization ABS issued are carried at their unpaid principal balances net of any unamortized discount or premium.

See *Note 12* for further discussion on ABS issued.

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Note 3. Summary of Significant Accounting Policies (continued)

Long-Term Debt

Long-term debt includes trust preferred securities and subordinated notes at Redwood and is carried at its unpaid principal balance. Our long-term debt is unsecured with quarterly interest payments determined based upon a floating rate equal to the three-month London Interbank Offered Rate (LIBOR) plus a margin until it is redeemed in whole or matures at a future date.

See *Note 13* for further discussion on long-term debt.

Equity

Accumulated Other Comprehensive (Loss) Income

Net unrealized gains and losses on real estate securities available-for-sale and interest rate agreements previously designated as cash flow hedges are reported as components of accumulated other comprehensive (loss) income on our consolidated statements of changes in equity and our statements of consolidated comprehensive (loss) income. Net unrealized gains and losses on securities and interest rate agreements held by our taxable subsidiaries that are reported in other comprehensive (loss) income are adjusted for the effects of taxation and may create deferred tax assets or liabilities.

Noncontrolling Interest

Noncontrolling interest represents the aggregate limited partnership interests in the Fund held by third parties. In accordance with GAAP, the noncontrolling interest of the Fund is shown as a component of equity on our consolidated balance sheets, and the portion of income allocable to third parties is shown as net (loss) income attributable to noncontrolling interest in our consolidated statements of income. Equity attributable to noncontrolling interest is disclosed in our consolidated statements of changes in equity and our statements of consolidated comprehensive (loss) income. As we deconsolidated the Fund in the fourth quarter of 2011, there is no longer noncontrolling interest.

Earnings Per Common Share

Basic earnings per common share (EPS) is computed by dividing net income allocated to common shareholders by the weighted average common shares outstanding. Net income allocated to common shareholders represents net income applicable to common shareholders, less income allocated to participating securities (as described below). Diluted earnings per common share is computed by dividing income allocated to common shareholders by the weighted average common shares outstanding plus amounts representing the dilutive effect of equity awards.

Accounting guidance on EPS defines unvested share-based payment awards containing nonforfeitable rights to dividends as participating securities that are included in computing EPS using the two-class method. The two-class method is an earnings allocation formula under which EPS is calculated for common stock and participating securities according to dividends declared and participating rights in undistributed earnings. Under this method, all earnings (distributed and undistributed) are allocated to participating securities and common shares based on their respective rights to receive dividends.

See *Note 15* for further discussion on equity.

Incentive Plans

In May 2010, our shareholders approved an amendment to our previously amended 2002 Redwood Trust, Inc. Incentive Plan (Incentive Plan) for executive officers, employees, and non-employee directors. The amendment provided for an increase in the number of shares available for distribution under the plan. The Incentive Plan authorizes our Board of Directors (or a committee appointed by our Board of Directors) to grant incentive stock options (ISOs), non-qualifying stock options (NQSOs), performance stock units (PSUs),

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Note 3. Summary of Significant Accounting Policies (continued)

deferred stock units (DSUs), restricted stock, performance shares, performance units (including cash), stock appreciation rights, limited stock appreciation rights (awards), and dividend equivalent rights (DERs) to eligible recipients other than non-employee directors. These awards generally vest over a three- or four-year period. Non-employee directors are also provided annual awards under the Incentive Plan that generally vest immediately.

The cost of equity awards is determined in accordance with share-based payment accounting guidance and amortized over the vesting term using an accelerated method for equity awards granted prior to December 1, 2008. For equity awards granted after December 1, 2008, the cost of the awards is amortized over the vesting period on a straight-line basis. Timing differences between the accelerated and straight-line methods of amortization were determined to not be material to our consolidated financial statements.

Employee Stock Purchase Plan

In May 2009, our stockholders approved an amendment to our 2002 Redwood Trust, Inc. Employee Stock Purchase Plan (ESPP) to increase the number of shares available under the ESPP. The purpose of the ESPP is to give our employees an opportunity to acquire an equity interest in the Company through the purchase of shares of common stock at a discount. The ESPP allows eligible employees to purchase common stock at 85% of its fair value, subject to certain limits. Fair value as defined under the ESPP is the lesser of the closing market price of the common stock on the first day of the calendar year or the first day of the calendar quarter.

Executive Deferred Compensation Plan

In May 2002, our Board of Directors approved our 2002 Executive Deferred Compensation Plan (EDCP). The EDCP allows eligible employees and directors to defer portions of current salary and certain other forms of compensation. The Company matches some deferrals. Compensation deferred under the EDCP is recorded as a liability on our consolidated balance sheets and subject to the claims of our general creditors. The EDCP allows for the investment of deferrals in either an interest crediting account or DSUs.

401(k) Plan

We offer a tax-qualified 401(k) Plan to all employees for retirement savings. Under this Plan, employees are allowed to defer and invest up to 100% of their cash earnings, subject to the maximum 401(k) Plan contribution limit set forth by the Internal Revenue Service. We match some employee contributions to encourage participation and to provide a retirement planning benefit to employees. For the years ended December 31, 2011, 2010, and 2009, 401(k) matching contributions made by the Company were $0.4 million, $0.3 million, and $0.3 million, respectively. Vesting of the

401(k) Plan matching contributions is based on the employee s tenure at the Company, and over time, an employee becomes increasingly vested in both prior and new matching contributions.

See *Note 16* for further discussion on equity compensation plans.

Taxes

We have elected to be taxed as a REIT under the Internal Revenue Code and the corresponding provisions of state law. To qualify as a REIT we must distribute at least 90% of our annual REIT taxable income to shareholders (not including taxable income retained in our taxable subsidiaries) within the time frame set forth in the tax code and also meet certain other requirements related to assets, income, and stock ownership. We assess our tax positions for all open tax years and determine whether we have any material unrecognized liabilities in accordance with FASB guidance on accounting for uncertainty in income taxes. We record these liabilities to the extent we deem them incurred. We classify interest and penalties on material uncertain tax positions as interest expense and operating expense, respectively, in our consolidated statements of income.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 3. Summary of Significant Accounting Policies (continued)

See *Note 18* for further discussion on taxes.

Recent Accounting Pronouncements

In April 2011, the FASB issued Accounting Standards Update (ASU) 2011-02, *A Creditor s Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, which provides additional guidance to creditors for evaluating troubled debt restructurings. The amendments clarify the guidance in ASC 310-40, *Receivables: Troubled Debt Restructurings by Creditors*, which requires a creditor to classify a restructuring as a TDR if (1) the restructuring includes a concession by the creditor to the borrower and (2) the borrower is experiencing financial difficulties. The amended guidance requires a creditor to consider all aspects of the restructuring to determine whether it has granted a concession, and includes additional guidance to identify concessions, as well as indicators for determining whether the debtor is facing financial difficulties. In addition, ASU 2011-02 ended the public-entity deferral of TDR disclosures in ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses.*

We adopted ASU 2011-02 in the second quarter of 2011. At December 31, 2011, the recorded investment in receivables for which the allowance for loan losses was previously measured under a general allowance for loan losses and are now impaired under ASC 310-10-35 was $3 million. The allowance for loan losses associated with those receivables, on a basis of current evaluation of loss, was $0.2 million at December 31, 2011. For additional disclosures related to TDRs, see *Note 6*.

In May 2011, the FASB issued ASU 2011-04, *Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. This ASU converges fair value measurement and disclosure guidance in U.S. GAAP with the guidance concurrently issued by the International Accounting Standards Board. While the amendments in ASU 2011-04 do not modify the requirements for when fair value measurements apply, they do generally represent clarifications on how to measure and disclose fair value under ASC 820, Fair Value Measurement. This ASU is effective for interim and annual periods beginning after December 15, 2011 and should be applied prospectively. Early adoption is not permitted. ASU 2011-04 may increase our disclosures related to fair value measurements, but will not have an effect on our consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, *Comprehensive Income: Presentation of Comprehensive Income.* This ASU eliminates the option to present components of other comprehensive income in the statement of changes in equity and requires entities to present all non-owner changes in stockholders equity either as a single continuous statement of comprehensive income or as two separate but consecutive statements. This ASU is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2011. We adopted ASU 2011-05 in the fourth quarter of 2011, and chose to present the components of comprehensive income as two separate but consecutive statements. The adoption of ASU 2011-05 did not have an effect on our financial results.

Note 4. Principles of Consolidation

We apply FASB guidance to determine whether we must consolidate transferred financial assets and VIEs for financial reporting purposes. Specifically, GAAP requires us to consider whether securitizations and other transfers of financial assets should be treated as sales or financings, as well as whether any VIEs (e.g., certain legal entities often used in securitization and other structured finance transactions) should be included in our consolidated financial statements.

The tables below present our analysis of VIEs where we maintain an interest, as distinguished by those we have consolidated for financial reporting purposes and those we have not. The principles of consolidation we apply require us to reassess our requirement to consolidate VIEs each quarter and therefore our determination may change based upon new facts and circumstances pertaining to each VIE. This could result in a material impact to our consolidated financial statements during subsequent reporting periods.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 4. Principles of Consolidation (continued)

Analysis of Consolidated VIEs

The VIEs we are required to consolidate include certain Sequoia securitization entities, the Acacia entities, and the resecuritization entity. Each of these entities is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of ours, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities. The following table presents a summary of the assets and liabilities of these VIEs. Intercompany balances have been eliminated for purposes of this presentation.

Assets and Liabilities of Consolidated VIEs at December 31, 2011

December 31, 2011 (Dollars in thousands)	Sequoia Entities	Acacia Entities	Resecuritization	Total
Residential loans, held-for-investment	$3,799,648	$	$	$3,799,648
Commercial loans, at fair value		12,129		12,129
Real estate securities, at fair value		231,101	324,705	555,806
Restricted cash	287	14,600		14,887
Accrued interest receivable	7,786	2,065	961	10,812
Derivative assets		2,326		2,326
Deferred securities issuance costs	5,686		1,155	6,841
Other assets	5,775	126		5,901
Total Assets	$3,819,182	$262,347	$ 326,821	$4,408,350
Accrued interest payable	$3,978	$2,894	$ 42	$6,914
Derivative liabilities		62,695		62,695
Accrued expenses and other liabilities		160		160
Asset-backed securities issued	3,710,423	209,381	219,551	4,139,355
Total Liabilities	$3,714,401	$275,130	$ 219,593	$4,209,124
Noncontrolling interest	$	$	$	$
Number of VIEs	39	10	1	50

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 4. Principles of Consolidation (continued)

Assets and Liabilities of Consolidated VIEs at December 31, 2010

December 31, 2010 (Dollars in thousands)	Sequoia Entities	Acacia Entities	The Fund	Total
Residential loans held-for-investment	$ 3,542,158	$	$	$ 3,542,158
Commercial loans, at fair value		19,850		19,850
Real estate securities, at fair value		308,363	23,256	331,619
Restricted cash	331	21,790	2,403	24,524
Accrued interest receivable	6,264	2,735	84	9,083
Derivative assets		6,825		6,825
Deferred securities issuance costs	4,639			4,639
Other assets	14,241	538		14,779
Total Assets	$ 3,567,633	$ 360,101	$ 25,743	$ 3,953,477
Accrued interest payable	$ 2,357	$ 2,911	$	$ 5,268
Derivative liabilities		69,372		69,372
Accrued expenses and other liabilities	105	372	1,234	1,711
Asset-backed securities issued	3,458,501	303,077		3,761,578
Total Liabilities	$ 3,460,963	$ 375,732	$ 1,234	$ 3,837,929
Noncontrolling interest	$	$	$ 10,839	$ 10,839
Number of VIEs	37	10	1	48

We consolidate the assets and liabilities of certain Sequoia securitization entities issued prior to 2010, as we did not meet the sale criteria at the time we transferred financial assets to these entities. Had we not been the transferor and depositor of these securitizations, we would likely not have consolidated them as we determined that we are not the primary beneficiary of these entities in accordance with ASC 810-10. During and since 2010, we have sponsored three residential jumbo mortgage securitizations through our Sequoia program totaling $908 million. We recorded the assets and liabilities of these entities on our consolidated balance sheets, as we did not meet the sale criteria at the time we transferred financial assets to these entities. Additionally, we determined that we are the primary beneficiary of these VIEs as our ongoing loss mitigation and resolution responsibilities provide us with the power to direct the activities that most significantly impact the economic performance of these entities and our significant investment interests provide us with the obligation to absorb losses or the right to receive benefits that are significant.

We consolidate the assets and liabilities of the Acacia securitization entities, as we did not meet the sale criteria at the time we transferred financial assets to these entities and we are the primary beneficiary of these VIEs. Our ongoing asset management responsibilities and call options provide us with the power to direct the activities that most significantly impact the economic performance of these individual entities, and our equity investments in each entity provide us with the obligation to absorb losses or the right to receive benefits that are significant.

We consolidate the assets and liabilities of the entity formed in connection with the resecuritization transaction we engaged in during the third quarter of 2011, as we did not meet the sale criteria at the time the financial assets were transferred to this entity and we are the primary beneficiary. We transferred an aggregate of $365 million ($437 million principal value) of residential senior securities to Credit Suisse First Boston Mortgage Securities Corp., which subsequently sold them to CSMC 2011-9R, a resecuritization entity. In connection with this transaction, senior securities of $245 million were issued by CSMC 2011-9R and sold to third-party investors, and we acquired $192 million of subordinate securities issued by CSMC 2011-9R. We also received $243 million in cash and acquired $245 million notional amount of variable rate, interest-only senior certificates.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 4. Principles of Consolidation (continued)

We engaged in this resecuritization primarily for the purpose of obtaining permanent non-recourse financing on a portion of our residential securities portfolio. Our credit risk exposure is largely unchanged as a result of engaging in the transaction, as we remain economically exposed to the financed securities through the first loss position in the structure.

Prior to the third quarter of 2011, we consolidated the assets, liabilities, and noncontrolling interests of the Fund, as we determined that we were the primary beneficiary of this VIE. Our ongoing asset management responsibilities provided us with the power to direct the activities that most significantly impacted the Fund s economic performance, and our general and limited partnership interests provided us with the obligation to absorb losses or the right to receive benefits that were significant. In the second quarter of 2011, the Fund sold all of its remaining investments. As all partners received final cash asset distributions in the fourth quarter of 2011 and there were no remaining assets or liabilities in the Fund, we deconsolidated the Fund and recognized a loss on deconsolidation of less than $1 million in our consolidated statements of income through realized gains on sales and calls, net.

Analysis of Third-Party VIEs

Third-party VIEs are securitization entities in which we maintain an economic interest but do not sponsor. Our economic interest may include several securities from the same third-party VIE, and in those cases, the analysis is performed in consideration of all of our interests. The following table presents a summary of our interest in third-party VIEs at December 31, 2011 and 2010, grouped by collateral type and ownership interest.

Third-Party VIE Summary

(Dollars in Thousands)	December 31, 2011 Fair Value	December 31, 2011 Number of VIEs	December 31, 2010 Fair Value	December 31, 2010 Number of VIEs
Real estate securities at Redwood Residential				
Senior	$ 229,867	64	$ 664,444	99
Re-REMIC	119,366	16	85,076	9
Subordinate	70,345	165	65,162	182
Commercial	5,445	8	7,496	14
CDO	1,010	8	1,038	10
Total Third-Party Real Estate Securities	$ 426,033	261	$ 823,216	314

We determined that we are not the primary beneficiary of any third-party residential, commercial, or CDO entities, as we do not have the required power to direct the activities that most significantly impact the economic performance of these entities. Specifically, we do not service or manage these entities or otherwise hold decision making powers that are significant. As a result of this assessment, we do not consolidate any of the underlying assets and liabilities of these third-party VIEs we only account for our specific interests in each.

Our assessments of whether we are required to consolidate a VIE may change in subsequent reporting periods based upon changing facts and circumstances pertaining to each VIE. Any related accounting changes could result in a material impact to our financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 5. Fair Value of Financial Instruments

For financial reporting purposes, we follow a fair value hierarchy established under GAAP that is used to measure the fair value of the assets and liabilities. This hierarchy prioritizes relevant market inputs in order to determine an exit price, or the price at which an asset could be sold or a liability could be transferred in an orderly process that is not a forced liquidation or distressed sale at the date of measurement. Level 1 inputs are observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets. Level 2 inputs are observable inputs other than quoted prices for an asset or liability that are obtained through corroboration with observable market data. Level 3 inputs are unobservable inputs (e.g., our own data or assumptions) that are used when there is little, if any, relevant market activity for the asset or liability being measured at fair value.

In certain cases, inputs used to measure fair value fall into different levels of the fair value hierarchy. In such cases, the level in which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement. Our assessment of the significance of a particular input requires judgment and considers factors specific to the asset or liability being measured.

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value at December 31, 2011 and 2010.

(In Thousands)	December 31, 2011		December 31, 2010	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Residential loans, held-for-sale	$ 395,237	$ 401,909	$ 1,855	$ 1,855
Residential loans, held-for-investment	3,799,648	3,306,441	3,795,240	3,367,340
Commercial loans, at fair value	12,129	12,129	19,850	19,850
Commercial loans, held-for-investment	157,726	158,780	30,536	30,887
Trading securities	253,142	253,142	329,717	329,717
Available-for-sale securities	728,695	728,695	825,119	825,119
Cash and cash equivalents	267,176	267,176	46,937	46,937
Restricted cash	14,987	14,987	24,524	24,524
Accrued interest receivable	15,840	15,840	13,782	13,782
Derivative assets	2,373	2,373	8,051	8,051
REO (included in other assets)	5,669	5,669	14,481	14,481
Margin receivable (included in other assets)	71,976	71,976	16,233	16,233
Liabilities				
Short-term debt	428,056	428,056	44,137	44,137
Accrued interest payable	8,134	8,134	5,930	5,930

Derivative liabilities	127,564	127,564	83,115	83,115
ABS issued	4,139,355	3,467,054	3,761,578	3,263,074
Long-term debt	139,500	57,195	139,500	75,330

We did not elect the fair value option for any financial instruments that we acquired in 2011. We have elected the fair value option for all of the financial instruments at Acacia, including commercial loans, trading securities, and ABS issued, as well as certain residential securities and CDOs at Redwood.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 5. Fair Value of Financial Instruments (continued)

The following table presents assets and liabilities recorded at fair value on our consolidated balance sheets on a recurring basis and indicates the fair value hierarchy of the valuation techniques used to measure fair value.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

December 31, 2011	Carrying	Fair Value Measurements Using		
(In Thousands)	Value	Level 1	Level 2	Level 3
Assets				
Commercial loans, at fair value	$ 12,129	$	$	$ 12,129
Trading securities	253,142			253,142
Available-for-sale securities	728,695			728,695
Derivative assets	2,373	47	2,326	
Liabilities				
Derivative liabilities	127,564	5,246	102,818	19,500
ABS issued Acacia	209,381			209,381

December 31, 2010	Carrying	Fair Value Measurements Using		
(In Thousands)	Value	Level 1	Level 2	Level 3
Assets				
Commercial loans, at fair value	$ 19,850	$	$	$ 19,850
Trading securities	329,717			329,717
Available-for-sale securities	825,119			825,119
Derivative assets	8,051	1,051	6,999	1
Liabilities				
Derivative liabilities	83,115	1,010	82,105	
ABS issued Acacia	303,077			303,077

The following table presents additional information about Level 3 assets and liabilities for the years ended December 31, 2011 and 2010. During the third quarter of 2011, we transferred $20 million of derivative liabilities from Level 2 to Level 3 classification. The entire amount relates to an interest rate swap held at one Acacia securitization entity that required an adjustment to its fair value due to valuation inputs pertaining to counterparty exposure.

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis

(In Thousands)	Assets Commercial Loans	Trading Securities	AFS Securities	Derivative Assets	Liabilities Derivative Liabilities	ABS Issued - Acacia
Beginning balance December 31, 2010	$ 19,850	$ 329,717	$ 825,119	$ 1	$	$ 303,077
Transfer to Level 3					20,052	
Principal paydowns	(8,768)	(53,990)	(112,145)			(80,006)
Gains (losses) in net income, net	1,047	(9,556)	34,028		2,499	(27,314)
Unrealized losses in OCI, net			(83,456)			
Acquisitions			128,566			
Sales		(13,588)	(63,525)			
Other settlements, net		559	108	(1)	(3,051)	13,624
Ending Balance December 31, 2011	$ 12,129	$ 253,142	$ 728,695	$	$ 19,500	$ 209,381

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 5. Fair Value of Financial Instruments (continued)

(In Thousands)	Assets				Liabilities	
	Commercial Loans	Trading Securities	AFS Securities	Derivative Assets	Derivative Liabilities	ABS Issued - Acacia
Beginning balance December 31, 2009	$12,089	$277,274	$810,471	$46	20,301	$297,596
Principal paydowns	(218)	(60,254)	(145,053)			(77,828)
Gains (losses) in net income, net	7,979	102,797	37,448	(20)	(283)	71,695
Unrealized gains in OCI, net			56,644			
Acquisitions		17,137	261,657			
Sales		(7,855)	(196,153)			
Other settlements, net		618	105	(25)	(20,018)	11,614
Ending Balance December 31, 2010	$19,850	$329,717	$825,119	$1	$	$303,077

The following table presents the portion of gains or losses included in our consolidated statements of income that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and still held at December 31, 2011 and 2010. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the years ended December 31, 2011 and 2010 are not included in this presentation.

Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at December 31, 2011 and 2010 Included in Net Income

(In Thousands)	Included in Net Income Years Ended December 31, 2011	2010
Assets		
Commercial loans, at fair value	$ (68)	$ 7,979
Trading securities	(18,128)	99,879
Available-for-sale securities	(7,852)	(4,325)
Derivative assets		14
Liabilities		
Derivative liabilities	2,499	
ABS issued Acacia	27,313	(71,695)

The following table presents information on assets and liabilities recorded at fair value on a non-recurring basis at

December 31, 2011 and 2010.

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at December 31, 2011

December 31, 2011 (In Thousands)	Carrying Value	Fair Value Measurements Using Level 1	Level 2	Level 3	Gain (Loss) Year Ended December 31, 2011
Assets					
Residential loans, held-for-sale	$ 2,169	$	$	$ 2,169	$ 380
REO	5,669			5,669	(1,624)

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 5. Fair Value of Financial Instruments (continued)

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at December 31, 2010

December 31, 2010 (In Thousands)	Carrying Value	Fair Value Measurements Using Level 1	Level 2	Level 3	Gain (Loss) Year Ended December 31, 2010
Assets					
Residential loans, held-for-sale	$ 1,855	$	$	$ 1,855	$ 462
REO	14,481			14,481	(2,617)

The following table presents the components of market valuation adjustments, net, recorded in our consolidated statements of income for the years ended December 31, 2011, 2010, and 2009.

Market Valuation Adjustments, Net

(In Thousands)	Years Ended December 31, 2011	2010	2009
Assets			
Commercial loans, at fair value	$ 616	$ 7,979	$ 3,611
Residential loans, held-for-sale	380	462	19
Trading securities	(9,293)	102,612	22,176
REO	(1,624)	(2,617)	(2,036)
Impairments on AFS securities	(9,472)	(9,887)	(73,758)
Liabilities			
Derivative instruments, net	(47,937)	(46,408)	18,598
ABS issued Acacia	27,313	(71,695)	(56,238)
Market Valuation Adjustments, Net	$ (40,017)	$ (19,554)	$ (87,628)

A description of the instruments measured at fair value as well as the general classification of such instruments pursuant to the Level 1, Level 2, and Level 3 valuation hierarchy is listed below.

Residential loans

Residential loan fair values are determined based on an exit price to securitization, as that is the principal market where we transact. Significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the limited availability of market quotes on new issuance residential mortgage-backed securities (RMBS) and related inputs.

Relevant market indicators that are factored in the analyses include third-party RMBS sales, pricing points for secondary sales of our past issued RMBS, Agency issued RMBS yields, Rating Agency guidance on expected credit enhancement levels for new issue RMBS transactions, interest rates, and prepayment speeds (Level 3).

Commercial loans

Commercial loan fair values are determined by available market quotes and discounted cash flow analyses (Level 3). The availability of market quotes for all of our commercial loans is limited. Any changes in fair value are primarily a result of instrument specific credit risk.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 5. Fair Value of Financial Instruments (continued)

Real estate securities

Real estate securities are residential, commercial, CDO, and other asset-backed securities that are illiquid in nature and trade infrequently. Fair values are determined by discounted cash flow analyses and other valuation techniques using market pricing assumptions that are confirmed by third-party dealer/pricing indications, to the extent available. Significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the lack of readily available market quotes and related inputs. Relevant market indicators that are factored in the analyses include bid/ask spreads, credit losses, interest rates, and prepayment speeds. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3).

We request and consider indications of value (marks) from third-party dealers to assist us in our valuation process. For December 31, 2011, we received dealer marks on 78% of our securities. In the aggregate, our internal valuations of the securities on which we received dealer marks were 6% lower (i.e., more conservative) than the aggregate dealer marks.

Derivative assets and liabilities

Our derivative instruments include interest rate agreements, TBAs, and financial futures. Fair values of derivative instruments are determined using quoted prices from active markets when available or valuation models and are verified by valuations provided by dealers active in derivative markets. TBA and financial futures fair values are generally obtained using quoted prices from active markets (Level 1). Valuation models require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of such inputs. Model inputs for interest rate agreements can generally be verified and model selection does not involve significant management judgment (Level 2). For other derivatives, valuations are based on various factors such as liquidity, bid/offer spreads, and credit considerations for which we rely on available market evidence. In the absence of such evidence, management s best estimate is used (Level 3).

Cash and cash equivalents

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less. Fair values equal carrying values.

Restricted cash

Restricted cash primarily includes interest-earning cash balances in ABS entities and the Fund for the purpose of distribution to bondholders or limited partners, and reinvestment. Due to the short-term nature of the restrictions, fair values approximate carrying values.

Accrued interest receivable and payable

Accrued interest receivable and payable includes interest due on our assets and payable on our liabilities. Due to the short-term nature of when these interest payments will be received or paid, fair values approximate carrying values.

Short-term debt

Short-term debt includes our credit facilities that mature within one year. Short-term debt is generally at an adjustable rate. Fair values approximate carrying values.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 5. Fair Value of Financial Instruments (continued)

ABS issued

ABS issued includes asset-backed securities issued through our Sequoia, Acacia, and resecuritization programs. These instruments are illiquid in nature and trade infrequently, if at all. Fair values are determined by discounted cash flow analyses and other valuation techniques using market pricing assumptions that are confirmed by third-party dealer/pricing indications, to the extent available. Significant inputs in the valuation analysis are predominantly Level 3, due to the nature of these instruments and the lack of readily available market quotes. Relevant market indicators factored into the analyses include dealer price indications to the extent available, bid/ask spreads, external spreads, collateral credit losses, interest rates and collateral prepayment speeds. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3).

We request and consider indications of value (marks) from third-party dealers to assist us in our valuation process. For December 31, 2011, we received dealer marks on 93% of our ABS issued. Our internal valuations of our ABS issued on which we received dealer marks were 1% higher (i.e., more conservative) than the aggregate dealer marks.

Long-term debt

Long-term debt includes our subordinated notes and trust preferred securities. Fair values are determined using comparable market indicators of current pricing. Significant inputs in the valuation analysis are predominantly Level 3 due to the nature of these instruments and the lack of readily available market quotes. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3).

REO

REO includes properties owned in satisfaction of foreclosed loans. Fair values are determined using available market quotes, appraisals, broker price opinions, comparable properties, or other indications of value (Level 3).

Margin receivable

Margin receivable reflects cash collateral Redwood has posted with our various derivative and lending counterparties as required to satisfy the minimum margin requirements. Fair values approximate carrying values.

Note 6. Residential Loans

We invest in residential real estate loans that we acquire from third-party originators. During the year ended December 31, 2011, we purchased $830 million (principal value) of residential loans in connection with our Sequoia securitization program. The following table summarizes the classifications and carrying value of the residential loans owned at Redwood and at consolidated Sequoia entities at December 31, 2011 and 2010.

December 31, 2011 (In Thousands)	Redwood	Sequoia	Total
Held-for-sale	$ 395,237	$	$ 395,237
Held-for-investment		3,799,648	3,799,648
Total Residential Loans	$ 395,237	$ 3,799,648	$ 4,194,885

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 6. Residential Loans (continued)

December 31, 2010 (In Thousands)	Redwood	Sequoia	Total
Held-for-sale	$ 1,855	$	$ 1,855
Held-for-investment	253,081	3,542,159	3,795,240
Total Residential Loans	$ 254,936	$ 3,542,159	$ 3,797,095

We do not currently service any residential loans, although we did acquire the rights to service $137 million (principal value) of loans purchased from third-party originators in 2011.

Residential Loan Characteristics

The following table displays the geographic concentration of residential loans recorded on our consolidated balance sheets at December 31, 2011 and 2010.

Geographic Concentration (by Principal)	December 31, 2011		2010	
California	26	%	22	%
Florida	11	%	13	%
New York	7	%	7	%
Texas	6	%	5	%
Georgia	4	%	5	%
New Jersey	4	%	4	%
Other states (none greater than 4%)	42	%	44	%
Total	100	%	100	%

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 6. Residential Loans (continued)

The following table displays the loan product type and accompanying loan characteristics of residential loans recorded on our consolidated balance sheets at December 31, 2011 and 2010.

December 31, 2011 (In Thousands)	Loan Balance	Number of Loans	Interest Rate[1]		Maturity Date		Total Principal	30 89 Days DQ	90+ Days DQ
ARM loans:	$0 to $250	7,075	0.13% to 6.25	%	11/2012	11/2035	$838,753	$22,997	$24,926
	$251 to $500	2,483	0.00% to 4.13	%	02/2013	05/2036	876,388	24,042	38,490
	$501 to $750	771	0.00% to 4.38	%	08/2013	12/2035	468,735	16,428	22,510
	$751 to $1,000	394	0.38% to 3.25	%	12/2013	07/2035	351,340	5,529	14,164
	over $1,000	314	0.00% to 3.00	%	09/2013	05/2036	500,332	8,879	25,104
		11,037					3,035,548	77,875	125,194
Hybrid ARM loans:	$0 to $250	14	2.63% to 6.50	%	08/2033	08/2037	2,397		
	$251 to $500	92	1.63% to 6.88	%	07/2033	07/2047	37,969		4,162
	$501 to $750	154	1.63% to 6.75	%	07/2033	07/2047	96,321	2,013	4,402
	$751 to $1,000	128	1.63% to 6.38	%	07/2033	06/2047	114,851	870	2,422
	over $1,000	97	1.63% to 6.00	%	08/2033	01/2042	138,779	1,090	1,274
		485					390,317	3,973	12,260
Fixed loans:	$0 $250	14	3.70% to 5.50	%	02/2039	09/2041	2,400		
	$251 $500	106	3.00% to 5.63	%	01/2026	12/2041	45,324		
	$501 $750	338	3.10% to 5.50	%	01/2026	01/2042	210,552	1,194	
	$751 $1000	305	3.13% to 5.50	%	01/2026	01/2042	269,679	1,992	
	over $1000	205		%	12/2025	12/2041	270,925		

		3.50% to 5.38			
	968		798,880	3,186	
Total	12,490		$4,224,745	$85,034	$137,454

(1) Rate is net of servicing fee.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 6. Residential Loans (continued)

Residential Loans Held-for-Sale

On December 31, 2011, we reclassified $393 million (recorded investment) of loans previously classified as held-for-investment to held-for-sale, as we intend to transfer these loans to Sequoia securitization entities and account for these transfers as sales for financial reporting purposes. We did not record a valuation adjustment related to this reclassification. At December 31, 2010, there were eleven residential loans held-for-sale with $3 million in outstanding principal value and a lower of cost or fair value of $2 million.

Residential Loans Held-for-Investment

The following table details the carrying value for residential loans held-for-investment at December 31, 2011 and 2010. These loans are owned at Sequoia securitization entities that we consolidate for financial reporting purposes.

	December 31,	
(In Thousands)	2011	2010
Principal balance	$3,829,847	$3,815,273
Unamortized premium, net	36,682	42,399
Recorded investment	3,866,529	3,857,672
Allowance for loan losses	(66,881)	(62,432)
Carrying Value	$3,799,648	$3,795,240

Of the $3.8 billion of principal value and $37 million of unamortized premium on loans held-for-investment at December 31, 2011, $1.5 billion of principal value and $23 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. During 2011, 8% of these residential loans prepaid and we amortized 17% of the premium based upon the accounting elections we apply. For residential loans acquired after July 1, 2004, the principal value was $2.3 billion and the unamortized premium was $14 million. During 2011, 10% of these loans prepaid and we amortized 14% of the premium.

Of the $3.8 billion of principal value and $42 million of unamortized premium on loans held-for-investment at December 31, 2010, $1.7 billion of principal value and $27 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. For residential loans acquired after July 1, 2004, the principal value was $2.1 billion and the unamortized premium was $15 million.

Credit Characteristics of Residential Loans Held-for-Investment

As a percentage of total recorded investment, 99% of residential loans held-for-investment at December 31, 2011, were first lien, predominately prime-quality loans at the time of origination. The remaining 1% of loans were second lien, home equity lines of credit. The weighted average original loan-to-value (LTV) ratio for our residential loans held-for-investment outstanding at December 31, 2011 was 66%. The weighted average FICO score for the borrowers of these loans (at origination) was 737.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 6. Residential Loans (continued)

We consider the year of origination of our residential loans held-for-investment to be a general indicator of credit performance as loans originated in specific years often had similar product and credit characteristics. The following table displays the recorded investment and year of origination for residential loans held-for-investment at December 31, 2011 and 2010.

	December 31,	
(In Thousands)	2011	2010
2003 & Earlier	$ 1,771,111	$ 1,939,618
2004	1,045,815	1,116,358
2005	129,163	136,481
2006	181,017	191,945
2007	63,301	75,136
2008		
2009	144,116	189,355
2010	343,278	208,779
2011	188,728	
Total Recorded Investment	$ 3,866,529	$ 3,857,672

Allowance for Loan Losses on Residential Loans

For residential loans held-for-investment, we establish and maintain an allowance for loan losses. The allowance includes a component for loans collectively evaluated for impairment that includes pools of residential loans owned at Sequoia securitization entities, and a component for loans individually evaluated for impairment that includes modified residential loans at Sequoia entities that have been determined to be troubled debt restructurings.

Activity in the Allowance for Loan Losses on Residential Loans

The following table summarizes the activity in the allowance for loan losses for years ended December 31, 2011, 2010, and 2009.

	Years Ended December 31,		
(In Thousands)	2011	2010	2009
Balance at beginning of period	$ 62,432	$ 54,220	$ 35,713
Charge-offs, net	(11,095)	(15,923)	(16,271)
Provision for loan losses	15,544	24,135	49,573

Deconsolidation adjustment			(14,795)
Balance at End of Period	$ 66,881	$ 62,432	$ 54,220

During the year ended December 31, 2011, there were $11 million of charge-offs of residential loans that reduced our allowance for loan losses. These charge-offs arose from $34 million of defaulted loan principal. During both years ended December 31, 2010 and 2009, there were $16 million of charge-offs of residential loans. These charge-offs arose from $50 million and $58 million of defaulted loan principal, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 6. Residential Loans (continued)

Residential Loans Collectively Evaluated for Impairment

We collectively evaluate most of our residential loans for impairment. The following table summarizes the balances for loans collectively evaluated for impairment at December 31, 2011 and 2010.

	December 31,	
(In Thousands)	2011	2010
Principal balance	$ 3,815,010	$ 3,801,921
Recorded investment	3,852,455	3,844,372
Related allowance	64,069	57,804

The following table summarizes the recorded investment and past due status of residential loans collectively evaluated for impairment at December 31, 2011 and 2010.

(In Thousands)	30 59 Days Past Due	60 89 Days Past Due	90+ Days Past Due	Current	Total Loans
December 31, 2011	$ 58,954	$ 20,938	$ 135,671	$ 3,636,892	$ 3,852,455
December 31, 2010	65,708	21,674	133,695	3,623,295	3,844,372

We establish the allowance for residential loan losses based primarily on the characteristics of the loan pools underlying the securitization entities that own the loans, including loan product types, credit characteristics, and origination years. The collective analysis is further divided into two segments. The first segment reflects our estimate of losses on delinquent loans within each loan pool. These loss estimates are determined by applying the loss factors described in *Note 3* to the delinquent loans, including our expectations of the timing of defaults and the loss severities we expect once defaults occur. The second segment relates to our estimate of losses incurred on nondelinquent loans within each loan pool. This estimate is based on losses we expect to realize over a 23-month loss confirmation period, which is based on our historical loss experience as well as consideration of the loss factors described in *Note 3*.

Residential Loans Individually Evaluated for Impairment

If we determine that a loan meets the criteria of a TDR, we remove it from the general loan pools used for determining the allowance for residential loan losses and assess it for impairment on an individual basis. This assessment is based primarily on whether an adverse change in the expected future cash flows resulted from the restructuring. The average recorded investment of loans individually evaluated for impairment for the years ended December 31, 2011, 2010, and 2009, was $12 million, $11 million, and $2 million, respectively. For the year ended December 31, 2011, we recorded $30 thousand interest income on individually impaired loans. For the years ended December 31, 2010 and 2009, we did not record any interest income on individually impaired loans.

The following table summarizes the balances for loans individually evaluated for impairment at December 31, 2011 and 2010.

	December 31,	
(In Thousands)	2011	2010
Principal balance	$ 14,837	$ 13,352
Recorded investment	14,074	13,300
Related allowance	2,812	4,628

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 6. Residential Loans (continued)

The following table summarizes the recorded investment and past due status of residential loans individually evaluated for impairment at December 31, 2011 and 2010.

(In Thousands)	30 59 Days Past Due	60 89 Days Past Due	90+ Days Past Due	Current	Total Loans
December 31, 2011	$ 768	$ 2,222	$ 2,026	$ 9,058	$ 14,074
December 31, 2010	2,604		1,046	9,650	13,300

Troubled Debt Restructurings

As part of the loss mitigation efforts undertaken by servicers of residential loans owned at Sequoia securitization entities, an increasing number of loan modifications have been completed to help make mortgage loans more affordable for qualifying borrowers. For the years ended December 31, 2011 and 2010, all of the loan modifications determined to be troubled debt restructurings were either: (i) conversions of a floating rate mortgage loan into a fixed rate mortgage loan; or, (ii) reductions in the contractual interest rates of a mortgage loan paired with capitalization of accrued interest.

The following table presents the details of the loan modifications determined to be troubled debt restructurings for the years ended December 31, 2011, 2010, and 2009.

	Years Ended December 31,		
(Dollars in Thousands)	2011	2010	2009
Troubled Debt Restructurings			
Number of modifications	18	15	12
Pre-modification outstanding recorded investment	$ 7,932	$ 8,629	$ 6,462
Post-modification outstanding recorded investment	8,449	8,872	6,742
Loan modification effect on Net Interest Income	(1,648)	(2,648)	(1,784)
Troubled Debt Restructurings that Subsequently Defaulted			
Number of modifications	3	2	5
Recorded investment	$ 1,436	$ 1,065	$ 2,874

Note 7. Commercial Loans

We invest in commercial loans that we originate and service as well as loans that we acquire from third-party originators. Some of these loans are financed through the Acacia entities that we sponsor. The following table summarizes the classifications and carrying value of the commercial loans at December 31, 2011 and 2010.

December 31, 2011 (In Thousands)	Redwood	Acacia	Total Loans
Fair value	$	$ 12,129	$ 12,129
Held-for-investment	157,726		157,726
Total Commercial Loans	$ 157,726	$ 12,129	$ 169,855

December 31, 2010 (In Thousands)	Redwood	Acacia	Total Loans
Fair value	$	$ 19,850	$ 19,850
Held-for-investment	30,536		30,536
Total Commercial Loans	$ 30,536	$ 19,850	$ 50,386

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 7. Commercial Loans (continued)

Commercial Loans at Fair Value

Commercial loans at fair value are owned at the consolidated Acacia securitization entities. At December 31, 2011, there were three commercial loans at fair value with an aggregate outstanding principal value of $14 million and an aggregate fair value of $12 million. At December 31, 2010, there were four commercial loans at fair value with an aggregate outstanding principal value of $23 million and an aggregate fair value of $20 million.

Commercial Loans Held-for-Investment

The following table provides additional information for our commercial loans held-for-investment at December 31, 2011 and 2010.

	December 31,	
(In Thousands)	2011	2010
Principal balance	$ 158,847	$ 30,955
Unamortized discount, net	(513)	(419)
Recorded investment	158,334	30,536
Allowance for loan losses	(608)	
Carrying Value	$ 157,726	$ 30,536

Commercial loans held-for-investment are loans we originate or acquire from third-party originators. These loans are characterized as mezzanine loans that are secured by a borrower s ownership percentage in a single purpose entity that owns commercial property, rather than a lien on the commercial property. At December 31, 2011, there were 15 commercial loans held-for-investment with an outstanding principal value of $159 million and a carrying value of $158 million. Of the $158 million of recorded investment in commercial loans held-for-investment at December 31, 2011, 81% was originated in 2011, 19% was originated in 2010, and less than 1% was acquired in 2004. At December 31, 2010, there were four commercial loans held-for-investment with an outstanding principal value and carrying value of $31 million. Of the $31 million of recorded investment in commercial loans held-for-investment at December 31, 2010, 99% was originated in the fourth quarter of 2010 and 1% was originated in 2004.

Commercial Loan Characteristics

The following table displays the geographic concentration of commercial loans recorded on our consolidated balance sheets at December 31, 2011 and 2010.

	December 31,	
Geographic Concentration (by Principal):	2011	2010
Illinois	25 %	41 %
California	20 %	1 %
New York	15 %	34 %
Michigan	7 %	
Connecticut	2 %	8 %
Arizona		16 %
Other states (none greater than 4%)	31 %	
Total	100 %	100 %

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 7. Commercial Loans (continued)

The following table displays the loan product type and accompanying loan characteristics of commercial loans recorded on our consolidated balance sheets at December 31, 2011 and 2010.

(In Thousands)	Loan Balance	Number of Loans	Interest Rate		Maturity Date		Total Principal	30 89 Days DQ	Seriously Delinquent
Fixed-rate loans:	$0 to $5,000	5	4.55% to 10.00	%	9/2014	6/2021	$ 16,488	$	$
	$ 5,001 to $10,000	6	5.86% to 11.00	%	9/2014	4/2018	38,570		
	$ 10,001 to $15,000	3	9.50% to 11.00	%	11/2013	6/2021	37,410		
	$ 15,001 to $20,000	1	11.00	%	6/2016		17,700		
	$ 20,001 to $25,000	1	9.50	%	12/2014		21,500		
	$ 25,001 to $30,000	1	10.00	%	10/2016		26,220		
		17					157,888		
ARM loans:	$ 10,001 to $15,000	1	11.20	%	11/2013		15,000		
Total		18					$ 172,888	$	$

Allowance for Loan Losses on Commercial Loans

For commercial loans classified as held-for-investment, we establish and maintain an allowance for loan losses. The allowance includes a component for loans collectively evaluated for impairment and a component for loans individually evaluated for impairment.

Activity in the Allowance for Loan Losses on Commercial Loans

The following table summarizes the activity in the allowance for commercial loan losses for the years ended December 31, 2011, 2010, and 2009.

	Years Ended December 31,		
(In Thousands)	2011	2010	2009
Balance at beginning of period	$	$ 2,348	$ 2,348
Charge-offs, net		(2,348)	
Provision for loan losses	608		
Balance at End of Period	$ 608	$	$ 2,348

During 2010, we charged off an $11 million commercial mezzanine loan with no impact to our consolidated statements of income, as we had fully reserved for this loan in 2007.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 7. Commercial Loans (continued)

Commercial Loans Collectively Evaluated for Impairment

We recorded an allowance for loan losses based on our estimate of credit losses inherent in our portfolio at the reporting date. Our estimate of credit losses is informed by loss rates and delinquency trends. At December 31, 2011 and 2010, all of the commercial loans collectively evaluated for impairment were current and were assigned an impairment status of Pass. The following table summarizes the balances for loans collectively evaluated for impairment at December 31, 2011 and 2010.

	December 31,	
(In Thousands)	2011	2010
Principal balance	$ 158,847	$ 30,955
Recorded investment	158,334	30,536
Related allowance	608	

Commercial Loans Individually Evaluated for Impairment

We did not have any loans individually evaluated for impairment for either of the years ended December 31, 2011 or 2010.

Note 8. Real Estate Securities

We invest in third-party residential, commercial, and CDO securities. The following table presents the fair values of our real estate securities by collateral type and entity at December 31, 2011 and 2010.

December 31, 2011 (In Thousands)	Redwood	Acacia	Total Securities
Residential	$ 744,281	$ 175,062	$ 919,343
Commercial	5,445	37,923	43,368
CDO	1,010	18,116	19,126
Total Real Estate Securities	$ 750,736	$ 231,101	$ 981,837

December 31, 2010 (In Thousands)	Redwood(1)	Acacia	Total Securities

Residential	$ 833,694	$ 248,494	$ 1,082,188
Commercial	7,496	43,828	51,324
CDO	5,283	16,041	21,324
Total Real Estate Securities	$ 846,473	$ 308,363	$ 1,154,836

(1) Includes $19 million of residential securities and $4 million of CDO securities held at the Fund at December 31, 2010.

Senior securities are those interests in a securitization that have the first right to cash flows and are last in line to absorb losses. Re-REMIC securities, as presented herein, were created through the resecuritization of certain senior interests to provide additional credit support to those interests. These re-REMIC securities are therefore subordinate to the remaining senior interest, but senior to any subordinate tranches of the securitization from which they were created. Subordinate securities are all interests below senior and re-REMIC interests.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 8. Real Estate Securities (continued)

Trading Securities

We elected the fair value option for certain securities at Redwood and the Acacia entities, and classify them as trading securities. The unpaid principal balance of these trading securities was $1.11 billion and $1.58 billion at December 31, 2011 and 2010, respectively. The following table presents trading securities by collateral type and ownership entity at December 31, 2011 and 2010.

	December 31, 2011			December 31, 2010		
(In Thousands)	Redwood	Acacia	Total	Redwood	Acacia	Total
Senior Securities						
Residential prime	$	$3,019	$3,019	$	$4,412	$4,412
Residential non-prime	20,608	88,280	108,888	19,742	117,623	137,365
Commercial		11,216	11,216		11,000	11,000
Total Senior Securities	20,608	102,515	123,123	19,742	133,035	152,777
Subordinate Securities						
Residential prime	343	31,718	32,061	386	49,620	50,006
Residential non-prime	130	52,045	52,175	188	76,839	77,027
Commercial		26,707	26,707		32,828	32,828
CDO	960	18,116	19,076	1,038	16,041	17,079
Total Subordinate Securities	1,433	128,586	130,019	1,612	175,328	176,940
Total Trading Securities	$22,041	$231,101	$253,142	$21,354	$308,363	$329,717

AFS Securities

The following table presents our available-for-sale securities by collateral type at December 31, 2011 and 2010.

	December 31,	
(In Thousands)	2011	2010
Senior Securities		
Residential prime	$ 278,240	$ 315,891
Residential non-prime	255,724	339,280
Commercial		
Total Senior Securities	533,964	655,171
Re-REMIC Securities	119,366	85,077
Subordinate Securities		

Residential prime	58,717	53,846
Residential non-prime	11,153	19,284
Commercial	5,445	7,496
CDO	50	4,245
Total Subordinate Securities	75,365	84,871
Total AFS Securities	$ 728,695	$ 825,119

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 8. Real Estate Securities (continued)

Of the senior securities shown above at December 31, 2011, $175 million of prime securities and $150 million of non-prime securities were financed through a non-recourse resecuritization entity, as discussed in *Note 4*. Of the securities shown above, $13 million of residential senior non-prime securities, $6 million of subordinate non-prime securities, and $4 million of CDO securities were assets of the Fund at December 31, 2010.

We often purchase AFS securities at a discount to their outstanding principal values. To the extent we purchase an AFS security that has a likelihood of incurring a loss, we generally do not amortize into income the portion of the purchase discount that we do not expect to collect due to the inherent credit risk of the security. We may also expense a portion of our investment in the security to the extent we believe that principal losses will exceed the purchase discount. We designate any amount of unpaid principal balance that we do not expect to receive and thus do not expect to earn or recover as a credit reserve on the security. Any remaining net unamortized discounts or premiums on the security are amortized into income over time using the interest method.

At December 31, 2011, there were $4 million of AFS residential securities that had contractual maturities greater than five years but less than ten years, and the remainder of our real estate securities had contractual maturities greater than ten years.

The following table presents the components of carrying value (which equals fair value) of AFS securities at December 31, 2011 and 2010.

December 31, 2011 (In Thousands)	Residential	Commercial	CDO	Total
Principal balance	$ 1,148,952	$ 50,499	$ 10,717	$ 1,210,168
Credit reserve	(242,261)	(43,012)	(10,717)	(295,990)
Net unamortized discount	(235,833)	(3,554)		(239,387)
Amortized cost	670,858	3,933		674,791
Gross unrealized gains	85,360	1,702	50	87,112
Gross unrealized losses	(33,018)	(190)		(33,208)
Carrying Value	$ 723,200	$ 5,445	$ 50	$ 728,695

December 31, 2010 (In Thousands)	Residential	Commercial	CDO	Total
Principal balance	$ 1,257,601	$ 89,103	$ 89,476	$ 1,436,180
Credit reserve	(297,849)	(76,979)	(88,394)	(463,222)

Net unamortized (discount) premium	(291,093)	(5,591)	11,485	(285,199)
Amortized cost	668,659	6,533	12,567	687,759
Gross unrealized gains	153,125	1,604		154,729
Gross unrealized losses	(8,406)	(641)	(8,322)	(17,369)
Carrying Value	$ 813,378	$ 7,496	$ 4,245	$ 825,119

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 8. Real Estate Securities (continued)

The following table presents the changes for years ended December 31, 2011 and 2010, of the unamortized discount and designated credit reserves on AFS securities.

Year Ended December 31, 2011 (In Thousands)	Residential Credit Reserve	Residential Unamortized Discount, Net	Commercial Credit Reserve	Commercial Unamortized Discount, Net	CDO Credit Reserve	CDO Unamortized Premium, Net
Beginning balance December 31, 2010	$297,849	$291,093	$76,979	$5,591	$88,394	$(11,485)
Amortization of net discount		(41,927)		(181)		(31)
Realized credit losses	(92,022)		(33,579)		(4,205)	
Acquisitions	18,280	39,653				
Sales, calls, other	(20,517)	(21,379)	(2,653)	(1,439)	(74,662)	12,146
Impairments	7,064		1,848		560	
Transfers to (release of) credit reserves	31,607	(31,607)	417	(417)	630	(630)
Ending Balance December 31, 2011	$242,261	$235,833	$43,012	$3,554	$10,717	$

Year Ended December 31, 2010 (In Thousands)	Residential Credit Reserve	Residential Unamortized Discount, Net	Commercial Credit Reserve	Commercial Unamortized Discount, Net	CDO Credit Reserve	CDO Unamortized Premium, Net
Beginning balance December 31, 2009	$469,273	$401,808	$146,018	$5,130	$87,017	$(8,941)
Amortization of net (discount) premium		(44,187)		241		(1,167)
Realized credit losses	(150,791)		(69,894)			
Acquisitions	14,501	74,652				
Sales, calls, other	(65,619)	(119,507)				
Impairments	8,812		1,075			
Transfers to (release of) credit reserves	21,673	(21,673)	(220)	220	1,377	(1,377)
	$297,849	$291,093	$76,979	$5,591	$88,394	$(11,485)

Ending Balance December 31, 2010

Credit Characteristics of AFS Securities

Of the $242 million of credit reserve on our residential securities at December 31, 2011, $44 million was related to residential senior securities, $61 million was related to residential re-REMIC securities, and $137 million was related to residential subordinate securities. The loans underlying our residential senior securities totaled $18 billion at December 31, 2011, and consisted of $10 billion prime and $8 billion non-prime credit quality at time of origination. Serious delinquencies at December 31, 2011, were 12.38% of outstanding principal balances. The loans underlying all of our residential re-REMIC securities totaled $8 billion at December 31, 2011, and were all prime credit quality at time of origination. Serious delinquencies at December 31, 2011 were 9.67% of outstanding principal balances. The loans underlying our residential subordinate securities totaled $23 billion at December 31, 2011, and consisted of $21 billion prime and $2 billion non-prime. Serious delinquencies at December 31, 2011, were 5.81% of outstanding principal balances.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 8. Real Estate Securities (continued)

The loans underlying our commercial subordinate securities totaled $18 billion at December 31, 2011, and consist primarily of office (29%), retail (36%), and multifamily (11%) loans. Serious delinquencies (60+ days, in foreclosure or REO) at December 31, 2011 were 5.9% of current principal balances.

AFS Securities with Unrealized Losses

The following table presents the components comprising the total carrying value of AFS securities that were in a gross unrealized loss position at December 31, 2011 and 2010.

	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
December 31, 2011	Amortized	Unrealized	Fair	Amortized	Unrealized	Fair
(In Thousands)	Cost	Losses	Value	Cost	Losses	Value
Residential	$ 242,595	$ (21,976)	$ 220,619	$ 75,245	$ (11,042)	$ 64,203
Commercial	151	(38)	113	1,090	(152)	938
CDO						
Total Securities	$ 242,746	$ (22,014)	$ 220,732	$ 76,335	$ (11,194)	$ 65,141

	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
December 31, 2010	Amortized	Unrealized	Fair	Amortized	Unrealized	Fair
(In Thousands)	Cost	Losses	Value	Cost	Losses	Value
Residential	$ 104,154	$ (1,628)	$ 102,526	$ 26,374	$ (6,778)	$ 19,596
Commercial	2,134	(257)	1,877	1,728	(384)	1,344
CDO				12,567	(8,322)	4,245
Total Securities	$ 106,288	$ (1,885)	$ 104,403	$ 40,669	$ (15,484)	$ 25,185

At December 31, 2011, after giving effect to purchases, sales, and extinguishments due to credit losses, our consolidated balance sheet included 425 AFS securities, of which 139 were in an unrealized loss position and 26 were in a continuous unrealized loss position for twelve consecutive months or longer. At December 31, 2010, our consolidated balance sheet included 509 AFS securities, of which 80 were in a continuous unrealized loss position, of which 46 were in a continuous unrealized loss position for twelve consecutive months or longer.

At December 31, 2010, $10 million of unrealized losses related to securities owned at the Fund and the remaining unrealized losses related to securities owned at Redwood.

Evaluating AFS Securities for Other-than-Temporary Impairments

When the fair value of an AFS security is below its cost basis, we evaluate the security for OTTI. Part of this evaluation is based upon adverse changes in the assumptions used to value the security. The table below summarizes the significant valuation assumptions we used for our AFS securities at December 31, 2011.

Significant Valuation Assumptions

	Range for Securities		
December 31, 2011	Prime	Non-prime	Commercial
Prepayment rates	2 15 %	2 10 %	N/A
Loss severity	23 57 %	29 73 %	33 50 %
Projected losses	0 35 %	5 41 %	2 8 %

The credit component of OTTI is recognized through our consolidated statements of income as a component of market valuation adjustments, net, while the non-credit component of OTTI is recognized through accumulated other comprehensive (loss) income, a component of equity. Total credit OTTI for the years ended December 31, 2011 and 2010 was $9 million and $10 million, respectively. Total non-credit OTTI

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 8. Real Estate Securities (continued)

for years ended December 31, 2011 and 2010, was $6 million and $8 million, respectively. The following table details the activity related to the credit component of OTTI (i.e., OTTI in either current earnings or retained earnings) for AFS securities that also had a non-credit component and were still held at December 31, 2011 and 2010.

Activity of Credit Component of Other-than-Temporary Impairments

	Years Ended December 31,	
(In Thousands)	2011	2010
Balance at beginning of period	$ 121,016	$ 146,454
Additions		
Initial credit impairments	1,428	768
Subsequent credit impairments	4,557	6,651
Reductions		
Securities sold, or expected to sell	(12,317)	(5,113)
Securities with no outstanding principal at period end	(36,558)	(27,744)
Balance at End of Period	$ 78,126	$ 121,016

The credit component is reduced if we sell, intend to sell, or believe we will be required to sell previously credit-impaired debt securities. Additionally, the credit loss component is reduced if we receive or expect to receive cash flows in excess of what we previously expected to receive over the remaining life of the credit-impaired debt security, the security matures, or the security experiences an event (such as full prepayment or principal losses) such that the outstanding principal is reduced to zero.

Gross Realized Gains and Losses

Gains and losses from the sale of AFS securities are recorded as realized gains on sales and calls, net, in our consolidated statements of income. The following table presents the gross realized gains on sales and calls of AFS securities for the years ended December 31, 2011, 2010, and 2009.

	Years Ended December 31,		
(In Thousands)	2011	2010	2009
Gross realized gains sales	$ 12,665	$ 56,983	$ 39,154
Gross realized gains calls	1,365	2,220	
Gross realized losses sales	(3,523)	(3,335)	(1,402)
Gross realized losses calls	(223)		

Total Realized Gains on Sales and Calls of AFS Securities, net	$ 10,284	$ 55,868	$ 37,752

Note 9. Derivative Financial Instruments

The following table presents the aggregate fair value of derivative financial instruments held by Redwood and the consolidated Acacia entities at December 31, 2011 and 2010.

	December 31,	
(In Thousands)	2011	2010
Derivative assets	$ 2,373	$ 8,051
Derivative liabilities	(127,564)	(83,115)

The following table presents the aggregate fair value and notional amount of derivative financial instruments held by Redwood and the consolidated Acacia entities at December 31, 2011 and 2010. The derivatives held at Acacia entities are not assets or legal obligations of Redwood.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 9. Derivative Financial Instruments (continued)

December 31, 2011 (In Thousands)	Redwood Fair Value	Notional Amount	Acacia Fair Value	Notional Amount	Total Fair Value	Notional Amount
Assets Risk Management Derivatives						
Interest rate swaps	$	$	$857	$5,595	$857	$5,595
TBAs						
Futures	47	126,000			47	126,000
Interest rate caps			1,469	704,400	1,469	704,400
Total Assets	$47	$126,000	$2,326	$709,995	$2,373	$835,995
Liabilities Cash Flow Hedges						
Interest rate swaps	$(54,353)	$165,000	$	$	$(54,353)	$165,000
Liabilities Risk Management Derivatives						
Interest rate swaps	(5,270)	189,500	(62,695)	558,968	(67,965)	748,468
TBAs	(5,060)	492,000			(5,060)	492,000
Futures	(186)	180,000			(186)	180,000
Total Liabilities	$(64,869)	$1,026,500	$(62,695)	$558,968	$(127,564)	$1,585,468

December 31, 2010 (In Thousands)	Redwood Fair Value	Notional Amount	Acacia Fair Value	Notional Amount	Total Fair Value	Notional Amount
Assets Risk Management Derivatives						
Interest rate swaps	$175	$44,000	$813	$18,037	$988	$62,037
TBAs	348	35,000			348	35,000
Futures	703	433,000			703	433,000
Interest rate caps			6,012	703,400	6,012	703,400
Total Assets	$1,226	$512,000	$6,825	$721,437	$8,051	$1,233,437
Liabilities Cash Flow Hedges						
Interest rate swaps	$(11,449)	$155,500	$	$	$(11,449)	$155,500
Liabilities Risk Management Derivatives						
Interest rate swaps	(1,283)	26,000	(69,373)	663,604	(70,656)	689,604

TBAs	(951)	124,000			(951)	124,000
Futures	(59)	225,000			(59)	225,000
Total Liabilities	$(13,742)	$530,500	$(69,373)	$663,604	$(83,115)	$1,194,104

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 9. Derivative Financial Instruments (continued)

Risk Management Derivatives

To offset to varying degrees the changes in the value of mortgage products to which we have exposure, we may enter into interest rate agreements, TBA contracts, and Eurodollar futures contracts.

Certain Risks Related to Unsecuritized Residential and Commercial Loans at Redwood

In order to manage certain risks associated with residential loans we own or plan to acquire and securitize and commercial loans we invest in, at December 31, 2011, we were party to interest rate agreements with an aggregate notional amount of $189 million, TBA contracts sold with a notional amount of $492 million, and financial futures with an aggregate notional amount of $306 million. Net negative market valuation adjustments on these derivatives were $22 million and less than $1 million for the years ended December 31, 2011 and 2010, respectively.

Certain Risks Related to Liabilities at Acacia Entities

Net valuation adjustments on interest rate agreements at Acacia were negative $25 million and negative $46 million for the years ended December 31, 2011 and 2010, respectively.

Derivatives Designated as Cash Flow Hedges

To hedge the variability in interest expense related to our long-term debt and certain adjustable-rate securitization entity liabilities that are included in our consolidated balance sheets for financial reporting purposes, we designated interest rate swaps as cash flow hedges during 2010 and during the second quarter of 2011 with an aggregate notional balance of $165 million. For the year ended December 31, 2011, these hedges decreased in value by $42 million, which was recorded as a decrease to accumulated other comprehensive (loss) income, a component of equity.

For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in accumulated other comprehensive income was $67 million at December 31, 2011 and $29 million at December 31, 2010. For both the years ended December 31, 2011 and 2010, we reclassified $4 million of unrealized losses on derivatives to interest expense. We estimate that we will reclassify $4 million of unrealized losses to interest expense during 2012.

The following table illustrates the impact on interest expense of our interest rate agreements accounted for as cash flow hedges for the years ended December 31, 2011, 2010, and 2009.

Impact on Interest Expense of Our Interest Rate Agreements Accounted for as Cash Flow Hedges

	Years Ended December 31,		
(In Thousands)	2011	2010	2009
Net interest expense on cash flow interest rate agreements	$(6,392)	$(4,041)	$
Realized net expense due to net ineffective portion of hedges	(4)	(10)	
Realized net losses reclassified from other comprehensive (loss) income	(4,243)	(3,721)	(4,457)
Total Interest Expense	$(10,639)	$(7,772)	$(4,457)

Credit Derivatives

At December 31, 2011 and 2010, we had no outstanding CDS contracts or obligations. During 2010, the reference securities underlying our CDS experienced principal losses and corresponding obligations of $20 million.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 9. Derivative Financial Instruments (continued)

Derivative Counterparty Credit Risk

We incur credit risk to the extent that counterparties to our derivative financial instruments do not perform their obligations under specified contractual agreements. If a derivative counterparty does not perform, we may not receive the proceeds to which we may be entitled under these agreements. To mitigate this risk, we enter into agreements that are either a) transacted on a national exchange or b) transacted with counterparties that are either i) designated by the Federal Reserve Bank of New York as a primary government dealer, ii) affiliates of primary government dealers, or iii) rated A or higher by a Nationally Recognized Statistical Rating Organization (NRSRO). We also attempt to transact with several different counterparties in order to reduce our specific counterparty exposure. We consider counterparty risk as part of our fair value assessments of all derivative financial instruments.

At December 31, 2011, Redwood had outstanding derivative agreements with eight bank counterparties and Acacia entities had outstanding derivative agreements with five bank counterparties. At December 31, 2011, Redwood and the Acacia entities were in compliance with International Swaps and Derivatives Association (ISDA) agreements governing these open derivative positions.

Note 10. Other Assets

Other assets at December 31, 2011 and 2010 are summarized in the following table.

Other Assets

(In Thousands)	December 31, 2011	2010
REO	$ 5,669	$ 14,481
Fixed assets and leasehold improvements	2,048	3,692
Margin posted, net	71,976	16,233
Investment receivable	1,741	883
Income tax receivables	4,741	1,243
Prepaid expenses	1,706	1,973
Other	381	157
Total Other Assets	$ 88,262	$ 38,662

REO consists of foreclosed properties received in full satisfaction of defaulted real estate loans. The carrying value of REO at December 31, 2011 was $6 million, which includes the net effect of $11 million related to transfers into REO during 2011, offset by $18 million of REO liquidations and $2 million of negative market valuation adjustments. At

December 31, 2011, there were 43 REO properties recorded on our consolidated balance sheet, all of which were owned at Sequoia. At December 31, 2010, there were 83 REO properties recorded on our balance sheet, of which 81 were owned at Sequoia and two were owned at Redwood. Properties located in Ohio, Michigan, Georgia, and California accounted for 72% of our REO properties at December 31, 2011.

Margin posted, net, resulted from margin calls from our swap, master repurchase agreement, and warehouse facility counterparties that required us to post collateral.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 11. Short-Term Debt

We enter into repurchase agreements, bank warehouse agreements, and other forms of collateralized (and generally uncommitted) short-term borrowings with several banks and major investment banking firms. At December 31, 2011, Redwood had outstanding agreements with six bank counterparties and we were in compliance with all of the related covenants. The table below summarizes the outstanding balances of short-term debt at December 31, 2011 and 2010 by the type of collateral securing the debt.

Short-Term Debt

	December 31, 2011				
(Dollars in Thousands)	Number of Facilities	Outstanding	Limit	Maturity	
Collateral Type					
Residential loans	2	$ 307,149	$ 400,000	11/2012	
Real estate securities	4	120,907		1/2012	2/2012
Secured line of credit	1		10,000	08/2012	
Total	7	$ 428,056			

	December 31, 2010			
(Dollars in Thousands)	Number of Facilities	Outstanding	Limit	Maturity
Collateral Type				
Residential loans		$	$	
Real estate securities	1	44,137		01/2011
Total	1	$ 44,137		

Borrowings under these facilities generally bear interest based on a specified margin over the one-month LIBOR interest rate. They are uncommitted and mature within a year. For the year ended December 31, 2011, the average balance of short-term debt was $57 million, with a weighted average interest cost of 1.82%. For the year ended December 31, 2010, the average balance of short-term debt was $5 million, with a weighted average interest cost of 1.68%. At December 31, 2011 and 2010, accrued interest payable on short-term debt was $0.6 million and $43 thousand, respectively.

Characteristics of Short-Term Debt

The table below summarizes short-term debt by weighted average interest rates and by collateral type at December 31, 2011 and 2010.

(In Thousands)	December 31, 2011 Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity	December 31, 2010 Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity
Residential loan collateral	$ 307,149	1.93 %	322	$		
Real estate securities collateral	120,907	1.88 %	31	44,137	1.50 %	8
Total Short-Term Debt	$ 428,056	1.92 %	240	$ 44,137	1.50 %	8

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 11. Short-Term Debt (continued)

Remaining Maturities of Short-Term Debt

The following table presents the remaining maturities of short-term debt at December 31, 2011 and 2010.

(In Thousands)	December 31, 2011	2010
Within 30 days	$ 105,607	$ 44,137
31 to 90 days	15,300	
Over 90 days	307,149	
Total Short-Term Debt	$ 428,056	$ 44,137

Note 12. Asset-Backed Securities Issued

The Sequoia and Acacia securitization entities issue ABS to acquire assets from us and from third parties. Each series of ABS issued consists of various classes that pay interest on a monthly or quarterly basis. Substantially all of our consolidated ABS issued pay variable rates of interest, which are indexed to one, three, or six-month LIBOR. Some ABS issued pay fixed rates of interest or pay hybrid rates, which are fixed rates that subsequently adjust to variable rates. ABS issued also include some interest-only classes with coupons set at a fixed-rate or a fixed spread to a benchmark rate, or set at a spread to the interest rates earned on the assets less the interest rates paid on the liabilities of a securitization entity.

In 2011, we securitized $671 million of loans through our Sequoia program and issued $640 million of ABS to third parties. In July 2011, we transferred $365 million of residential securities into a resecuritization, with $245 million of ABS issued to third parties. The components of ABS issued by consolidated securitization entities at December 31, 2011 and 2010, along with other selected information, are summarized in the following table.

Asset-Backed Securities Issued

(Dollars in Thousands)	December 31, 2011 Sequoia	Acacia	Resecuritization	Total
Certificates with principal balance	$3,697,894	$2,884,967	$ 219,551	$6,802,412
Interest-only certificates	16,904			16,904
Unamortized premium	1,280			1,280
Unamortized discount	(5,655)			(5,655)
Fair value adjustment, net		(2,675,586)		(2,675,586)

Total ABS Issued	$3,710,423	$209,381	$219,551	$4,139,355
Range of weighted average interest rates, by series	0.39% to 4.15%	0.76% to 1.94%	2.19%	
Stated maturities	2014 2047	2039 2052	2046	
Number of series	39	10	1	

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Note 12. Asset-Backed Securities Issued (continued)

	December 31, 2010			
(Dollars in Thousands)	Sequoia	Acacia	Resecuritization	Total
Certificates with principal balance	$3,445,882	$2,956,657	$	$6,402,539
Interest-only certificates	15,587			15,587
Unamortized premium	1,726			1,726
Unamortized discount	(4,694)			(4,694)
Fair value adjustment, net		(2,653,580)		(2,653,580)
Total ABS Issued	$3,458,501	$303,077	$	$3,761,578
Range of weighted average interest rates, by series	0.45% to 4.40%	0.76% to 1.88%		
Stated maturities	2014 2047	2039 2052		
Number of series	37	10		

The maturity of each class of ABS issued is primarily determined by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption (call) according to the specific terms of the respective governing documents. As a result, the actual maturity of ABS issued will often occur earlier than its stated maturity. At December 31, 2011, $4.1 billion of ABS issued ($6.75 billion principal balance) had contractual maturities of over five years and $50 million of ABS issued ($50 million principal balance) had contractual maturities of one to five years. Amortization of the resecuritization and Sequoia deferred ABS issuance costs was $2 million for both of the years ended December 31, 2011 and 2010.

The following table summarizes the accrued interest payable on ABS issued at December 31, 2011 and 2010. Interest due on Sequoia and resecuritization ABS issued is payable monthly and interest due on Acacia ABS issued is payable quarterly.

Accrued Interest Payable on Asset-Backed Securities Issued

	December 31,	
(In Thousands)	2011	2010
Sequoia	$ 3,978	$ 2,356
Acacia	2,894	2,911
Resecuritization	42	
Total Accrued Interest Payable on ABS Issued	$ 6,914	$ 5,267

The following table summarizes the carrying value components of the collateral for ABS issued and outstanding at December 31, 2011 and 2010.

Collateral for Asset-Backed Securities Issued

	December 31, 2011			
(In Thousands)	Sequoia	Acacia	Resecuritization	Total
Real estate loans	$ 3,799,648	$ 12,129	$	$ 3,811,777
Real estate securities		246,212	324,705	570,917
REO	5,669			5,669
Restricted cash	287	14,600		14,887
Accrued interest receivable	7,786	2,065	961	10,812
Total Collateral for ABS Issued	$ 3,813,390	$ 275,006	$ 325,666	$ 4,414,062

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 12. Asset-Backed Securities Issued (continued)

	December 31, 2010			
(In Thousands)	Sequoia	Acacia	Resecuritization	Total
Real estate loans	$ 3,542,159	$ 19,850	$	$ 3,562,009
Real estate securities		327,919		327,919
REO	14,241			14,241
Restricted cash	331	21,790		22,121
Accrued interest receivable	6,264	2,735		8,999
Total Collateral for ABS Issued	$ 3,562,995	$ 372,294	$	$ 3,935,289

Note 13. Long-Term Debt

In 2006, we issued $100 million of trust preferred securities through Redwood Capital Trust I, a Delaware statutory trust, in a private placement transaction. These trust preferred securities require quarterly distributions at a floating coupon rate equal to three-month LIBOR plus 2.25% until the notes are redeemed, which will be no later than January 30, 2037. The interest expense yield on our trust preferred securities was 2.65% and 3.18% for the years ended December 31, 2011 and 2010, respectively. Including hedging costs and amortization of deferred securities issuance costs, the interest expense yield on our trust preferred securities was 6.88% and 5.97% for the years ended December 31, 2011 and 2010, respectively. The earliest optional redemption date without penalty was January 30, 2012. In December 2010, we repurchased $500 thousand principal amount of these trust preferred securities.

In 2007, we issued an additional $50 million of subordinated notes. These subordinated notes require quarterly distributions at a floating interest rate equal to three-month LIBOR plus 2.25% until the notes are redeemed, which will be no later than July 30, 2037. The interest expense yield on our subordinated notes was 2.65% and 3.18% for the years ended December 31, 2011 and 2010, respectively. Including hedging costs, and amortization of deferred securities issuance costs, the interest expense yield on our subordinated notes was 6.88% and 5.97% for the years ended December 31, 2011 and 2010, respectively. The earliest optional redemption date without a penalty is July 30, 2012. In July 2009, we repurchased $10 million principal amount of this subordinated debt.

At both December 31, 2011 and 2010, the accrued interest payable balance on long-term debt was less than $1 million. Under the terms of our long-term debt, we covenant to, among other things, use our best efforts to continue to qualify as a REIT. If an event of default were to occur in respect of our long-term debt, we would generally be restricted under its terms (subject to certain exceptions) from making dividend distributions to stockholders, from repurchasing common stock or repurchasing or redeeming any other then-outstanding equity securities, and from making any other payments in respect of any equity interests in us or in respect of any then-outstanding debt that is *pari passu* or subordinate to our long-term debt.

Note 14. Commitments and Contingencies

Lease Commitments

At December 31, 2011, we were obligated under non-cancelable operating leases with expiration dates through 2018 for $11 million. Operating lease expense was $2 million for both the years ended December 31, 2011 and 2010.

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Note 14. Commitments and Contingencies (continued)

The following table presents our future lease commitments at December 31, 2011.

Future Lease Commitments by Year

(In Thousands)	December 31, 2011
2012	$ 1,913
2013	1,759
2014	1,800
2015	1,756
2016	1,498
2017 and thereafter	2,193
Total	$ 10,919

In the fourth quarter of 2011, we entered into a new lease agreement for our executive office. The new lease, which goes into effect in the second quarter of 2012, will recast our existing lease obligations at that time and expire in 2018. The remaining payments required under both the current and new lease will be recognized as office rent expense on a straight-line basis over the respective lease terms. In the fourth quarter of 2011, we also relocated our New York office and entered into a new lease agreement. This lease expires in 2015 and accounts for approximately ten percent of our future lease obligation.

Leasehold improvements for our offices are amortized into expense over the prior lease term, expiring in 2012. The unamortized leasehold improvement balance was $1 million and $3 million, respectively, at December 31, 2011 and 2010. For all of the years ended December 31, 2011, 2010, and 2009, we recognized leasehold amortization expense of $1 million.

Loss Contingencies Litigation

On December 23, 2009, the Federal Home Loan Bank of Seattle (the FHLB-Seattle) filed a claim in Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (SRF), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the FHLB-Seattle Defendants). The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, *et seq.*) and seeks to rescind the purchase of a mortgage pass-through certificate (or, residential mortgage backed securities, RMBS) issued through our Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2005-4 securitization transaction and purchased by the FHLB-Seattle. The FHLB-Seattle also seeks to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received), as well as attorneys fees and costs. On June 10, 2010, the FHLB-Seattle filed an amended complaint. Subsequently, on October 18, 2010, the FHLB-Seattle Defendants filed motions to dismiss the FHLB-Seattle s complaint. Redwood Trust, Inc. and SRF additionally moved to dismiss the complaint for lack of personal jurisdiction. The FHLB-Seattle alleges that the FHLB-Seattle Defendants offering materials for this RMBS contained materially untrue statements and omitted material facts about this RMBS and the loans securitized in this transaction. Among other things, the FHLB-Seattle alleges that the FHLB-Seattle Defendants made untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, and (4) ratings assigned to this RMBS. In a series of rulings issued between June 23, 2011 and August 15, 2011, the Washington State Superior Court dismissed the allegations relating to occupancy status and denied other grounds for dismissal. On July 19, 2011, the Court granted Redwood Trust, Inc. and SRF s motion to dismiss for lack of personal jurisdiction. Redwood Trust, Inc. does not know whether the FHLB-Seattle will appeal or otherwise contest the dismissal, or file a claim in another jurisdiction. The Sequoia RMBS that is the subject of the FHLB-Seattle s claim was issued with an

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 14. Commitments and Contingencies (continued)

original principal amount of approximately $133 million and, at December 31, 2011, had a remaining outstanding principal amount of approximately $28 million. We believe that this claim is without merit and we intend to defend any action related to it vigorously. In connection with the issuance of the Sequoia RMBS that is the subject of the FHLB-Seattle s claim, Redwood agreed to indemnify the underwriters of this RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. The FHLB-Seattle s claims against the underwriters of this RMBS were not dismissed for lack of personal jurisdiction. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On August 18, 2010, Redwood Trust, Inc. s subsidiary, SRF, received service of process with respect to a claim filed on July 15, 2010 in Superior Court for the State of California in San Francisco (case number CGC-10-501610) by The Charles Schwab Corporation (Schwab). In the complaint, Schwab is suing SRF and 26 other named defendants (collectively, the Schwab Defendants) in relation to RMBS sold or issued by the Schwab Defendants. With respect to SRF, Schwab alleges a cause of action of negligent misrepresentation under California state law and seeks unspecified damages and attorneys fees and costs with respect to a RMBS issued through the Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2005-4 securitization transaction (which is the same transaction at issue in the litigation initiated by the FHLB-Seattle described in the preceding paragraph). Among other things, Schwab alleges that the offering materials for this Sequoia RMBS contained materially untrue statements or omissions regarding this RMBS and the loans securitized in this securitization transaction, including untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, and (4) ratings assigned to this RMBS. On September 22, 2011, the Schwab Defendants moved to dismiss the complaint, and on January 27, 2011, the California State Superior Court denied the motion on several grounds, and with respect to certain other grounds gave Schwab the opportunity to amend the complaint. The Sequoia RMBS that is the subject of Schwab s claim was issued with an original principal amount of approximately $14.8 million and, at December 31, 2011, had a remaining outstanding principal amount of approximately $3.1 million. We believe that this case is without merit and we intend to defend the action vigorously. In connection with the issuance of the Sequoia RMBS that is the subject of Schwab s claim, Redwood agreed to indemnify the underwriters of this RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On July 12, 2010, two notices of Election to Void Sale of Securities pursuant to Illinois Securities Law (815 ILCS Section 5/13(A)) were received from the Federal Home Loan Bank of Chicago (FHLB-Chicago). In the notices, the FHLB-Chicago sought to void its purchase of two RMBS that were issued in 2006 by a securitization trust with respect to which Redwood Trust, Inc. s subsidiary, SRF, was the depositor. Subsequently, on October 15, 2010, the FHLB-Chicago filed a claim in the Circuit Court of Cook County, Illinois (case number 10-CH-45033) against SRF and more than 45 other named defendants (collectively, the FHLB-Chicago Defendants) in relation to RMBS sold or issued by the FHLB-Chicago Defendants or by entities controlled by the FHLB-Chicago Defendants. In an amended complaint filed on March 16, 2011, FHLB-Chicago added as defendants Redwood Trust, Inc. and another one of our subsidiaries, RWT Holdings, Inc. With respect to Redwood Trust, Inc. and SRF, the FHLB-Chicago alleges that the offering materials for two RMBS issued through the Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2006-1 securitization transaction contained untrue and misleading statements and material misrepresentations in violation of Illinois Securities Law (815 ILCS Sections 5/12(F)-(H)) and North Carolina Securities Law (N.C.G.S.A. §78A-8(2) & §78A-56(a)) and also alleges a claim of negligent misrepresentations under Illinois common law. On some of the causes of action, the FHLB-Chicago seeks to rescind the purchase of these RMBS and to collect interest on the original purchase price at the statutory interest rate of 10% per

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 14. Commitments and Contingencies (continued)

annum from the date of original purchase (net of interest received). On one cause of action, the FHLB-Chicago seeks unspecified damages. The FHLB-Chicago also seeks attorneys fees and costs. Among other things, the FHLB-Chicago alleges that the offering materials for this RMBS contained materially untrue statements or omissions regarding this RMBS and the loans securitized in this transaction, including untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, (4) ratings assigned to these RMBS, and (5) due diligence performed on these mortgage loans. The first of these two Sequoia RMBS was issued with an original principal amount of approximately $105 million and, at December 31, 2011, had a remaining outstanding principal amount of approximately $42 million. The second of these two Sequoia RMBS was issued with an original principal amount of approximately $379 million and, at December 31, 2011, had a remaining outstanding principal amount of approximately $152 million. On March 27, 2011, the FHLB-Chicago Defendants moved to dismiss the amended complaint, which motions are now pending. We believe that this case is without merit, and we intend to defend the action vigorously. In connection with the issuance of the Sequoia RMBS that is the subject of the FHLB-Chicago s claim, Redwood agreed to indemnify the underwriters of these RMBS for certain losses and expenses they might incur as a result of claims made against them relating to these RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

We cannot determine the outcome of any of the above-referenced litigation matters at this time or predict the results with certainty. We cannot be certain that any of these matters will not have a material adverse effect on our results of operations in any future period, and any loss or expense related to any of this litigation could have a material adverse impact on our consolidated financial statements.

In accordance with FASB guidance on accounting for contingencies, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability, and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due. If, with respect to a matter, it is not both probable to result in liability and the amount of loss cannot be reasonably estimated (as is the case for each of the above-referenced litigation matters), FASB guidance on accounting for contingencies provides that an estimate of possible loss or range of loss be disclosed unless such an estimate cannot be made. There are numerous factors that make it difficult to meaningfully estimate possible loss or range of loss at this stage of these litigation matters, including that: the proceedings are in relatively early stages, there are significant factual and legal issues to be resolved, information obtained or rulings made during the lawsuits could affect the methodology for calculation of rescission and the related statutory interest rate, our belief that these litigations are without merit, and our intent to defend these actions vigorously. In addition, with respect to claims where damages are the requested relief, no amount of loss or damages has been specified. We also may have additional rights and/or obligations pursuant to indemnity agreements, representations and warranties, and other contractual provisions with other parties relating to these litigation matters. These rights and obligations could offset or increase our potential losses. We are unable at this time to estimate the potential amount of any such offset or loss.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 15. Equity

The following table provides a summary of changes to stockholders equity for the years ended December 31, 2011 and 2010.

Stockholders Equity

	Years Ended December 31,	
(In Thousands)	2011	2010
Balance at beginning of period	$1,064,753	$971,721
Net income attributable to Redwood Trust, Inc.	26,343	110,052
Distributions to shareholders	(81,155)	(79,987)
Unrealized (losses) gains on securities and derivatives, net	(125,490)	47,479
Other changes in equity, net	8,133	15,488
Balance at End of Period	$892,584	$1,064,753

Accumulated Other Comprehensive (Loss) Income

The following table provides a summary of the components of accumulated other comprehensive (loss) income at December 31, 2011 and 2010.

	December 31,	
(In Thousands)	2011	2010
Net unrealized gains on real estate securities	$53,904	$137,360
Less: Unrealized losses attributable to noncontrolling interest		(4,164)
Net unrealized gains on real estate securities recognized in equity	53,904	141,524
Net unrealized losses on interest rate agreements accounted for as cash flow hedges	(67,055)	(29,185)
Total Accumulated Other Comprehensive (Loss) Income	$(13,151)	$112,339

Noncontrolling Interest

Noncontrolling interest represents the aggregate limited partnership (LP) interests in the Fund held by third parties. During the second quarter of 2011, the Fund sold all remaining securities and during the fourth quarter of 2011, the Fund distributed all remaining cash to investors, and had no assets or liabilities at December 31, 2011. There was no noncontrolling interest on our consolidated balance sheet at December 31, 2011. Of the total equity recorded on our consolidated balance sheet at December 31, 2010, $11 million was noncontrolling interest. Income allocated to the noncontrolling interest is based on the 48% third-party LP ownership percentage. The ownership percentage is determined by dividing the number of units held by third-party LP investors by the total units outstanding.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 15. Equity (continued)

Earnings Per Common Share

The following table provides the basic and diluted earnings per common share computations for the years ended December 31, 2011, 2010, and 2009.

Basic and Diluted Earnings Per Common Share

	Years Ended December 31,		
(In Thousands, Except Share Data)	2011	2010	2009
Basic Earnings Per Common Share:			
Net income attributable to Redwood	$26,343	$110,052	$39,195
Less: Dividends and undistributed earnings allocated to participating securities	2,246	3,155	822
Net income allocated to common shareholders	$24,097	$106,897	$38,373
Basic weighted average common shares outstanding	78,299,510	77,841,634	68,458,009
Basic Earnings Per Common Share	$0.31	$1.37	$0.56
Diluted Earnings Per Common Share:			
Net income attributable to Redwood	$26,343	$110,052	$39,195
Less: Dividends and undistributed earnings allocated to participating securities	2,246	2,801	822
Net income allocated to common shareholders	$24,097	$107,251	$38,373
Basic weighted average common shares outstanding	78,299,510	77,841,634	68,458,009
Net effect of dilutive equity awards		969,315	532,882
Diluted weighted average common shares outstanding	78,299,510	78,810,949	68,990,891
Diluted Earnings Per Common Share	$0.31	$1.36	$0.55

For the year ended December 31, 2011, there were no dilutive equity awards determined under the two-class method as dividend distributions were greater than net income. Therefore, diluted earnings per common share was computed in the same manner as basic earnings per share. For the years ended December 31, 2010 and 2009, there were 969,314 and 532,882, respectively, of dilutive equity awards determined under the two-class method. We included participating securities in the calculation of diluted earnings per common share as we determined that the two-class method was more dilutive than the alternative treasury stock method. For the year ended December 31, 2011, the number of outstanding equity awards that were antidilutive totaled 1,510,322, under the two-class method. For the years ended December 31, 2010 and 2009, the number of outstanding equity awards that were antidilutive totaled 393,696 and 353,423, respectively, under the two-class method. There were no other participating securities during these periods.

Stock Repurchases

We announced a stock repurchase authorization in November 2007 for the repurchase of up to 5,000,000 common shares. This plan replaced all previous share repurchase plans and has no expiration date. During the year ended December 31, 2011, there were 652,086 shares acquired under the plan. At December 31, 2011, there remained 4,005,985 shares available for repurchase under this plan.

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Note 16. Equity Compensation Plans

At December 31, 2011 and 2010, 298,634 and 1,052,826 shares of common stock, respectively, were available for grant under Redwood s Incentive Plan. The unamortized compensation cost under the Incentive Plan and the Employee Stock Purchase Plan totaled $21 million at December 31, 2011, as shown in the following table.

(In Thousands)	Year Ended December 31, 2011 Stock Options	Restricted Stock	Deferred Stock Units	Performance Stock Units	Employee Stock Purchase Plan	Total
Unrecognized compensation cost at beginning of period	$	$ 1,390	$ 14,420	$ 3,320	$	$ 19,130
Equity grants		896	6,362	3,428	120	10,806
Equity compensation cost		(494)	(7,219)	(1,234)	(120)	(9,067)
Unrecognized Compensation Cost at End of Period	$	$ 1,792	$ 13,563	$ 5,514	$	$ 20,869

At December 31, 2011, the weighted average amortization period remaining for all of our equity awards was less than two years.

Stock Options

The following table summarizes the activity related to stock options for the years ended December 31, 2011, 2010, and 2009.

	Years Ended December 31, 2011 Shares	Weighted Average Exercise Price	2010 Shares	Weighted Average Exercise Price	2009 Shares	Weighted Average Exercise Price
Outstanding at beginning of period	459,115	$ 53.13	500,073	$ 50.25	647,873	$ 41.46
Granted						
Exercised			(11,500)	14.24	(147,800)	11.74
Forfeited			(3,008)	34.18		
Expired	(78,336)	49.37	(26,450)	17.63		
Outstanding at End of Period	380,779	$ 53.91	459,115	$ 53.13	500,073	$ 50.25

Exercisable at End of Period	380,779	$ 53.91	459,115	$ 53.13	500,073	$ 50.25

At December 31, 2011, there were 380,779 of fully vested stock options outstanding. As of December 31, 2011 and 2010, all of the outstanding stock options were fully vested. There was no aggregate intrinsic value for the options outstanding and exercisable at December 31, 2011.

For the year ended December 31, 2011, there were no stock options exercised. The net cash proceeds received and the total intrinsic value (fair value less exercise price) for options exercised was less than $1 million for the years ended December 31, 2010 and 2009.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2011

Note 16. Equity Compensation Plans (continued)

The following table summarizes information about outstanding and exercisable stock options at December 31, 2011.

Outstanding Stock Options as of December 31, 2011

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
$ 0 to $20			$		$
$20 to $30	11,480	0.83	27.43	11,480	27.43
$30 to $40	2,500	1.35	36.19	2,500	36.19
$40 to $50	15,000	2.19	48.48	15,000	48.48
$50 to $60	351,799	2.01	55.13	351,799	55.13
$ 0 to $60	380,779	1.98	53.91	380,779	53.91

Restricted Stock

The following table summarizes the activity related to restricted stock for the years ended December 31, 2011, 2010, and 2009.

	Years Ended December 31,					
	2011		2010		2009	
	Shares	Weighted Average Grant Date Fair Market Value	Shares	Weighted Average Grant Date Fair Market Value	Shares	Weighted Average Grant Date Fair Market Value
Outstanding at beginning of period	119,071	$ 15.68	75,645	$ 18.87	53,242	$ 25.78
Granted	85,218	10.62	60,095	13.99	33,610	14.58
Vested	(18,948)	20.15	(13,127)	26.03	(8,587)	39.50
Forfeited	(932)	18.44	(3,542)	16.85	(2,620)	36.64
Outstanding at End of Period	184,409	$ 12.87	119,071	$ 15.68	75,645	$ 18.87

For each of the years ended December 31, 2011, 2010, and 2009, the expenses related to restricted stock were less than $1 million. As of December 31, 2011, there was $2 million of unrecognized compensation cost related to unvested restricted stock. This cost will be recognized over a weighted average period of two years. Restrictions on shares of restricted stock outstanding lapse through 2016.

REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 16. Equity Compensation Plans (continued)

Deferred Stock Units

The following table summarizes the activity related to DSUs for the years ended December 31, 2011, 2010, and 2009.

Deferred Stock Units Activity

	Years Ended December 31, 2011		2010		2009	
	Units	Weighted Average Grant Date Fair Market Value	Units	Weighted Average Grant Date Fair Market Value	Units	Weighted Average Grant Date Fair Market Value
Outstanding at beginning of period	2,351,804	$ 18.60	1,708,326	$ 21.40	1,730,531	$ 30.33
Granted	598,542	11.05	838,547	14.20	550,599	14.78
Distributions	(456,638)	27.14	(60,067)	43.35	(522,147)	43.51
Forfeitures	(17,537)	14.43	(135,002)	15.66	(50,657)	28.38
Balance at End of Period	2,476,171	$ 15.23	2,351,804	$ 18.60	1,708,326	$ 21.40

We generally grant DSUs annually as part of compensation in the fourth quarter. As of December 31, 2011, 2010, and 2009, the number of outstanding DSUs that were unvested was 1,407,888, 1,309,463, and 1,413,896, respectively. The weighted average grant-date fair value of these unvested DSUs was $13.21, $15.44, and $17.78, as of December 31, 2011, 2010, and 2009, respectively. Unvested DSUs at December 31, 2011 will vest through 2015.

Expenses related to DSUs were $7 million, $11 million, and $6 million for the years ended December 31, 2011, 2010, and 2009, respectively. As of December 31, 2011, there was $14 million of unrecognized compensation cost related to unvested DSUs. This cost will be recognized over a weighted average period of less than 2 years. As of December 31, 2011, 2010, and 2009, the number of outstanding DSUs that had vested was 1,068,283, 1,042,341, and 294,430, respectively.

In 2010, vesting of 376,564 DSUs previously awarded to Mr. George E. Bull, III, was accelerated, in connection with the announcement that he would retire from serving as Chief Executive Officer. We recorded a $4 million equity compensation expense during 2010 related to modifications of these DSUs.

Performance Stock Units

During 2011 and 2010, 348,725 and 243,754 PSUs were granted, respectively, with grant date fair values of $9.83 and $14.01, respectively. No PSUs were granted in 2009. PSUs cliff vest, if at all, on the third anniversary of their grant date, with vesting contingent on total stockholder return over the three-year vesting period.

As of December 31, 2011, the number of outstanding PSUs that were unvested was 592,479. The grant date fair value of the PSUs granted in 2011 and 2010 was determined through Monte-Carlo simulations using the following assumptions: Redwood s common stock closing price on the day prior to the grant date, the average closing price of Redwood s common stock price for the 20 trading days prior to the grant date, and the range of potential payouts based on total stockholder return over three years from the grant date. For the 2011 PSU grant, an implied volatility assumption of 40% (based on historical volatility), a risk free rate of 0.41% (the three-year Treasury rate on the grant date), and a 0% dividend yield (the mathematical equivalent to reinvesting the dividends over the performance period as is consistent with the terms of the PSUs), were used. For the 2010 PSU grant, an implied volatility assumption of 46% (based on historical volatility), a risk free rate of 0.41% (the three-year Treasury rate on the grant date), and a 0% dividend yield were used.

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Note 16. Equity Compensation Plans (continued)

Expenses related to PSUs were $1 million and less than $1 million for the years ended December 31, 2011 and 2010, respectively. As of December 31, 2011, there was $6 million of unrecognized compensation cost related to unvested PSUs. This cost will be recognized over a weighted average period of less than two years. As of December 31, 2011, none of the outstanding PSUs had vested.

Employee Stock Purchase Plan

The ESPP allows a maximum of 200,000 shares of common stock to be purchased in aggregate for all employees. As of December 31, 2011, 2010, and 2009, 152,212, 121,643, and 92,479, shares have been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP at December 31, 2011.

The following table summarizes the activity related to the ESPP for the years ended December 31, 2011, 2010, and 2009.

Employee Stock Purchase Plan Activity

	Years Ended December 31,		
(In Thousands)	2011	2010	2009
Balance at beginning of period	$	$ 3	$ 22
Employee purchases	332	356	293
Cost of common stock issued	(324)	(359)	(312)
Balance at End of Period	$ 8	$	$ 3

Executive Deferred Compensation Plan

The following table summarizes the activity related to the EDCP for the years ended December 31, 2011, 2010, and 2009.

EDCP Cash Accounts Activity

	Years Ended December 31,		
(In Thousands)	2011	2010	2009
Balance at beginning of period	$ 1,210	$ 775	$ 7,607
New deferrals	505	889	406
Accrued interest	59	48	35

Withdrawls	(280)	(502)	(7,273)
Balance at End of Period	$ 1,494	$ 1,210	$ 775

Deferrals were made to the cash accounts of the EDCP of less than $1 million for the years ended December 31, 2011, 2010 and 2009.

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Note 17. Operating Expenses

Components of our operating expenses for the years ended December 31, 2011, 2010, and 2009, are presented in the following table.

Operating Expenses

(In Thousands)	Years Ended December 31, 2011	2010	2009
Fixed compensation expense	$ 15,442	$ 14,845	$ 15,012
Variable compensation expense	2,831	7,542	7,470
Equity compensation expense	9,067	11,353	6,105
Total compensation expense	27,340	33,740	28,587
Systems	7,592	7,658	7,012
Office costs	6,689	7,027	7,047
Accounting and legal	4,177	3,866	2,904
Other operating expenses	1,884	1,424	1,445
Total Operating Expenses	$ 47,682	$ 53,715	$ 46,995

Note 18. Taxes

We assessed our tax positions for all open tax years (i.e., Federal, 2006 to 2010, and State, 2007 to 2010) and, at December 31, 2011 and 2010, concluded that we had no material unrecognized tax liabilities. Components of our net deferred tax assets are presented in the following table.

Deferred Tax Assets

(In Thousands)	December 31, 2011	2010
Net operating loss carry forward and basis differences state	$ 874	$ 6,233
Net capital loss carry forward state	28,691	18,375
Net operating loss carry forward federal	10,259	10,227
Net capital loss carry forward federal	14,437	9,008
Real estate assets	3,824	4,430
Interest rate agreements	4,008	586
Other	326	326
Total net deferred tax assets	62,419	49,185

Valuation allowance	(62,419)	(45,698)
Total benefited deferred tax assets through tax provision		3,487
Tax effect of unrealized losses OCI	702	167
Valuation allowance	(702)	(167)
Total Deferred Tax Assets, net of Valuation Allowance	$	$ 3,487

Redwood, its taxable subsidiaries, and the Acacia entities accumulated an estimated state net operating loss (NOL) of $1.8 billion at December 31, 2011, substantially all of which expires beginning in 2029. Additionally, for state tax purposes, at December 31, 2011, mortgage-backed security basis differences totaled $749 million. The total of these two amounts was offset by tax liabilities related to the Acacia entities that exceeded the corresponding GAAP liabilities by $2.5 billion at December 31, 2011. The net deferred tax asset associated with these differences (using a 7.2% effective state tax rate) was less than $1 million for the year ended December 31, 2011.

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Note 18. Taxes (continued)

Realization of our deferred tax asset at December 31, 2011, is dependent on many factors, including generating sufficient taxable income prior to the expiration of NOL carry forwards and generating sufficient capital gains in future periods prior to the expiration of capital loss carry forwards. We determine the extent to which realization of this deferred asset is not assured and establish a valuation allowance accordingly. Our deferred tax asset valuation allowance increased during 2011, as compared to 2010, due to the uncertainty of generating sufficient capital gains or taxable income in future periods to exhaust the additional deferred assets generated in 2011. Our estimate of net deferred tax assets could change in future periods to the extent that actual or revised estimates of future taxable income during the carry forward periods change from current expectations.

The following table summarizes the provision for (benefit from) income taxes for the years ended December 31, 2011, 2010, and 2009.

Provision for (Benefit from) Income Taxes

	Years Ended December 31,		
(In Thousands)	2011	2010	2009
Current provision for (benefit from) income taxes			
Federal	$ 19	$ (1,049)	$ (3,081)
State	23	6	15
Total current provision for (benefit from) income taxes	42	(1,043)	(3,066)
Deferred provision for (benefit from) income taxes			
Taxable subsidiaries		1,323	(1,202)
Total Provision for (Benefit from) Income Taxes	$ 42	$ 280	$ (4,268)

Our dividend distribution requirements will remain at zero until we generate taxable income in excess of our NOL carry forward at the REIT. At December 31, 2011 our federal NOL carry forward at the REIT was $70 million, which will expire in 2029. In order to utilize NOL s at the REIT, taxable income must exceed dividend distributions. At December 31, 2011, our taxable REIT subsidiaries had federal NOLs of $30 million, which will expire between 2030 and 2031.

The following is a reconciliation of the statutory federal and state rates to the effective rates, for the years ended December 31, 2011, 2010, and 2009.

Reconciliation of Statutory Tax Rate to Effective Tax Rate

	Years Ended December 31,		
	2011	2010	2009
Federal statutory rate	34.0 %	34.0 %	34.0 %
State statutory rate, net of Federal tax effect	7.2 %	7.2 %	7.2 %
Differences in taxable (loss) income from GAAP income	(10.9)%	(39.4)%	(53.4)%
Dividends paid deduction	(30.1)%	(1.5)%	
Effective Tax Rate	0.2 %	0.3 %	(12.2)%

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 18. Taxes (continued)

We believe that we have met all requirements for qualification as a REIT for federal income tax purposes. Many requirements for qualification as a REIT are complex and require analysis of particular facts and circumstances. Often there is only limited judicial or administrative interpretive guidance and as such there can be no assurance that the Internal Revenue Service or courts would agree with our various tax positions. If we did not meet the requirements for statutory relief, we could be subject to a 100% prohibited transaction tax for certain transactions, be required to distribute additional dividends, or be subject to federal income tax at regular corporate rates. We could also potentially lose our REIT status. Any of these outcomes could have a material adverse impact on our consolidated financial statements.

Note 19. Subsequent Events

During January 2012, we transferred $416 million (principal balance) of recently originated, first-lien, residential mortgage loans into Sequoia Mortgage Trust 2012-1, a Sequoia securitization entity sponsored by us. We anticipate accounting for this transfer as a sale for financial reporting purposes and recognizing a gain of approximately $2 million, pending our final interpretation of applicable GAAP pertaining to the transfer of financial assets and consolidation of VIEs. We acquired certain securities issued by this securitization entity for an aggregate investment of $38 million.

At December 31, 2011, we planned to purchase up to $390 million of residential mortgage loans previously originated by third parties. Of this amount, $99 million settled during January 2012 in relation to our completion of the Sequoia Mortgage Trust 2012-1 securitization. An additional $129 million of this amount settled as of February 21, 2012. We expect further settlements to occur during the first quarter of 2012, subject to loan availability and delivery.

Note 20. Quarterly Financial Data Unaudited

(In Thousands, Except Per Share Data)	Three Months Ended December 31,	September 30,	June 30,	March 31,
2011				
Operating results:				
Interest income	$ 56,495	$ 53,396	$ 52,955	$ 54,333
Interest expense	(29,115)	(24,317)	(23,633)	(21,972)
Net interest income	27,380	29,079	29,322	32,361
Net (loss) income	(2,558)	1,297	9,439	18,165

Per share data:				
Net (loss) income basic	$ (0.03)	$ 0.01	$ 0.12	$ 0.23
Net (loss) income diluted	(0.03)	0.01	0.11	0.22
Regular dividends declared per common share	0.25	0.25	0.25	0.25
2010				
Operating results:				
Interest income	$ 55,753	$ 59,015	$ 56,570	$ 58,716
Interest expense	(21,624)	(23,695)	(21,164)	(18,181)
Net interest income	34,129	35,320	35,406	40,535
Net income	14,709	19,898	28,601	46,844
Per share data:				
Net income basic	$ 0.18	$ 0.25	$ 0.36	$ 0.59
Net income diluted	0.18	0.25	0.35	0.58
Regular dividends declared per common share	0.25	0.25	0.25	0.25

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