

GETTY REALTY CORP /MD/  
Form 10-Q  
August 04, 2006

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

FORM 10-Q

(Mark one)

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

For the quarterly period ended JUNE 30, 2006

OR

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

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

Commission file number 001-13777

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

MARYLAND  
(State or other jurisdiction  
of incorporation or organization)

11-3412575  
(I.R.S. Employer  
Identification No.)

125 JERICHO TURNPIKE, SUITE 103  
JERICHO, NEW YORK 11753  
(Address of principal executive offices)  
(Zip Code)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

Yes [ ] No [X]

Registrant had outstanding 24,731,465 shares of Common Stock, par value \$.01 per share, as of August 1, 2006.

GETTY REALTY CORP.

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GETTY REALTY CORP. AND SUBSIDIARIES

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CONSOLIDATED BALANCE SHEETS  
(in thousands, except share data)  
(unaudited)

|   | June 30,<br>2006 | December 31,<br>2005 |
|---|------------------|----------------------|
|   | -----            | -----                |
| Assets:   |                  |                      |
| Real Estate:  |                  |                      |
| Land  | \$ 180,602       | \$ 171,839           |
| Buildings and improvements  | 204,340          | 198,656              |
|   | -----            | -----                |
|   | 384,942          | 370,495              |
| Less - accumulated depreciation and amortization  | (113,170)        | (109,800)            |
|   | -----            | -----                |
| Real estate, net  | 271,772          | 260,695              |
| Deferred rent receivable  | 30,883           | 29,287               |
| Cash and equivalents  | 862              | 1,247                |
| Recoveries from state underground storage tank funds, net   | 4,010            | 4,264                |
| Mortgages and accounts receivable, net  | 3,908            | 3,129                |
| Prepaid expenses and other assets   | 1,307            | 1,359                |
|   | -----            | -----                |
| Total assets  | \$ 312,742       | \$ 299,981           |
|   | =====            | =====                |
| Liabilities and Shareholders' Equity:   |                  |                      |
| Debt  |                  |                      |
| Debt  | \$ 48,509        | \$ 34,224            |
| Environmental remediation costs   | 16,751           | 17,350               |
| Dividends payable   | 11,269           | 11,009               |
| Accounts payable and accrued expenses   | 8,724            | 9,515                |
|   | -----            | -----                |
| Total liabilities   | 85,253           | 72,098               |
|   | -----            | -----                |
| Commitments and contingencies   |                  |                      |
| Shareholders' equity:   |                  |                      |
| Common stock, par value \$.01 per share; authorized<br>50,000,000 shares; issued 24,731,465 at June 30, 2006<br>and 24,716,614 at December 31, 2005 | 247              | 247                  |
| Paid-in capital   | 258,085          | 257,766              |
| Dividends paid in excess of earnings  | (31,020)         | (30,130)             |
| Accumulated other comprehensive income  | 177              | --                   |
|   | -----            | -----                |
| Total shareholders' equity  | 227,489          | 227,883              |
|   | -----            | -----                |
| Total liabilities and shareholders' equity  | \$ 312,742       | \$ 299,981           |
|   | =====            | =====                |

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

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

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|  | Three months<br>ended June 30, |          | Six months<br>ended June 30, |          |
|--|--------------------------------|----------|------------------------------|----------|
|  | 2006                           | 2005     | 2006                         | 2005     |
| Revenues from rental properties          | \$18,180                       | \$17,872 | \$36,247                     | \$35,268 |
| Expenses:                                |                                |          |                              |          |
| Rental property expenses                 | 2,488                          | 2,560    | 4,972                        | 5,184    |
| Environmental expenses, net              | 810                            | 1,348    | 1,911                        | 1,411    |
| General and administrative expenses      | 1,333                          | 1,289    | 2,740                        | 2,600    |
| Depreciation and amortization expense    | 1,996                          | 2,065    | 3,912                        | 4,014    |
| Total expenses                           | 6,627                          | 7,262    | 13,535                       | 13,209   |
|  | 11,553                         | 10,610   | 22,712                       | 22,059   |
| Operating income                         |                                |          |                              |          |
| Other income, net                        | 477                            | 55       | 559                          | 191      |
| Interest expense                         | (918)                          | (451)    | (1,628)                      | (600)    |
| Net earnings                             | \$11,112                       | \$10,214 | \$21,643                     | \$21,650 |
| Net earnings per common share:           |                                |          |                              |          |
| Basic                                    | \$ .45                         | \$ .41   | \$ .88                       | \$ .88   |
| Diluted                                  | \$ .45                         | \$ .41   | \$ .87                       | \$ .88   |
| Weighted average shares outstanding:     |                                |          |                              |          |
| Basic                                    | 24,725                         | 24,714   | 24,721                       | 24,707   |
| Stock options and restricted stock units | 22                             | 14       | 25                           | 14       |
| Diluted                                  | 24,747                         | 24,728   | 24,746                       | 24,721   |
| Dividends declared per share             | \$ .455                        | \$ .435  | \$ .910                      | \$ .870  |

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

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

|  | Six months<br>ended June 30, |           |
|--|------------------------------|-----------|
|  | 2006                         | 2005      |
| Cash flows from operating activities:  |                              |           |
| Net earnings   | \$ 21,643                    | \$ 21,650 |
| Adjustments to reconcile net earnings to<br>net cash provided by operating activities: |                              |           |
| Depreciation and amortization expense  | 3,912                        | 4,014     |
| Deferred rental revenue  | (1,596)                      | (1,885)   |

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|   |          |          |
|---|----------|----------|
| Gain on dispositions of real estate                       | (457)    | (72)     |
| Accretion expense   | 348      | 420      |
| Stock-based employee compensation expense                 | 87       | 64       |
| Changes in assets and liabilities:                        |          |          |
| Recoveries from state underground storage tank funds, net | 416      | 660      |
| Mortgages and accounts receivable, net                    | (659)    | 58       |
| Prepaid expenses and other assets                         | 229      | (1,092)  |
| Environmental remediation costs                           | (1,109)  | (929)    |
| Accounts payable and accrued expenses                     | (791)    | (1,776)  |
|   | -----    | -----    |
| Net cash provided by operating activities                 | 22,023   | 21,112   |
|   | -----    | -----    |
| Cash flows from investing activities:                     |          |          |
| Property acquisitions and capital expenditures            | (15,358) | (29,571) |
| Collection (issuance) of mortgages receivable, net        | (120)    | 142      |
| Proceeds from dispositions of real estate                 | 826      | 785      |
|   | -----    | -----    |
| Net cash used in investing activities                     | (14,652) | (28,644) |
|   | -----    | -----    |
| Cash flows from financing activities:                     |          |          |
| Cash dividends paid                                       | (22,273) | (21,255) |
| Borrowings under credit agreement, net                    | 14,300   | 13,700   |
| Repayment of mortgages payable                            | (15)     | (271)    |
| Proceeds from stock issued                                | 232      | 309      |
|   | -----    | -----    |
| Net cash used in financing activities                     | (7,756)  | (7,517)  |
|   | -----    | -----    |
| Net decrease in cash and equivalents                      | (385)    | (15,049) |
| Cash and equivalents at beginning of period               | 1,247    | 15,700   |
|   | -----    | -----    |
| Cash and equivalents at end of period                     | \$ 862   | \$ 651   |
|   | =====    | =====    |
| Supplemental disclosures of cash flow information         |          |          |
| Cash paid (refunded) during the period for:               |          |          |
| Interest  | \$ 1,362 | \$ 611   |
| Income taxes, net   | 328      | 217      |
| Recoveries from state underground storage tank funds      | (859)    | (1,033)  |
| Environmental remediation costs                           | 2,030    | 2,174    |

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

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

1. General:

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

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

The consolidated financial statements are unaudited but, in the opinion of management, reflect all adjustments (consisting of normal recurring accruals) necessary for a fair presentation. These statements should be read in conjunction with the consolidated financial statements and related notes, which appear in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

### 2. Commitments and Contingencies:

In order to minimize the Company's exposure to credit risk associated with financial instruments, the Company places its temporary cash investments with high credit quality institutions. Temporary cash investments, if any, are held in an institutional money market fund or federal agency discount notes.

As of June 30, 2006, the Company leased nine hundred twenty-nine of its one thousand sixty-four properties on a long-term net basis to Getty Petroleum Marketing Inc. ("Marketing") under a master lease ("Master Lease") and a coterminous supplemental lease for one property (collectively the "Marketing Leases") (see note 2 to the consolidated financial statements which appear in the Company's Annual Report on Form 10-K for the year ended December 31, 2005). Marketing operated substantially all of the Company's petroleum marketing businesses when it was spun-off to the Company's shareholders as a separate publicly held company in March 1997 (the "Spin-Off"). In December 2000, Marketing was acquired by a subsidiary of OAO Lukoil, one of Russia's largest oil companies. The Company's financial results depend largely on rental income from Marketing, and

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to a lesser extent on rental income from other tenants, and are therefore materially dependent upon the ability of Marketing to meet its obligations under the Marketing Leases. Substantially all of the deferred rental revenue of \$30,883,000 recorded as of June 30, 2006 is due to recognition of rental revenue on a straight-line basis under the Marketing Leases. Marketing's financial results depend largely on retail petroleum marketing margins and rental income from its dealers. The petroleum marketing industry has been and continues to be volatile and highly competitive. Marketing has made all required monthly rental payments under the Marketing Leases when due.

Under the Master Lease, the Company has agreed to provide limited environmental indemnification to Marketing, capped at \$4,250,000 and expiring in 2010, for certain pre-existing conditions at six of the terminals which are owned by the Company. Under the agreement, Marketing will pay the first \$1,500,000 of costs and expenses incurred in connection with remediating any such pre-existing conditions, Marketing and the Company will share equally the next \$8,500,000 of those costs and expenses and Marketing will pay all

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additional costs and expenses over \$10,000,000. The Company has accrued \$300,000 as of June 30, 2006 and December 31, 2005 in connection with this indemnification agreement.

The Company is subject to various legal proceedings and claims which arise in the ordinary course of its business. In addition, the Company has retained responsibility for all pre-spin-off legal proceedings and claims relating to the petroleum marketing business. As of June 30, 2006 and December 31, 2005 the Company had accrued \$2,645,000 and \$2,667,000, respectively, for certain of these matters which it believes were appropriate based on information then currently available. The ultimate resolution of these matters is not expected to have a material adverse effect on the Company's financial condition or results of operations.

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

From October 2003 through June 2006 the Company was notified that the Company was made party to thirty-nine cases in Connecticut, Florida, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Vermont, Virginia and West Virginia brought by local water providers or governmental agencies. These cases allege various theories of liability due to contamination of groundwater with MTBE as the basis for claims seeking compensatory and punitive damages. Each

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case names as defendants approximately fifty petroleum refiners, manufacturers, distributors and retailers of MTBE, or gasoline containing MTBE. The accuracy of the allegations as they relate to the Company, its defenses to such claims, the aggregate amount of damages, the definitive list of defendants and the method of allocating such amounts among the defendants have not been determined. Accordingly, the ultimate legal and financial liability of the Company, if any, cannot be estimated with any certainty at this time.

Prior to the spin-off, the Company was self-insured for workers' compensation, general liability and vehicle liability up to predetermined amounts above which third-party insurance applies. As of June 30, 2006 and December 31, 2005, the Company's consolidated balance sheets included, in accounts payable and accrued expenses, \$335,000 and \$291,000 relating to insurance obligations. The Company estimates its loss reserves for claims, including claims incurred but not reported, by utilizing actuarial valuations

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provided annually by its insurance carriers. The Company is required to deposit funds for these loss reserves with its insurance carriers, and may be entitled to refunds of amounts previously funded, as the claims are evaluated on an annual basis. Although future loss reserve adjustments may have a significant impact on results of operations for any single fiscal year or interim period, the Company currently believes that such costs will not have a material adverse effect on the Company's long-term financial position. Since the spin-off, the Company has maintained insurance coverage subject to certain deductibles.

In order to qualify as a REIT, among other items, the Company paid a \$64,162,000 special one-time "earnings and profits" (as defined in the Internal Revenue Code) cash distribution to shareholders in August 2001. Determination of accumulated earnings and profits for federal income tax purposes is extremely complex. Should the Internal Revenue Service successfully assert that the Company's accumulated earnings and profits were greater than the amount distributed, the Company may fail to qualify as a REIT; however, the Company may avoid losing its REIT status by paying a deficiency dividend to eliminate any remaining accumulated earnings and profits. The Company may have to borrow money or sell assets to pay such a deficiency dividend. As of June 30, 2006 and December 31, 2005 the Company had accrued \$701,000 for this and certain other uncertain tax matters which it believes was appropriate based on information then currently available. The accrual for uncertain tax positions is adjusted as circumstances change and as the uncertainties become more clearly defined, such as when audits are settled or exposures expire. In June 2006 the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 ("FIN 48") "Accounting for Uncertainty in Income Taxes." FIN 48 addresses the recognition and measurement of tax positions taken or expected to be taken in a tax return. The Company does not believe that the adoption of FIN 48 in January 2007 will have a material impact on the Company's financial position or results of operation.

### 3. Environmental Expenses

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

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and related assets are measured at fair value based on their expected future cash flows which have been adjusted for inflation and discounted to present value. For the three and six months ended June 30, 2006, the net changes in estimated remediation costs included in environmental expenses in the Company's consolidated statements of operations were \$331,000 and \$826,000, respectively, as compared to \$1,025,000 and \$1,292,000, respectively, for the comparable prior year periods, which amounts were net of changes in estimated recoveries from state underground storage tank ("UST") remediation funds. Environmental expenses also include project management fees, legal fees and provisions for environmental litigation loss reserves.

In accordance with leases with certain tenants, the Company has agreed to bring the leased properties with known environmental contamination to within applicable standards and to regulatory or contractual closure ("Closure") in an



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efficient and economical manner. Generally, upon achieving Closure at each individual property, the Company's environmental liability under the lease for that property will be satisfied and future remediation obligations will be the responsibility of the Company's tenant. Generally, the liability for the retirement and decommissioning or removal of UST's and other equipment is the responsibility of the tenants. The Company is contingently liable for these obligations in the event that the tenants do not satisfy their responsibilities. A liability has not been recognized for obligations that are the responsibility of our tenants. Of the nine hundred twenty-nine properties leased to Marketing as of June 30, 2006, the Company has agreed to pay all costs relating to, and to indemnify Marketing for, certain environmental liabilities and obligations for the remaining two hundred thirty-four properties that are scheduled in the Master Lease and have not achieved Closure. The Company will continue to seek reimbursement from state UST remediation funds related to these environmental expenditures where available.

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

Environmental exposures are difficult to assess and estimate for numerous reasons, including the extent of contamination, alternative treatment methods that may be applied, location of the property which subjects it to differing local laws and regulations and their interpretations, as well as the time it takes to remediate contamination. In developing the Company's liability for probable and reasonably estimable environmental remediation costs, on a property by property basis, the Company considers among other things, enacted laws and regulations, assessments of contamination and surrounding geology, quality of information available, currently available technologies for treatment, alternative methods of remediation and prior experience. These accrual estimates are subject to significant change, and are adjusted as the remediation treatment progresses, as circumstances change and as these contingencies become more clearly defined and reasonably estimable. As of June 30, 2006, the Company had remediation action plans in place for 292 (94%) of the 312 properties for which it retained environmental responsibility and has not received a no further action letter and the remaining 20 properties (6%) remain in the assessment phase.

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As of June 30, 2006, December 31, 2005 and December 31, 2004, the Company had accrued \$16,751,000, \$17,350,000, and \$20,626,000, respectively, as management's best estimate of the fair value of reasonably estimable environmental remediation costs. As of June 30, 2006, December 31, 2005 and December 31, 2004, the Company had also recorded \$4,010,000, \$4,264,000 and \$5,437,000, respectively, as management's best estimate for recoveries from state UST remediation funds, net of allowance, related to environmental obligations and liabilities. Accrued environmental remediation costs and recoveries from state UST remediation funds have been accreted for the change in present value due to the passage of time and, accordingly, \$348,000 and \$420,000 of net accretion expense is included in environmental expenses for the six months ended June 30, 2006 and 2005, respectively.

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In view of the uncertainties associated with environmental expenditures, however, the Company believes it is possible that the fair value of future actual net expenditures could be substantially higher than these estimates. Adjustments to accrued liabilities for environmental remediation costs will be reflected in the Company's financial statements as they become probable and a reasonable estimate of fair value can be made. Although future environmental expenses may have a significant impact on results of operations for any single fiscal year or interim period, the Company currently believes that such costs will not have a material adverse effect on the Company's long-term financial position.

#### 4. Shareholders' Equity:

A summary of the changes in shareholders' equity for the six months ended June 30, 2006 is as follows (in thousands, except share amounts):

|  | Common Stock |        | Paid-in<br>Capital | Dividends<br>Paid In<br>Excess Of | Accumulated<br>Other<br>Comprehensive | Total     |
|--|--------------|--------|--------------------|-----------------------------------|---------------------------------------|-----------|
|  | Shares       | Amount |                    | Earnings                          | Income                                |           |
| Balance, December 31, 2005                   | 24,716,614   | \$247  | \$257,766          | \$(30,130)                        | \$ --                                 | \$227,888 |
| Net earnings                                 |              |        |                    | 21,643                            |                                       | 21,643    |
| Dividends                                    |              |        |                    | (22,533)                          |                                       | (22,533)  |
| Stock-based employee<br>compensation expense |              |        | 87                 |                                   |                                       | 87        |
| Net unrealized gain on<br>interest rate swap |              |        |                    |                                   | 177                                   | 177       |
| Stock issued                                 | 14,851       |        | 232                |                                   |                                       | 232       |
| Balance, June 30, 2006                       | 24,731,465   | \$247  | \$258,085          | \$(31,020)                        | \$177                                 | \$227,487 |

The Company is authorized to issue 20,000,000 shares of preferred stock, par value \$.01 per share, of which none were issued as of December 31, 2005 or June 30, 2006.

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#### 5. Acquisitions

On February 28, 2006, the Company acquired eighteen retail motor fuel and convenience store properties located in Western New York for \$13,389,000. Simultaneous with the closing on the acquisition, the Company entered into a triple-net lease with a single tenant for all of the properties. The lease provides for annual rentals at a competitive rate and provides for escalations thereafter. The lease has an initial term of fifteen years and provides the tenant options for three renewal terms of five years each. The lease also provides that the tenant is responsible for all existing and future environmental conditions at the properties.

On March 25, 2005 the Company acquired twenty-three convenience store and retail motor fuel properties in Virginia for \$28,960,000. All of the properties are triple-net-leased to a single tenant who previously leased the properties

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from the seller and operates the locations under its proprietary convenience store brand in its network of over 200 locations. The lease provides for annual rentals at a competitive rate and provides for escalations thereafter. The lease has an initial term of fifteen years and provides the tenant options for three renewal terms of five years each. The lease also provides that the tenant is responsible for all existing and future environmental conditions at the properties.

### 6. Derivative Financial Instruments

In April 2006 the Company entered into a \$45,000,000 LIBOR based interest rate swap, effective May 1, 2006 through June 30, 2011. The interest rate swap is intended to hedge the Company's current exposure to market interest rate risk by effectively fixing, at 5.44%, the LIBOR component of the interest rate determined under its existing credit agreement or future exposure to variable interest rate risk due to borrowing arrangements that may be entered into prior to the expiration of the interest rate swap. The Company's borrowings under its credit agreement bear interest at a rate equal to the sum of a base rate or a LIBOR rate plus an applicable margin based on the Company's leverage ratio and ranging from 0.25% to 1.75%. Effective May 1, 2006, \$45,000,000 of the Company's LIBOR based borrowings under the credit agreement bear interest at a 6.69% effective rate.

The Company entered into the \$45,000,000 notional five year interest rate swap agreement designated and qualifying as a cash flow hedge to reduce its exposure to the variability in future cash flows attributable to changes in the LIBOR rate. The Company's primary objective when undertaking hedging transactions and derivative positions is to reduce its variable interest rate risk by effectively fixing a portion of the interest rate for existing debt and anticipated refinancing transactions.

The Company determined, as of both the hedging instrument's inception and as of June 30, 2006, that the derivative used in the hedging transaction is highly effective in offsetting changes in cash flows associated with the hedged items and that no gain or loss was required to be recognized in earnings during the quarter representing the hedge's ineffectiveness. At June 30, 2006, the Company's consolidated balance sheets included, in prepaid expenses and other assets, derivatives with a fair value of \$177,000. The fair value of the interest rate swap is based upon the estimated amounts the Company would receive or pay to terminate the contract at the reporting date and is determined using interest rate market pricing models. For the three months ended June 30, 2006, the

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Company has recorded the change in fair value of the swap contract related to the effective portion of the interest rate contract totaling approximately \$177,000 in accumulated other comprehensive income in the Company's consolidated balance sheets. The accumulated comprehensive income will be reclassified as a reduction in interest expense over the term of the five year interest rate swap agreement since it is expected that the Credit Agreement will be refinanced with variable interest rate debt at its maturity. The Company does not expect to settle the interest rate swap prior to its maturity and expects to reclassify approximately \$35,000 of the amount recorded in accumulated other comprehensive income relating to the interest rate swap contract as a reduction in interest expense within the next twelve months. The Company will reclassify the amount recorded in accumulated other comprehensive income relating to the interest rate swap into earnings if the interest rate swap agreement is not effective for accounting purposes or if the \$45,000,000 notional amount of the interest rate

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swap agreement exceeded the Company's projected debt outstanding under variable interest rate borrowing arrangements.

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

This discussion and analysis of financial condition and results of operations should be read in conjunction with the sections entitled "Part I, Item 1A. Risk Factors" and "Part II, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations," which appear in our Annual Report on Form 10-K for the year ended December 31, 2005, and the unaudited consolidated financial statements and related notes which appear in this Quarterly Report on Form 10-Q.

#### General

We are a real estate investment trust specializing in the ownership and leasing of retail motor fuel and convenience store properties and petroleum distribution terminals. We elected to be taxed as a REIT under the federal income tax laws beginning January 1, 2001. As a REIT, we are not subject to federal corporate income tax on the taxable income we distribute to our shareholders. In order to continue to qualify for taxation as a REIT, we are required, among other things, to distribute at least ninety percent of our taxable income to shareholders each year.

We lease or sublet our properties primarily to distributors and retailers engaged in the sale of gasoline and other motor fuel products, convenience store products and automotive repair services. These tenants are responsible for the payment of taxes, maintenance, repair, insurance and other operating expenses and for managing the actual operations conducted at these properties. As of June 30, 2006, we leased nine hundred twenty-nine of our one thousand sixty-four properties on a long-term basis under a master lease (the "Master Lease") and a coterminous supplemental lease for one property, (collectively the "Marketing Leases") to Getty Petroleum Marketing Inc. ("Marketing") which was spun-off to our shareholders as a separate publicly held company in March 1997. In December 2000, Marketing was acquired by a subsidiary of OAO Lukoil ("Lukoil"), one of Russia's largest integrated oil companies.

Substantially all of our revenues (87% for the six months ended June 30, 2006), are derived from the Marketing Leases. Accordingly, our revenues are dependent to a large degree on the economic performance of Marketing and of the petroleum marketing industry and any factor that adversely affects Marketing or our other lessees may have a material adverse effect on our financial condition and results of operations. Marketing's financial results depend largely on retail petroleum marketing margins and rental income from subtenants who operate our properties. The petroleum marketing industry has been and continues to be volatile and highly competitive. Factors that could adversely affect Marketing or our other lessees include those described under "Part I, Item 1A. Risk Factors", in our Annual Report on Form 10-K. In the event that Marketing cannot or will not perform its monetary obligations under the Marketing Leases with us, our financial condition and results of operations would be materially adversely affected. Although Marketing is wholly owned by a subsidiary of Lukoil, no assurance can be given that Lukoil will cause Marketing to fulfill any of its monetary obligations under the Marketing Leases.

We periodically receive and review Marketing's financial statements and other financial data. We receive this information from Marketing pursuant to the terms of the Master Lease. Certain of this

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information is not publicly available and the terms of the Master Lease prohibit us from including this financial information in our Annual Reports on Form 10-K, our Quarterly Reports on Form 10-Q or in our Annual Reports to Shareholders. The financial performance of Marketing may deteriorate, and Marketing may ultimately default on its monetary obligations to us before we receive financial information from Marketing that would indicate the deterioration or before we would have the opportunity to advise our shareholders of any increased risk of default.

Certain financial and other information concerning Marketing is available from Dun & Bradstreet and may be accessed by their web site (www.dnb.com) upon payment of their fee.

Selected balance sheet data of Marketing at December 31, 2004, 2003 and 2002 and selected operating data of Marketing for each of the three years in the period ending December 31, 2004, which is publicly available, has been provided in "Part II, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations," which appears in our Annual Report on Form 10-K for the year ended December 31, 2005.

The audited consolidated financial statements of Marketing for their fiscal year ended December 31, 2005 have been provided to us. Selected balance sheet data of Marketing at December 31, 2005 is publicly available and is provided below. Selected operating data of Marketing for the year ended December 31, 2005 is not publicly available. Neither we, nor our auditors, were involved in the preparation of any of Marketing's financial data and as a result can provide no assurance thereon. Additionally, our auditors have not been engaged to review or audit this data.

Getty Petroleum Marketing Inc.  
Selected Balance Sheet Data  
(unaudited, in thousands)

|  | December 31,<br>2005 |
|--|----------------------|
|  | -----                |
| ASSETS:                                    |                      |
| Cash and equivalents                       | \$ 103,815           |
| Other assets                               | 625,947              |
|  | -----                |
| Total assets                               | \$ 729,762           |
|  | =====                |
| LIABILITIES AND STOCKHOLDER'S EQUITY:      |                      |
| Total liabilities                          | \$ 617,780           |
| Total stockholder's equity                 | 111,982              |
|  | -----                |
| Total liabilities and stockholder's equity | \$ 729,762           |
|  | =====                |

Based on our review of the financial statements and other financial data Marketing has provided to us to date, we believe that Marketing has the

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liquidity and financial ability to continue to pay timely its monetary obligations under the Marketing Leases, as it has since the inception of the Master Lease in 1997.

As part of a periodic review by the Division of Corporation Finance of the Securities and Exchange Commission ("SEC") of our Annual Report on Form 10-K for the year ended December 31, 2003, we received and responded to a number of comments. The only comment that remains unresolved pertains to the SEC's position that we must include the financial statements and summarized financial data of Marketing in our periodic filings. The SEC subsequently indicated that, unless we file Marketing's financial statements and summarized financial data with our periodic reports: (i) it will not consider our Annual Reports on Forms 10-K for the years beginning with 2000 to be compliant; (ii) it will not consider us to be current in our reporting requirements; (iii) it will not be in a position to declare effective any registration statements we may file for public offerings of our securities; and (iv) we should consider how the SEC's conclusion impacts our ability to make

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offers and sales of our securities under existing registration statements and if we have a liability for such offers and sales made pursuant to registration statements that did not contain the financial statements of Marketing.

We believe that the SEC's position is based on their interpretation of certain provisions of their internal Accounting Disclosure Rules and Practices Training Material, Staff Accounting Bulletin No. 71 and Rule 3-13 of Regulation S-X. We do not believe that any of this guidance is clearly applicable to our particular circumstances and that, even if it were, we believe that we should be entitled to certain relief from compliance with such requirements. Marketing subleases our properties to approximately nine hundred independent, individual service station/convenience store operators (subtenants), most of whom were our tenants when Marketing was spun-off to our shareholders. Consequently, we believe that we, as the owner of these properties and the Getty brand, and our prior experience with Marketing's tenants, could relet these properties to the existing subtenants or others at market rents. Because of this particular aspect of our landlord-tenant relationship with Marketing, we do not believe that the inclusion of Marketing's financial statements in our filings is necessary to evaluate our financial condition. Our position was included in a written response to the SEC. To date, the SEC has not accepted our position regarding the inclusion of Marketing's financial statements in our filings. We are endeavoring to achieve a resolution of this issue that will be acceptable to the SEC. We can not accurately predict the consequences if we are ultimately unsuccessful in achieving an acceptable resolution.

We do not believe that offers or sales of our securities made pursuant to existing registration statements that did not or do not contain the financial statements of Marketing constitute, by reason of such omission, a violation of the Securities Act of 1933, as amended, or the Exchange Act. Additionally, we believe that, if there ultimately is a determination that such offers or sales, by reason of such omission, resulted in a violation of those securities laws, we would not have any material liability as a consequence of any such determination.

We manage our business to enhance the value of our real estate portfolio and, as a REIT, place particular emphasis on minimizing risk and generating cash sufficient to make required distributions to shareholders of at least ninety percent of our taxable income each year. In addition to measurements defined by generally accepted accounting principles ("GAAP"), our management also focuses

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on funds from operations available to common shareholders ("FFO") and adjusted funds from operations available to common shareholders ("AFFO") to measure our performance. FFO is generally considered to be an appropriate supplemental non-GAAP measure of the performance of REITs. FFO is defined by the National Association of Real Estate Investment Trusts as net earnings before depreciation and amortization of real estate assets, gains or losses on dispositions of real estate, non-FFO items reported in discontinued operations and extraordinary items and cumulative effect of accounting change. Other REITs may use definitions of FFO and/or AFFO that are different than ours and, accordingly, may not be comparable.

We believe that FFO is helpful to investors in measuring our performance because FFO excludes various items included in GAAP net earnings that do not relate to, or are not indicative of, our fundamental operating performance such as gains or losses from property dispositions and depreciation and amortization of real estate assets. In our case, however, GAAP net earnings and FFO include the significant impact of deferred rental revenue (straight-line rental revenue) on our recognition of revenues from rental properties, which results primarily from fixed rental

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increases scheduled under certain leases with our tenants. In accordance with GAAP, the aggregate minimum rent due over the initial term of these leases are recognized on a straight-line basis rather than when due. GAAP net earnings and FFO may also include an income tax provision or benefit recognized due to adjustments in amounts accrued for uncertain tax positions related to being taxed as a C-Corp., rather than as a REIT, prior to 2001. As a result, management pays particular attention to AFFO, a supplemental non-GAAP performance measure that we define as FFO less straight-line rental revenue and income taxes. Income taxes did not have a significant impact on our earnings for the periods presented, and accordingly, do not appear as a separate item in our statement of operations or our reconciliation of AFFO from net earnings. In management's view, AFFO provides a more accurate depiction than FFO of the impact of scheduled rent increases under these leases and our election to be taxed as a REIT beginning in 2001. Neither FFO nor AFFO represent cash generated from operating activities calculated in accordance with generally accepted accounting principles and therefore these measures should not be considered an alternative for GAAP net earnings or as a measure of liquidity.

A reconciliation of net earnings to FFO and AFFO for the three and six months ended June 30, 2006 and 2005 is as follows (in thousands, except per share amounts):

|   | Three months ended<br>June 30, |          | Six months ended<br>June 30, |          |
|---|--------------------------------|----------|------------------------------|----------|
|   | 2006                           | 2005     | 2006                         | 2005     |
| Net earnings  | \$11,112                       | \$10,214 | \$21,643                     | \$21,650 |
| Depreciation and amortization of real estate assets | 1,996                          | 2,065    | 3,912                        | 4,014    |
| Gains on dispositions of real estate                | (423)                          | --       | (457)                        | (72)     |
|   | 12,685                         | 12,279   | 25,098                       | 25,592   |
| Funds from operations                               | 12,685                         | 12,279   | 25,098                       | 25,592   |
| Deferred rental revenue (straight-line rent)        | (773)                          | (985)    | (1,596)                      | (1,885)  |
|   | -----                          | -----    | -----                        | -----    |

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|   |          |          |          |          |
|---|----------|----------|----------|----------|
| Adjusted funds from operations              | \$11,912 | \$11,294 | \$23,502 | \$23,707 |
|   | =====    | =====    | =====    | =====    |
| Diluted per share amounts:                  |          |          |          |          |
| Earnings per share                          | \$ .45   | \$ .41   | \$ 0.87  | \$ 0.88  |
| Funds from operations per share             | \$ .51   | \$ .50   | \$ 1.01  | \$ 1.04  |
| Adjusted funds from operations per share    | \$ .48   | \$ .46   | \$ 0.95  | \$ 0.96  |
| Diluted weighted average shares outstanding | 24,747   | 24,728   | 24,746   | 24,721   |

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### Results of operations

Three months ended June 30, 2006 compared to the three months ended June 30, 2005.

Revenues from rental properties were \$18.2 million for the three months ended June 30, 2006 compared to \$17.9 million for the three months ended June 30, 2005. We received approximately \$15.0 million in the three months ended June 30, 2006 and \$14.9 million in the three months ended June 30, 2005, from properties leased to Marketing under the Marketing Leases. We also received rent of \$2.4 million in the three months ended June 30, 2006 and \$2.0 million in the three months ended June 30, 2005 from other tenants. The increase in rent received was primarily due to rent from properties acquired in February 2006 and rent escalations, partially offset by the effect of dispositions of real estate. In addition, revenues from rental properties include deferred rental revenues of \$0.8 million for the three months ended June 30, 2006 as compared to \$1.0 million for the three months ended June 30, 2005, recorded as required by GAAP, related to the fixed rent increases scheduled under certain leases with tenants. The aggregate minimum rent due over the initial term of these leases are recognized on a straight-line basis rather than when due.

Rental property expenses, which are primarily comprised of rent expense and real estate and other state and local taxes, were \$2.5 million for the three months ended June 30, 2006, which was comparable to \$2.6 million recorded for the three months ended June 30, 2005.

Environmental expenses, net for the three months ended June 30, 2006 were \$0.8 million as compared to \$1.3 million for the three months ended June 30, 2005. The decrease was primarily due to a \$0.7 million decrease in the change in estimated environmental costs, net of estimated recoveries.

General and administrative expenses for the three months ended June 30, 2006 were \$1.3 million which was comparable to the three months ended June 30, 2005.

Depreciation and amortization expense for the three months ended June 30, 2006 was \$2.0 million which was comparable to the three months ended June 30, 2005.

As a result, total operating expenses decreased by approximately \$0.6 million for the three months ended June 30, 2006, as compared to the three months ended June 30, 2005.

Other income, net was \$0.5 million for the three months ended June 30, 2006 and \$0.1 million for the three months ended June 30, 2005. The increase was primarily due to \$0.4 million of increased gains on dispositions of real estate.

Interest expense, primarily related to borrowings used to finance the acquisition of properties, was \$0.9 million for the three months ended June 30,



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2006 as compared to \$0.5 million for the three months ended June 30, 2005. The increase was primarily due to increased borrowings used to finance the acquisition of properties. Interest expense also increased due to higher interest rates which averaged 6.48% for the three months ended June 30, 2006 as compared to 4.25 % for the three months ended June 30, 2005.

In April 2006 we entered into a \$45.0 million LIBOR based interest rate swap, effective May 1, 2006 through June 30, 2011. The interest rate swap is intended to hedge our current exposure to

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market interest rate risk by effectively fixing, at 5.44%, the LIBOR component of the interest rate determined under our existing credit agreement or future exposure to variable interest rate risk due to borrowing arrangements that may be entered into prior to the expiration of the interest rate swap. Our borrowings under the credit agreement bear interest at a rate equal to the sum of a base rate or a LIBOR rate plus an applicable margin based on our leverage ratio and ranging from 0.25% to 1.75%. Effective May 1, 2006, \$45.0 million of our LIBOR based borrowings under the credit agreement bear interest at a 6.69% effective rate.

As a result, net earnings increased by 8.8%, or \$0.9 million, to \$11.1 million for the three months ended June 30, 2006, as compared to \$10.2 million for the comparable prior year period. For the same period, FFO was \$12.7 million, an increase of \$0.4 million, or 3.3% and AFFO was \$11.9 million, an increase of \$0.6 million, or 5.5%. The increases in FFO and AFFO for the quarter were primarily due to the changes in net earnings described above but exclude the improvement in earnings due to higher gains on dispositions of properties of \$0.4 million. AFFO increased more than FFO on both a dollar and percentage basis due to a \$0.2 million decrease in deferred rental revenue (which is included in net earnings and FFO but is excluded from AFFO) recorded for the three months ended June 30, 2006 as compared to the three months ended June 30, 2005.

Diluted earnings per share for the three months ended June 30, 2006 was \$0.45 per share, which increased \$0.04 per share, or 9.8%, as compared to the three months ended June 30, 2005. Diluted FFO per share for the three months ended June 30, 2006 was \$0.51 per share, which increased \$0.01 per share, or 2.0%, as compared to the three months ended June 30, 2005. Diluted AFFO per share for the three months ended June 30, 2006 was \$0.48 per share, which increased \$0.02 per share, or 4.3%, as compared to the three months ended June 30, 2005.

### Results of operations

Six months ended June 30, 2006 compared to the six months ended June 30, 2005

Revenues from rental properties were \$36.2 million for the six months ended June 30, 2006 compared to \$35.3 million for the six months ended June 30, 2005. We received approximately \$30.1 million in the six months ended June 30, 2006 and \$29.8 million in the six months ended June 30, 2005, from properties leased to Marketing under the Marketing Leases. We also received rent of \$4.5 million in the six months ended June 30, 2006 and \$3.6 million in the six months ended June 30, 2005 from other tenants. The increase in rent received was primarily due to rent from properties acquired in March 2005 and February 2006 and rent escalations, partially offset by the effect of dispositions of real estate. In addition, revenues from rental properties include deferred rental revenues of \$1.6 million for the six months ended June 30, 2006 as compared with \$1.9 million for the six months ended June 30, 2005.

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Rental property expenses, which are primarily comprised of rent expense and real estate and other state and local taxes, were \$5.0 million for the six months ended June 30, 2006, which was comparable to \$5.2 million recorded for the three months ended June 30, 2005.

Environmental expenses, net for the six months ended June 30, 2006 were \$1.9 million as compared to \$1.4 million for the six months ended June 30, 2005. The increase was primarily due to a \$0.9 million increase in legal fees and litigation related expenses as compared to the prior year period offset by a \$0.5 million decrease in change in estimated environmental costs, net of estimated

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recoveries. Legal fees and litigation related expenses were \$0.7 million for the six months ended June 30, 2006 compared to a credit of \$0.3 million for 2005, which prior period includes a net reduction in litigation loss reserve estimates.

General and administrative expenses for the six months ended June 30, 2006 were \$2.7 million which was comparable to the \$2.6 million recorded for the six months ended June 30, 2005.

Depreciation and amortization expense for the six months ended June 30, 2006 was \$3.9 million which was comparable to the \$4.0 million recorded for the six months ended June 30, 2005.

As a result, total operating expenses increased by approximately \$0.3 million for the six months ended June 30, 2006, as compared to the six months ended June 30, 2005.

Other income, net was \$0.6 million for the six months ended June 30, 2006 and \$0.2 million for the six months ended June 30, 2005. The increase was primarily due to \$0.4 million of increased gains on dispositions of real estate.

Interest expense, primarily related to borrowings used to finance the acquisition of properties, was \$1.6 million for the six months ended June 30, 2006 as compared with \$0.6 million for the six months ended June 30, 2005. The increase was primarily due to increased borrowings used to finance the acquisition of properties. Interest expense also increased due to higher interest rates which averaged 6.13% for the six months ended June 30, 2006 as compared to 4.14% for the six months ended June 30, 2005.

As a result, net earnings were \$21.6 million for the six months ended June 30, 2006 which was comparable to the \$21.7 million reported for the prior year period. For the same period, FFO was \$25.1 million, a decrease of \$0.5 million, or 1.9%, and AFFO was \$23.5 million, a decrease of \$0.2 million, or 1.0%. The decreases in FFO and AFFO for the six months ended June 30, 2006 were primarily due to the changes in net earnings described above but exclude the improvement in earnings due to higher gains on dispositions of properties of \$0.4 million. FFO decreased more than AFFO on both a dollar and percentage basis due to a \$0.3 million decrease in deferred rental revenue (which is included in net earnings and FFO but is excluded from AFFO) recorded for the six months ended June 30, 2006 as compared to the six months ended June 30, 2005.

Diluted earnings per share for the six months ended June 30, 2006 was \$0.87 per share, a decrease of \$0.01 per share, or 1.0%, compared to the six months ended June 30, 2005. Diluted FFO per share for the six months ended June 30, 2006 was \$1.01 per share, a decrease of \$0.03 per share or, 2.9%, as compared to

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the six months ended June 30, 2005. Diluted AFFO per share for the six months ended June 30, 2006 was \$0.95 per share, a decrease of \$0.01 per share, or 1.0%, as compared to the six months ended June 30, 2005.

### Liquidity and Capital Resources

Our principal sources of liquidity are the cash flows from our business, funds available under a revolving credit agreement that matures in 2008 and available cash and equivalents. Management believes that dividend payments and cash requirements for our business for the next twelve months, including environmental remediation expenditures, capital expenditures and debt service, can be met by cash flows from operations, borrowings under the credit agreement and available cash and equivalents.

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On June 30, 2005, we entered into an unsecured three-year senior revolving \$100.0 million credit agreement ("Credit Agreement") with a group of six domestic commercial banks. Subject to the terms of the Credit Agreement, we have the right to increase the Credit Agreement by \$25.0 million and to extend the term of the Credit Agreement for one additional year. Borrowings under the Credit Agreement bear interest at a rate equal to the sum of a base rate or a LIBOR rate plus an applicable margin based on our leverage ratio and ranging from 0.25% to 1.75%. The annual commitment fee on the unused Credit Agreement will range from 0.10% to 0.20% based on the amount of borrowings. The Credit Agreement includes customary terms and conditions, including financial covenants such as leverage and coverage ratios and other customary covenants, including limitations on our ability to incur debt and pay dividends and maintenance of tangible net worth, and events of default, including a change of control and failure to maintain REIT status. We do not believe that these covenants will limit our current business practices.

In April 2006 we entered into a \$45.0 million LIBOR based interest rate swap, effective May 1, 2006 through June 30, 2011. The interest rate swap is intended to hedge our current exposure to market interest rate risk by effectively fixing, at 5.44%, the LIBOR component of the interest rate determined under our existing credit agreement or future exposure to variable interest rate risk due to borrowing arrangements that may be entered into prior to the expiration of the interest rate swap. Effective May 1, 2006, \$45.0 million of our LIBOR based borrowings under the Credit Agreement bear interest at a 6.69% effective rate.

Total borrowings outstanding under the Credit Agreement at June 30, 2006 were \$48.3 million, bearing interest at an effective rate of 6.68% per annum. Total borrowings increased to \$50.7 million as of August 1, 2006 primarily due to additional borrowings used to pay \$11.0 million of dividends that were accrued as of June 30, 2006 and paid in July 2006, net of repayments from positive cash flows provided by rental operations. Accordingly, we had \$49.3 million available under the terms of the Credit Agreement as of August 1, 2006 or \$74.3 million available assuming we had exercised our right to increase the Credit Agreement by \$25.0 million.

We elected to be taxed as a REIT under the federal income tax laws with the year beginning January 1, 2001. As a REIT, we are required, among other things, to distribute at least ninety percent of our taxable income to shareholders each year. Payment of dividends is subject to market conditions, our financial condition and other factors, and therefore cannot be assured. Dividends paid to our shareholders aggregated \$22.3 million for the six months ended June 30, 2006 and \$21.3 million for the prior year period. We presently intend to pay common

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stock dividends of \$0.455 per share each quarter (\$1.82 per share on an annual basis), and commenced doing so with the quarterly dividend declared in February 2006.

As part of our overall growth strategy, we regularly review opportunities to acquire additional properties and we expect to continue to pursue acquisitions that we believe will benefit our financial performance. To the extent that our current sources of liquidity are not sufficient to fund such acquisitions we will require other sources of capital, which may or may not be available on favorable terms or at all.

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### Critical Accounting Policies

Our accompanying unaudited interim consolidated financial statements include the accounts of Getty Realty Corp. and our wholly-owned subsidiaries. The preparation of financial statements in accordance with GAAP requires management to make estimates, judgments and assumptions that affect amounts reported in its financial statements. Although we have made our best estimates, judgments and assumptions regarding future uncertainties relating to the information included in our financial statements, giving due consideration to the accounting policies selected and materiality, actual results could differ from these estimates, judgments and assumptions. We do not believe that there is a great likelihood that materially different amounts would be reported related to the application of the accounting policies described below.

Estimates, judgments and assumptions underlying the accompanying consolidated financial statements include, but are not limited to, deferred rent receivable, recoveries from state underground storage tank funds, environmental remediation costs, real estate, depreciation and amortization, impairment of long-lived assets, litigation, accrued expenses, income taxes and exposure to paying an earnings and profits deficiency dividend. The information included in our financial statements that is based on estimates, judgments and assumptions is subject to significant change and is adjusted as circumstances change and as the uncertainties become more clearly defined. Our accounting policies are described in note 1 to the consolidated financial statements that appear in our Annual Report on Form 10-K for the year ended December 31, 2005. We believe that the more critical of our accounting policies relate to revenue recognition, impairment of long-lived assets, income taxes, environmental costs and recoveries from state underground storage tank funds and litigation, each of which is discussed in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the year ended December 31, 2005.

In June 2006 the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 ("FIN 48") "Accounting for Uncertainty in Income Taxes." FIN 48 addresses the recognition and measurement of tax positions taken or expected to be taken in a tax return. We do not believe that the adoption of FIN 48 in January 2007 will have a material impact on our financial position or results of operation.

### Environmental Matters

We are subject to numerous existing federal, state and local laws and regulations, including matters relating to the protection of the environment such as the remediation of known contamination and the retirement and decommissioning or removal of long-lived assets including buildings containing hazardous materials, USTs and other equipment. In accordance with the leases with certain of our tenants, we have agreed to bring the leased properties with

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known environmental contamination to within applicable standards and to regulatory or contractual closure ("Closure") in an efficient and economical manner. Generally, upon achieving Closure at an individual property, our environmental liability under the lease for that property will be satisfied and future remediation obligations will be the responsibility of our tenant. We will continue to seek reimbursement from state UST remediation funds related to these environmental liabilities where available. Generally the liability for the retirement and decommissioning or removal of USTs and other equipment is the responsibility of our tenants. We are contingently liable for these obligations in the event that our

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tenants do not satisfy their responsibilities. A liability has not been recognized for obligations that are the responsibility of our tenants. As of June 30, 2006, we had remediation action plans in place for 292 (94%) of the 312 properties for which we retained environmental responsibility and the remaining 20 properties (6%) remain in the assessment phase.

As of June 30, 2006, December 31, 2005 and December 31, 2004, we had accrued \$16.8 million, \$17.4 million, and \$20.6 million, respectively, as management's best estimate of the fair value of reasonably estimable environmental remediation costs. As of June 30, 2006, December 31, 2005 and December 31, 2004, we had also recorded \$4.0 million, \$4.3 million and \$5.4 million, respectively, as management's best estimate for net recoveries from state UST remediation funds, net of allowance, related to environmental obligations and liabilities. The net environmental liabilities of \$13.1 million as of December 31, 2005 and \$15.2 million as of December 31, 2004 were subsequently accreted for the change in present value due to the passage of time and, accordingly, \$0.3 and \$0.4 million of accretion expense is included in environmental expenses for each of the six month periods ended June 30, 2006 and 2005. Environmental expenditures and recoveries from underground storage tank funds were \$2.0 million and \$0.9 million, respectively, for the six month period ended June 30, 2006.

Environmental liabilities and related assets are currently measured at fair value based on their expected future cash flows which have been adjusted for inflation and discounted to present value. We also use probability weighted alternative cash flow forecasts to determine fair value. We assumed a 50% probability factor that the actual environmental expenses will exceed engineering estimates for an amount assumed to equal one year of net expenses aggregating \$5.6 million. Accordingly, the environmental accrual as of June 30, 2006 was increased by \$2.2 million, net of assumed recoveries and before inflation and present value discount adjustments. The resulting net environmental accrual as of June 30, 2006 was then further increased by \$1.1 million for the assumed impact of inflation using an inflation rate of 2.75%. Assuming a credit-adjusted risk-free discount rate of 7.0%, we then reduced the net environmental accrual, as previously adjusted, by a \$2.2 million discount to present value. Had we assumed an inflation rate that was 0.5% higher and a discount rate that was 0.5% lower, net environmental liabilities as of June 30, 2006 would have increased by \$0.2 million and \$0.1 million, respectively, for an aggregate increase in the net environmental accrual of \$0.3 million. However, the aggregate net change in environmental estimates recorded during the six months ended June 30, 2006 would not have changed significantly if these changes in the assumptions were made effective December 31, 2005.

In view of the uncertainties associated with environmental expenditures, however, we believe it is possible that the fair value of future actual net expenditures could be substantially higher than these estimates. Adjustments to

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accrued liabilities for environmental remediation costs will be reflected in our financial statements as they become probable and a reasonable estimate of fair value can be made. For the six months ended June 30, 2006 and 2005, the aggregate of the net change in estimated remediation costs included in our consolidated statement of operations amounted to \$0.8 million and \$1.3 million, respectively, which amounts were net of probable recoveries from state UST remediation funds. Although future environmental costs may have a significant impact on results of operations for any single fiscal year or interim period, we believe that such costs will not have a material adverse effect on our long-term financial position.

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We cannot predict what environmental legislation or regulations may be enacted in the future or how existing laws or regulations will be administered or interpreted with respect to products or activities to which they have not previously been applied. We cannot predict if state underground storage tank fund programs will be administered and funded in the future in a manner that is consistent with past practices and if future environmental spending will continue to be eligible for reimbursement at historical recovery rates under these programs. Compliance with more stringent laws or regulations, as well as more vigorous enforcement policies of the regulatory agencies or stricter interpretation of existing laws, which may develop in the future, could have an adverse effect on our financial position, or that of our tenants, and could require substantial additional expenditures for future remediation.

Our discussion of environmental matters should be read in conjunction with "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" which appears in the Company's Annual Report on Form 10-K for the year ended December 31, 2005 and the unaudited consolidated financial statements and related notes (including notes 2 and 3) which appear in this Quarterly Report on Form 10-Q.

### Forward Looking Statements

Certain statements in this Quarterly Report may constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. When we use the words "believes," "expects," "plans," "projects," "estimates" and similar expressions, we intend to identify forward-looking statements. Examples of forward-looking statements include statements regarding our expectations regarding future payments from Marketing; the expected effect of regulations on our long-term performance; our expected ability to maintain compliance with applicable regulations; our ability to renew expired leases; the adequacy of our current and anticipated cash flows; our belief that we do not have a material liability for offers and sales of our securities made pursuant to registration statements that did not contain the financial statements or summarized financial data of Marketing; our expectations regarding future acquisitions; the impact of the covenants included in the Credit Agreement on our current business practices; our ability to maintain our REIT status; the probable outcome of litigation or regulatory actions; our expected recoveries from underground storage tank funds; our exposure to environmental remediation expenses; our estimates regarding remediation costs; our expectations as to the long-term effect of environmental liabilities on our financial condition; our exposure to interest rate fluctuations; our expectations regarding corporate level federal income taxes; the indemnification obligations of the Company and others; our intention to consummate future acquisitions; our assessment of the likelihood of future competition; assumptions regarding the future applicability of accounting estimates, assumptions and policies; our intention to pay future dividends; and our beliefs about the reasonableness of our accounting estimates,

judgments and assumptions.

These forward-looking statements are based on our current beliefs and assumptions and information currently available to us and involve known and unknown risks, uncertainties and other factors, which may cause our actual results, performance and achievements to be materially different from any future results, performance or achievements, expressed or implied by these forward-looking statements. Information concerning factors that could cause our actual results to materially differ from those forward looking results can be found in "Part I, Item 1A. Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2005, as well as in other filings we make with the Securities and Exchange Commission and include, but are not limited to risks

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associated with owning and leasing real estate generally; dependence on Marketing as a tenant and on rentals from companies engaged in the petroleum marketing and convenience store businesses; our unresolved SEC comment; competition for properties and tenants; risk of tenant non-renewal; the effects of taxation and other regulations; potential litigation exposure; our expectations as to the cost of completing environmental remediation; the risk of loss of our management team; the impact of our electing to be taxed as a REIT, including subsequent failure to qualify as a REIT; risks associated with owning real estate concentrated in one region of the United States; risks associated with potential future acquisitions; losses not covered by insurance; future dependence on external sources of capital; our potential inability to pay dividends and terrorist attacks and other acts of violence and war.

As a result of these and other factors, we may experience material fluctuations in future operating results on a quarterly or annual basis, which could materially and adversely affect our business, financial condition, operating results and stock price. An investment in our stock involves various risks, including those mentioned above and elsewhere in this report and those that are detailed from time to time in our other filings with the Securities and Exchange Commission.

You should not place undue reliance on forward-looking statements, which reflect our view only as of the date hereof. We undertake no obligation to publicly release revisions to these forward-looking statements to reflect future events or circumstances or reflect the occurrence of unanticipated events.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

Prior to April 2006, we had not used derivative financial or commodity instruments for trading, speculative or any other purpose, and had not entered into any instruments to hedge our exposure to interest rate risk. We do not have any foreign operations, and are therefore not exposed to foreign currency exchange rate risks.

We are exposed to interest rate risk, primarily as a result of our \$100.0 million Credit Agreement. Our Credit Agreement, which expires in June 2008, bears interest at a rate equal to the sum of a base rate or a LIBOR rate plus an applicable margin based on our leverage ratio and ranging from 0.25% to 1.75%. At June 30, 2006, we had borrowings outstanding of \$48.3 million under our Credit Agreement bearing interest at a rate of 6.68% per annum. We use borrowings under the Credit Agreement to finance acquisitions and for general corporate purposes.

We manage our exposure to interest rate risk by minimizing, to the extent

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feasible, our overall borrowing and monitoring available financing alternatives. Our interest rate risk as of June 30, 2006 increased due to increased borrowings under the Credit Agreement as compared to December 31, 2005. Due to the increased exposure, in April 2006 we entered into a \$45.0 million LIBOR based interest rate swap, effective May 1, 2006 through June 30, 2011, to manage a portion of our interest rate risk. The interest rate swap is intended to hedge our current exposure to variable interest rate risk by effectively fixing, at 5.44%, the LIBOR component of the interest rate determined under our existing Credit Agreement or future exposure to variable interest rate risk due to borrowing arrangements that may be entered into prior to the expiration of the interest rate swap. Effective May 1, 2006, \$45.0 million of our LIBOR based borrowings under the Credit Agreement bear interest at a 6.69% effective rate. As a result, we will be exposed to interest rate risk to the extent that our

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borrowings exceed the \$45.0 million notional amount of the interest rate swap. As of June 30, 2006, our borrowings exceeded the notional amount of the interest rate swap by \$3.3 million. We do not foresee any significant changes in our exposure or in how we manage this exposure in the near future.

We entered into the \$45,000,000 notional five year interest rate swap agreement designated and qualifying as a cash flow hedge to reduce our exposure to the variability in future cash flows attributable to changes in the LIBOR rate. Our primary objective when undertaking hedging transactions and derivative positions is to reduce our variable interest rate risk by effectively fixing a portion of the interest rate for existing debt and anticipated refinancing transactions. This in turn, reduces the risks that the variability of cash flows imposes on variable rate debt. Our strategy protects us against future increases in interest rates. While this agreement is intended to lessen the impact of rising interest rates, it also exposes us to the risk that the other party to the agreement will not perform, the agreement will be unenforceable and the underlying transactions will fail to qualify as a highly-effective cash flow hedge for accounting purposes.

In the event that we were to settle the interest rate swap prior to its maturity, if the corresponding LIBOR swap rate for the remaining term of the agreement is below the 5.44% fixed strike rate at the time we settle the swap, we would be required to make a payment to the swap counter-party; if the corresponding LIBOR swap rate is above the fixed strike rate at the time we settle the swap, we would receive a payment from the swap counter-party. The amount that we would either pay or receive would equal the present value of the basis point differential between the fixed strike rate and the corresponding LIBOR swap rate at the time we settle the swap.

Based on our projected average outstanding borrowings under the Credit Agreement for 2006, if market interest rates increase by an average of 0.5% more than the market interest rates as of June 30, 2006, the additional annualized interest expense caused by market interest rate increases since December 31, 2005 would decrease 2006 net income and cash flows by approximately \$152,000. This amount is the sum of (i) the actual impact of increased market interest rates for the six months ended June 30, 2006 of \$138,000 and (ii) \$14,000 for the effect of a hypothetical interest rate change on the portion of our average outstanding borrowings of \$50.5 million projected for the remainder of 2006 under our Credit Agreement that is not covered by our \$45.0 million interest rate swap. The projected average outstanding borrowings are before considering additional borrowings required for future acquisitions. The calculation also assumes that there are no other changes in our financial structure or the terms of our borrowings. Management believes that the fair value of its debt equals



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its carrying value at June 30, 2006 and December 31, 2005. Our exposure to fluctuations in interest rates will increase or decrease in the future with increases or decreases in the amount of borrowings outstanding under our Credit Agreement.

In order to minimize our exposure to credit risk associated with financial instruments, we place our temporary cash investments with high-credit-quality institutions. Temporary cash investments, if any, are held in an institutional money market fund and short-term federal agency discount notes.

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### Item 4. Controls and Procedures

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

As required by Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the quarter covered by this report. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective at a reasonable assurance level as of June 30, 2006.

There have been no changes in the Company's internal control over financial reporting during the latest fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

In February 2006, an action was commenced in the Supreme Court in Westchester County, New York against us and Marketing to recover cleanup and remediation costs related to a petroleum release and for damages in excess of \$1.0 million for, among other things, lost rent and diminution of property value. Although we have conducted, and continue to conduct, remediation activities at the property, we are unable at this time to estimate with any

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certainty our ultimate legal and financial liability, if any, for the damages claimed in the litigation.

In May 2006, we were advised of an action in the Superior Court of New Jersey, Middlesex County, filed by a property owner claiming damages for remediation of contaminated soil. It is not clear from the summons why we have been made a party to the action and we are in the process of determining whether there is any basis at all for the claim against us. Accordingly, we are unable at this time to estimate with any certainty our ultimate legal and financial liability, if any, for the damages claimed in the litigation.

In May 2006, we were advised of third party complaint filed in an action in the Superior Court of New Jersey, Essex County, against Getty Oil, Inc. and John Doe Corporations, filed by a property owner seeking to impose upon third parties (that may include a subsidiary of the Company) responsibility for damages it may suffer in the action for claims brought against it under federal environmental laws, the State's Spill Act, the State's Water Pollution Act and other theories of liability. It is not clear at this time whether the Company or any of its subsidiaries would have any liability for the asserted claims or whether or to what extent such liability would be covered by the Company's settlement agreement with ChevronTexaco in connection with pre-1985 contamination at the Newark Terminal property, which is near the property that is the subject of the litigation. Accordingly, we are unable at this time to estimate with any certainty our ultimate legal and financial liability, if any, for the damages claimed in the litigation.

In June 2006, we were served with a Toxic Substance Control Act Notice Letter, advising us that "prospective plaintiffs" listed on a schedule to the Notice Letter intend to file a TSCA citizens' civil action against the entities listed on a schedule to the Notice Letter, including the Company's subsidiaries, based upon alleged failure by such entities to provide information to the United States Environmental Protection Agency regarding MTBE as may be required by the Toxic Substance Control Act, and declaring that such action will be filed unless such information is delivered. We do not believe that we have any such information.

Please refer to "Item 3. Legal Proceedings" of our Annual Report on Form 10-K for the year ended December 31, 2005 and note 3 to our consolidated financial statements in such Form 10-K and note 2 to our accompanying unaudited consolidated financial statements which appear in this Form 10-Q for additional information.

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### Item 1A. Risk Factors

See "Part I, Item 1A. Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2005 for factors that could affect the Company's results of operations, financial condition and liquidity. There has been no material change in such factors since December 31, 2005.

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

We held our annual meeting of stockholders on May 16, 2006. There were 24,719,465 shares of our common stock outstanding and entitled to vote at our annual meeting, and 23,275,570 shares were represented in person or by proxy. The following matters were voted upon at the annual meeting:

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The five directors listed below were elected to serve an additional one-year term:

| Nominee            | Votes For  | Votes Withheld |
|--------------------|------------|----------------|
| Milton Cooper      | 23,188,638 | 86,932         |
| Philip E. Coviello | 23,040,120 | 235,450        |
| Leo Liebowitz      | 23,189,955 | 85,615         |
| Howard Safenowitz  | 23,044,649 | 230,921        |
| Warren G. Wintrub  | 22,661,285 | 614,285        |

It is with deep sorrow that we mourn the death of Warren Wintrub. Mr. Wintrub served as a member of the Board of Directors from 1994 until his death on June 13, 2006. His creativity, dedication and inspiration contributed greatly to the success of the Company. The Board of Directors and the Officers of the Company, on behalf of all Company employees, express their sincerest condolences to Warren's wife, Toby, and his family on their loss.

The appointment of PricewaterhouseCoopers LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2006 was ratified:

| Votes For  | Votes Against | Abstentions |
|------------|---------------|-------------|
| 23,121,672 | 48,003        | 105,895     |

There were no broker non-votes at the Annual Meeting.

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### Item 6. Exhibits

| Exhibit No. | Description of Exhibit   |
|-------------|--|
| 31(i).1     | Rule 13a-14(a) Certification of Chief Financial Officer                          |
| 31(i).2     | Rule 13a-14(a) Certification of Chief Executive Officer                          |
| 32.1        | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350 (a)  |
| 32.2        | Certifications of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 (a) |

(a) These certifications are being furnished solely to accompany the Report pursuant to 18 U.S.C. Section 1350, and are not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and are not

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to be incorporated by reference into any filing of the Company, whether made before or after the date hereof, regardless of any general incorporation language in such filing.

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SIGNATURES

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

GETTY REALTY CORP.  
(Registrant)

Dated: August 4, 2006

BY: /s/ Thomas J. Stirnweis

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(Signature)

THOMAS J. STIRNWEIS  
Vice President, Treasurer and  
Chief Financial Officer

Dated: August 4, 2006

BY: /s/ Leo Liebowitz

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(Signature)

LEO LIEBOWITZ  
Chairman and Chief Executive Officer

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