

WESCO INTERNATIONAL INC

Form 10-Q

August 02, 2012

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, 2012

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 001-14989

WESCO International, Inc.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

25-1723342

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

225 West Station Square Drive

Suite 700

Pittsburgh, Pennsylvania

(Address of principal executive offices)

N/A

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

(412) 454-2200

(Registrant's telephone number, including area code)

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 at least the past 90 days. Yes  No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

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

As of July 31, 2012, WESCO International, Inc. had 43,725,849 shares of common stock outstanding.

WESCO INTERNATIONAL, INC. AND SUBSIDIARIES  
 QUARTERLY REPORT ON FORM 10-Q

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WESCO INTERNATIONAL, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED BALANCE SHEETS  
 (unaudited)

Amounts in thousands, except share data	June 30, 2012	December 31, 2011
Assets		
Current Assets:		
Cash and cash equivalents	\$72,198	\$63,869
Trade accounts receivable, net of allowance for doubtful accounts of \$20,811 and \$21,590 in 2012 and 2011, respectively	1,013,990	939,422
Other accounts receivable	34,351	43,442
Inventories, net	651,824	626,967
Current deferred income taxes	27,963	28,217
Income taxes receivable	11,794	12,206
Prepaid expenses and other current assets	24,031	23,297
Total current assets	1,836,151	1,737,420
Property, buildings and equipment, net of accumulated depreciation of \$189,971 and \$190,385 in 2012 and 2011, respectively	137,199	133,550
Intangible assets, net	150,964	156,874
Goodwill	1,021,106	1,008,127
Deferred income taxes	18,025	18,090
Other assets	23,242	24,391
Total assets	\$3,186,687	\$3,078,452
Liabilities and Stockholders' Equity		
Current Liabilities:		
Accounts payable	\$707,085	\$642,777
Accrued payroll and benefit costs	48,316	76,915
Short-term debt	19,409	3,261
Current portion of long-term debt	2,037	3,150
Bank overdrafts	43,866	47,489
Other current liabilities	73,792	72,254
Total current liabilities	894,505	845,846
Long-term debt, net of discount of \$174,485 and \$175,908 in 2012 and 2011, respectively	562,750	642,922
Deferred income taxes	236,374	223,005
Other noncurrent liabilities	24,592	20,769
Total liabilities	\$1,718,221	\$1,732,542
Commitments and contingencies (Note 6)		
Stockholders' Equity:		
Preferred stock, \$.01 par value; 20,000,000 shares authorized, no shares issued or outstanding	—	—
Common stock, \$.01 par value; 210,000,000 shares authorized, 57,314,631 and 57,021,523 shares issued and 43,630,714 and 43,424,031 shares outstanding in 2012 and 2011, respectively	574	571
Class B nonvoting convertible common stock, \$.01 par value; 20,000,000 shares authorized, 4,339,431 issued and no shares outstanding in 2012 and 2011, respectively	43	43
Additional capital	1,049,523	1,036,867

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Retained earnings	1,003,641	891,789
Treasury stock, at cost; 18,023,348 and 17,936,923 shares in 2012 and 2011, respectively	(598,949	) (593,329 )
Accumulated other comprehensive income	13,702	10,057
Total WESCO International stockholders' equity	1,468,534	1,345,998
Noncontrolling interest	(68	) (88 )
Total stockholders' equity	1,468,466	1,345,910
Total liabilities and stockholders' equity	\$3,186,687	\$3,078,452

The accompanying notes are an integral part of the condensed consolidated financial statements.

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WESCO INTERNATIONAL, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME  
(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
Amounts in thousands, except share data	2012	2011	2012	2011
Net sales	\$ 1,672,734	\$ 1,524,515	\$ 3,278,752	\$ 2,955,820
Cost of goods sold (excluding depreciation and amortization below)	1,337,062	1,217,666	2,623,330	2,362,921
Selling, general and administrative expenses	231,179	214,212	459,318	427,971
Depreciation and amortization	8,442	7,641	16,521	15,187
Income from operations	96,051	84,996	179,583	149,741
Interest expense, net	11,477	13,931	20,439	26,572
Income before income taxes	84,574	71,065	159,144	123,169
Provision for income taxes	25,642	20,858	47,272	35,657
Net income	58,932	50,207	111,872	87,512
Less: Net income attributable to noncontrolling interest	58	—	58	102,624
			Florida	7
Georgia	41	77,256	5	
Michigan	32	65,672	4	
California	7	62,991	4	
Pennsylvania	7	62,716	4	
Nevada	27	53,063	4	
Indiana	26	51,010	3	
Ohio	30	50,101	3	
Minnesota	37	41,668	3	
Illinois	41	39,828	3	
Missouri	21	39,028	3	
North Carolina	13	39,005	3	
South Carolina	12	35,846	2	
Wisconsin	11	35,485	2	
Tennessee	46	31,931	2	
New York	14	31,542	2	
Iowa	22	30,080	2	
Oregon	7	28,802	2	
Oklahoma	21	27,377	2	
Kansas	4	26,801	2	
Kentucky	13	20,866	1	
Colorado	6	18,389	1	
Massachusetts	3	18,185	1	
Alabama	12	17,338	1	
Virginia	8	16,935	1	
Louisiana	16	14,077	*	
Mississippi	14	11,886	*	
Montana	3	10,978	*	
Arkansas	5	10,296	*	

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North Dakota	2	9,789	*
West Virginia	4	8,703	*
New Mexico	4	8,581	*
Vermont	2	7,089	*
Utah	3	3,960	*
Idaho	3	3,866	*
Nebraska	1	810	*
New Jersey	1	731	*
Washington	1	716	*
		<hr/>	
Total Investments	684	\$ 1,487,460	100%
		<hr/>	

\*

Less than 1%.

(a)

Dollar amount of investments includes the gross cost of real estate, related lease intangibles and the carrying amount of our mortgage and equipment loans receivable.

**Lease Expirations**

All of our owned properties are occupied and subject to leases. The weighted average remaining noncancelable lease term of our properties at December 31, 2005 was 14 years. The following table shows a summary of the lease expirations. Our leases generally provide for one or more renewal options ranging from five to 20 years. The table assumes that the tenants do not exercise any renewal options.

**Lease Expirations  
as of December 31, 2005**

	<b>Number of Properties</b>	<b>Total Dollar Amount of Real Estate Investments(a)</b>	<b>Percent of Total Dollar Amount of Real Estate Investments</b>
(Dollars in thousands)			
2007	2	\$ 1,752	*%
2008	1	940	*
2009	3	1,519	*
2010	14	28,138	2
2011	16	10,364	1
2012	9	18,153	1
2013	16	18,556	1
2014	73	109,370	8
2015	20	28,219	2
2016	18	19,613	2
2017	50	87,679	6
2018	32	128,817	9
2019	74	218,470	15
2020	70	230,254	16
2021 - 2025	191	526,608	37
<b>Total</b>	<b>589</b>	<b>\$ 1,428,452</b>	<b>100%</b>

\*  
Less than 1%.

(a)  
Dollar amount of real estate investments includes the gross cost of real estate investments and related lease intangibles.

**Loan Maturities**

The following table shows a summary of the scheduled principal maturities of our mortgage and equipment loans receivable as of December 31, 2005. The loans may be prepaid with penalties.

**Loan Maturities  
as of December 31, 2005**

	<b>Principal Amount Maturing</b>	<b>Percent of Total Principal Amount Maturing</b>
(Dollars in thousands)		
2006	\$ 684	1%
2007	965	2
2008	1,072	2
2009	1,205	2
2010	1,343	2
2011 - 2015	11,743	20
2016 - 2020	15,687	27
2021 - 2025	18,802	33
2026 - 2030	6,441	11
	57,942	100%
Premium on mortgage loans receivable	1,066	
	\$ 59,008	

**Item 3. Legal Proceedings**

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

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

No matters were submitted to a vote of the Company's stockholders during the fourth quarter of the year ended December 31, 2005.

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

Our common stock is traded on the NYSE under the symbol "SFC." The following table sets forth, for the periods indicated, the high and low sale prices in dollars on the NYSE for our common stock. Our common stock began trading on the NYSE on December 16, 2004 in connection with our initial public offering, and therefore, no data is available for periods prior to December 16, 2004. The closing stock price on December 31, 2005 was \$11.35.

	<b>High</b>	<b>Low</b>
<b>2005</b>		
Fourth Quarter	\$ 11.70	\$ 10.20



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	<u>High</u>	<u>Low</u>
Third Quarter	\$ 12.05	\$ 10.07
Second Quarter	\$ 11.75	\$ 10.03
First Quarter	\$ 12.76	\$ 10.60
<b><u>2004</u></b>		
Fourth Quarter	\$ 13.20	\$ 12.00

**Stockholder Information**

As of February 22, 2006, there were 46 record holders of our common stock. This figure does not reflect the beneficial ownership of shares held in nominee name.

**Distribution Information**

No distributions were declared during 2003. All record dates for 2004 were prior to our initial public offering. Distributions declared during 2005 and 2004 are summarized as follows:

Declaration Date	Payment Date	Dividends Declared Per Common Share		
		Taxable as Ordinary Income(a)	Return of Capital(b)	Total
<b>2005</b>				
December 27, 2005	January 25, 2006	(c)	(c)	\$ 0.21
September 26, 2005	October 25, 2005	\$ 0.11	\$ 0.08	0.19
June 27, 2005	July 25, 2005	0.11	0.08	0.19
March 25, 2005	April 25, 2005	0.11	0.08	0.19
				\$ 0.78
<b>2004</b>				
December 1, 2004	January 31, 2005	\$ 0.11	\$ 0.08	\$ 0.19
October 29, 2004	November 22, 2004	0.19		0.19
July 30, 2004	August 20, 2004	0.06		0.06
				\$ 0.44

- (a) Dividends are taxable as ordinary income in the year paid by the Company.
- (b) To the extent that the Company makes distributions in excess of current and accumulated earnings and profits, these distributions are treated as a tax free return of capital.
- (c) Treatment as ordinary income or return of capital will be determined in connection with 2006 activity.

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

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**Item 6. Selected Financial Data**

The following table presents selected consolidated financial and operating data for Spirit Finance Corporation for the years ended December 31, 2005 and 2004 and for the period from inception (August 14, 2003) to December 31, 2003 (dollars in thousands, except per share data).

	Years Ended December 31,		Date of Inception
	2005(a)	2004(a)	(August 14, 2003) to December 31, 2003(b)
<b>Operations Data:</b>			
Total revenues	\$ 84,501	\$ 24,953	\$ 286
Expenses:			
General and administrative	12,810	7,123	1,405
Depreciation and amortization	19,985	4,417	4
Interest	25,826	4,979	35
Total expenses	58,621	16,519	1,444
Income from continuing operations	25,880	8,434	(1,158)
Total discontinued operations	1,939	538	
Net income (loss)	\$ 27,819	\$ 8,972	\$ (1,158)
Income (loss) per common share:			
Basic:			
Continuing operations	\$ 0.38	\$ 0.22	\$ (0.22)
Discontinued operations	0.03	0.02	
Net income	\$ 0.41	\$ 0.24	\$ (0.22)
Diluted:			
Continuing operations	\$ 0.38	\$ 0.22	\$ (0.22)
Discontinued operations	0.03	0.02	
Net income	\$ 0.41	\$ 0.24	\$ (0.22)
Weighted average outstanding common shares:			
Basic	67,240,350	37,522,747	5,160,524
Diluted	67,462,750	37,688,074	5,160,524
Cash dividends declared per common share(c)	\$ 0.78	\$ 0.44	\$
<b>Balance Sheet Data:</b>			
Gross investments including related lease intangibles	\$ 1,487,460	\$ 667,927	\$ 78,297
Total assets	1,513,425	782,227	277,875
Total debt obligations	894,784	178,854	
Stockholders' equity(d)	592,793	587,703	276,902
<b>Other Data:</b>			
Number of real estate investments owned or financed	684	374	71
Cash flows from operating activities	\$ 54,292	\$ 17,442	\$ (169)
Funds from operations(e)	47,394	13,574	(1,158)

(a)

The gains and losses and all operations of individual properties sold during 2005 and 2004 have been reclassified to discontinued operations in accordance with Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." As a result of this reporting requirement, each time a property is sold, previously reported "income from continuing operations" will be restated to reclassify the operations of such property into discontinued operations.

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- (b) Operations for this period related primarily to organization and start-up activities prior to the closing of our December 2003 private offering.
- (c) All dividend record dates in 2004 were prior to our initial public offering.
- (d) In February 2006, the Company completed a public offering of 13.8 million additional shares of common stock which raised aggregate proceeds of \$154.2 million, after deducting the underwriters' discounts but before offering expenses.
- (e) Funds from operations (FFO) is a non-GAAP financial measure. For a definition of FFO and a reconciliation from net income prepared in accordance with U.S. generally accepted accounting principles, see Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, under the section entitled "Reconciliation of Non-GAAP Financial Measures."

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

Management's discussion and analysis of financial condition, liquidity and capital resources and results of operations are more clearly understood when read in conjunction with the accompanying consolidated financial statements and notes thereto as of December 31, 2005. Undue reliance should not be placed upon historical financial statements since they are not indicative of expected results of operations or financial conditions for any future periods.

### Overview

Spirit Finance Corporation is a self-managed and self-advised REIT formed as a Maryland corporation on August 14, 2003. Our objective is to acquire single tenant, operationally essential real estate throughout the United States to be leased on a long-term, triple-net basis to retail, distribution and service-oriented companies. Single tenant, operationally essential real estate consists of properties that are free-standing, commercial real estate facilities that are vital to the generation of our customers' sales and profits. A triple-net lease generally requires the tenant to pay all operating and maintenance costs, insurance premiums and real estate taxes on the property. We may also selectively originate or acquire long-term, commercial mortgage loans that are integral to our strategy of providing a complete solution of financing products to our customers. Since we began purchasing real estate assets in December 2003, we have completed over \$1.5 billion in real estate acquisitions and mortgage and equipment loan investments. Our common stock is listed on the New York Stock Exchange under the ticker symbol "SFC."

As of December 31, 2005, our investment portfolio totaled \$1.5 billion and represented 684 owned or financed properties geographically diversified across 40 states. Of our total investment portfolio as of December 31, 2005, \$1,428.5 million, or 96%, represented the gross cost of real estate and related lease intangibles that we own and \$59.0 million, or 4%, represented mortgage and equipment loans receivable. Only one state, Texas (17%), accounts for 10% or more of the total dollar value of our real estate and loan portfolio. Our properties are leased or financed to 106 customers operating in various industries. Our three largest property types at December 31, 2005 as a percentage of our total investment portfolio were restaurants (30%), movie theaters (13%) and educational facilities (10%). As of December 31, 2005, our 10 largest customers as a percentage of the total investment portfolio were: Carmike Cinemas, Inc. (NASDAQ: CKEC); Dickinson Theatres, Inc.; CarMax, Inc. (NYSE: KMX); United Supermarkets, Ltd.; Main Event Entertainment, LP, the operator of Main Event family entertainment centers; PamCo, Inc., a petroleum distribution, convenience store and car wash operator; CBH2O, LP, the operator of Camelback Ski and Camelbeach Water Park; University of Phoenix (NASDAQ: APOL); Gander Mountain Company (NASDAQ: GMTN); and AMC Entertainment, Inc. These customers accounted for 36% of our total investment portfolio at December 31, 2005, with no individual credit exposure greater than 5.7% of the total investment portfolio. In comparison, our top 10 customers as of December 31, 2004 accounted for 55% of our total investment portfolio, with the largest credit exposure at 6.5% of the total portfolio. As of December 31, 2005, all of our properties were occupied, and the monthly lease and loan payments were current.

We generate our revenue and cash flow primarily by leasing our real estate properties to our customers and from interest income on our portfolio of mortgage and equipment loans receivable. Our ability to generate positive cash flow will depend heavily on the difference between the income earned on our assets and the interest expense incurred on our borrowings. We expect to grow through continuing our principal strategy of acquiring single tenant, operationally essential real estate principally through sale-leaseback transactions.

Our ability to achieve our plan of continued growth is dependent on achieving a substantial volume of acquisitions at attractive yields without compromising our underwriting criteria and our ability to effectively finance those acquisitions to meet our targeted yields. The current environment for net lease real estate acquisitions continues to be highly competitive, and this competitive environment

could limit both the number of properties we acquire and the yield on those acquisitions. We may delay or decline opportunities if we feel the rewards do not warrant the capital risk. The timing of completing property acquisitions may vary significantly from quarter to quarter. In response to these challenges, we are committed to seeking numerous potential investment opportunities. We currently have a full-time acquisitions staff of six employees. We anticipate that our experienced team will continue to provide a strong investment pipeline throughout 2006. We continue to seek opportunities to combine our cost of capital and operational structure with efficient leverage strategies to deliver competitively priced lease products to our customers. We intend to fund future real estate investments primarily with borrowings on our secured credit facilities and by raising funds through the issuance of debt and additional equity securities.

### **Liquidity and Capital Resources**

We completed a private offering in December 2003 and an initial public offering in December 2004. Together with the exercise of underwriters' over-allotment options for both offerings, Spirit Finance raised aggregate proceeds of \$638.4 million, after deducting the underwriters' discounts and offering expenses.

Our real estate investments are acquired using a combination of cash and borrowings under our secured credit facilities. As of December 31, 2005, we had a maximum aggregate borrowing capacity of \$500 million under our two secured credit facilities.

During 2005, we acquired or financed 353 commercial real estate properties through various transactions totaling \$877.3 million. In conjunction with the acquisition of 41 of these real estate properties, we assumed existing mortgage notes payable or obtained new long-term, fixed-rate financing totaling \$190.1 million. We also used proceeds from the sale of some of our properties, totaling \$57.4 million in 2005, to acquire new properties. At December 31, 2005, we had contractual commitments totaling \$49.3 million for future improvements on properties we currently own. In accordance with the underlying lease agreements, these improvements, the majority of which are anticipated to be completed during 2006 and 2007, will result in increases in related contractual rent. In addition, as of January 2006, we had identified for review potential investment opportunities of more than \$2 billion. We consider investments as under review when we have signed a confidentiality agreement, we have exchanged financial information or we or our advisors are in current and active negotiations. Investments under review are generally subject to significant change, and the timing of completing any such transactions, which are dependent on the completion of due diligence and other factors that may not be under our control, may vary significantly from quarter to quarter. After further due diligence, we may decide not to pursue any or all of these transactions, we may not be the successful bidder on all of the transactions we pursue and there is no assurance that we will ultimately complete any of the real estate acquisitions.

We primarily generate our revenue and cash flow by leasing our real estate properties to our customers. We generally offer long-term leases that provide for payments of base rent with scheduled increases, increases based on future changes in the Consumer Price Index and/or contingent rent based on a percentage of the lessee's gross sales. At December 31, 2005, our weighted average noncancelable remaining initial lease term was approximately 14 years, and our leases generally provide for one or more renewal options. Less than 3% of the leases in our real estate investment portfolio at December 31, 2005 will expire prior to 2011. Our leases are generally triple-net, which provides that the lessee is responsible for the payment of all property operating expenses, such as insurance, real estate taxes and repairs and maintenance including any increased operating expenses that may have resulted from increases in oil prices during 2005. Since our tenants generally pay the property operating and maintenance costs, we do not believe we will incur significant capital expenditures on our properties; for example, we did not incur any significant capital expenditures related to properties in the areas impacted by hurricanes during 2005.

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Although we do not expect to make significant investments in mortgage and equipment loans, we may selectively originate or acquire such loans as opportunities arise in the market. Our real estate mortgage and equipment loans receivable, totaling \$59.0 million at December 31, 2005, generally require that our customers make monthly payments of principal and interest with balloon payments totaling \$13.5 million due in 2021. The mortgage loans receivable are secured by single tenant, operationally essential real estate. Our equipment loans receivable, representing less than 6% of total loans receivable, are secured by equipment used in the operation of certain real estate properties we own. We may also offer other financing products where we can improve our investment returns or competitiveness.

Our operating costs include interest expense on our debt and the general and administrative costs of acquiring and managing our real estate investment portfolio, such as the compensation and benefit costs of our employees, professional fees such as legal and portfolio servicing costs and office expenses such as rent and other operating costs. Noncash expenses include depreciation expense on the buildings and improvements in our real estate portfolio, stock-based compensation (included in general and administrative expenses) and amortization of deferred financing costs (included in interest expense).

During the year ended December 31, 2005, net cash provided by operating activities increased to \$54.3 million as compared to \$17.4 million for 2004, primarily due to the significant growth we achieved over the past two years in the size of our portfolio. Cash flow from operations was negative for the period from inception through December 31, 2003, as we were primarily engaged in start-up and organization activities.

We intend to make regular quarterly distributions to our stockholders so that we distribute each year all or substantially all of our REIT taxable income to avoid paying corporate level federal income tax and excise tax on our earnings. During the initial years of our operations, the distributions we pay have included a return of capital. Cash for future distributions is expected to be generated from operations, although we may also borrow funds to make distributions. Our ability to pay distributions will depend on, among other things, our actual results of operations, which are dependent primarily on our receipt of payments from our leases and loans with respect to our real estate investments. During 2005, we declared dividends of \$0.78 per share or \$52.8 million as compared to \$0.44 per share or \$16.5 million during 2004. We raised our quarterly dividend in the fourth quarter of 2005 to \$0.21 per common share. Dividends paid during 2005 (including those dividends declared in 2004 and paid in 2005) totaled \$45.7 million.

In order to continue to achieve growth in revenues and net income, we will need to continue to make substantial real estate acquisitions, which will in turn require that we obtain significant additional debt and equity funding beyond our currently committed external sources of liquidity. We used proceeds from our initial public offering in December 2004 to pay down \$272.7 million of debt in December 2004 and in the first quarter of 2005. Also during the first quarter of 2005, we repaid \$140.1 million of variable-rate mortgage notes payable outstanding at December 31, 2004 using cash and borrowings under then existing secured credit facilities.

We use secured credit facilities to partially fund the purchase of real estate pending the issuance of long-term, fixed-rate debt. During 2004, we established a \$250 million short-term secured credit facility with Bank of America Mortgage Capital Corporation, and, in March 2005, we added a \$125 million short-term secured credit facility with Citigroup Global Markets Realty Corp. During the third quarter of 2005, these facilities expired and the outstanding balances were paid in full.

In September 2005, we established a \$200 million revolving secured credit facility with Citigroup Global Markets Realty Corp. The facility matures in September 2006. Borrowings under the facility require monthly payments of interest indexed to one-month LIBOR plus 1.50%. In November 2005, we established a one-year \$200 million revolving short-term secured credit facility with Credit Suisse. The facility matures in November 2006. Borrowings under this facility require monthly payments of interest indexed to one-month LIBOR plus 1.25% and a non-use fee may be incurred under certain

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circumstances. The facilities are structured as master loan repurchase arrangements, and our borrowings under the facilities are secured by mortgages on specific properties we own. In December 2005, the Citigroup facility was amended to permit an additional \$100 million of borrowings, for a total borrowing capacity of \$300 million under this facility. The additional \$100 million of borrowings under the facility are secured by our equity ownership interest in one of the Company's wholly-owned, special purpose subsidiaries. Borrowings under this portion of the facility require monthly payments of interest based on one-month LIBOR plus 1.50% - 2.75%, depending on amounts borrowed. The interest rates on these borrowings are subject to increase in the event we exceed a specified leverage amount. At December 31, 2005, the one-month LIBOR rate was 4.39% and we had \$230 million outstanding on a maximum aggregate borrowing capacity of \$500 million under these credit facilities.

As described further in the Notes to Consolidated Financial Statements and Quantitative and Qualitative Disclosures About Market Risk, since we initially fund our real estate acquisitions using our revolving credit facilities, we use interest rate swaps to manage our exposure to changes in interest rates until we can put into place our long-term, fixed-rate debt strategies. As of December 31, 2005, Spirit Finance had three outstanding forward-starting interest rate swap agreements with a total notional amount of \$225 million. These derivative instruments were designated to hedge the variability of cash flows related to forecasted interest payments over a term of 15 years on long-term debt with an initial principal balance of at least \$230 million expected to be issued in 2006.

In July 2005, our special purpose subsidiary, Spirit Master Funding, LLC, issued \$441.3 million aggregate principal amount of net-lease mortgage notes rated AAA/Aaa by Standard & Poor's Ratings Services and Moody's Investors Service, Inc., respectively. The private placement consisted of \$183 million of Class A-1 fully amortizing notes bearing interest at an annual rate of 5.05% due in 2020 and \$258.3 million of Class A-2 interest-only notes bearing interest at an annual rate of 5.37% due in 2020. The timely payment of scheduled interest and ultimate payment of principal on the notes are guaranteed under an insurance policy issued by Ambac Assurance Corporation. The collateral pool securing the notes represents 408 single tenant commercial real estate properties. The notes may be prepaid at any time, subject to a yield maintenance prepayment premium, and the notes permit substitution of real estate collateral from time to time subject to certain conditions. In addition, the note structure allows for the addition of collateral to the pool and the issuance of additional series of notes secured by the increased collateral pool of properties. We used the net proceeds from the sale of the notes to repay balances outstanding under then-existing secured credit facilities totaling \$248.4 million. The remaining proceeds were used to provide funds for real estate acquisitions.

In conjunction with the issuance of the net-lease mortgage notes, we settled two forward-starting interest rate swap agreements in July 2005 for a net cash payment to the swap counterparty because long-term rates had decreased since the inception of the swaps. Accordingly, the fair value of the interest rate swaps at the time of settlement, totaling \$15.0 million, is being amortized to earnings as an increase to interest expense over a 25-year period such that the effective interest rate of the net-lease mortgage notes approximates the long-term rates in effect when the swaps were placed.

At December 31, 2005, our balance outstanding under the variable-rate secured credit facilities was \$229.9 million and the total carrying amount of our fixed-rate debt was \$664.9 million. Assets with an aggregate investment value of \$389.6 million and \$981.9 million were pledged as collateral for borrowings under the secured credit facilities and fixed-rate debt, respectively.

Over the long term, we expect lease rates to fluctuate commensurate with changes in long-term interest rates. In the near-term, we may experience a period where long-term interest rates on future borrowings rise faster than lease rates, which may reduce our cash flow. Therefore, in order to limit the effects of changes in interest rates on our operations, we seek to match-fund our long-term, fixed-rate assets with long-term, fixed-rate liabilities. At December 31, 2005, 66% of our investment portfolio was match-funded with long-term debt.



We are subject to various customary operating and financial covenants under the mortgage notes payable and the secured credit facilities. The mortgage notes payable and secured credit facilities include a limitation on our ability to incur additional indebtedness on the underlying secured real estate. Our secured credit facilities also include, among other requirements, a minimum liquidity requirement of \$15 million and a minimum tangible net worth requirement of \$400 million. As of December 31, 2005, we were in compliance with all of our debt covenants and requirements.

In the short-term, we believe that cash provided by our operating activities and the liquidity available on our secured credit facilities will be sufficient to meet our liquidity needs for the operating and financing obligations and commitments of our existing real estate investment portfolio. On a long-term basis, we intend to use a combination of debt and equity financing methods to accomplish our goal of acquiring real estate while maintaining our borrowings at a targeted leverage ratio, defined as the ratio of our total debt to total assets, of 65%. At December 31, 2005, our leverage ratio was 59%. We intend to obtain additional unsecured and/or secured financing through various sources including banks, institutional investors and other lenders. We may also obtain lines of credit, bridge loans, warehouse facilities and other debt arrangements or may incur debt in the form of publicly or privately placed debt instruments. We intend to use substantially all of our properties to secure our borrowings under our various debt financings. In addition, our ability to achieve continuous real estate investment growth will also depend on our ability to raise additional equity capital.

In February 2006, we completed a public offering of 13.8 million additional shares of common stock (including the exercise of an underwriters' overallotment option of 1.8 million shares) which raised aggregate proceeds of \$154.2 million, after deducting the underwriters' discounts but before offering expenses. We used \$110.3 million of the proceeds of the offering to pay down borrowings outstanding under one of our secured credit facilities.

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

The following table outlines the timing of payment requirements related to our off-balance sheet and contractual obligations as of December 31, 2005. The contractual obligations relating to mortgages and notes payable listed in the table below are included in the Consolidated Balance Sheet at December 31, 2005.

	<u>Total</u>	<u>2006</u>	<u>2007 - 2008</u>	<u>2009 - 2010</u>	<u>2011 and Thereafter</u>
	(Dollars in thousands)				
Mortgages and notes payable	\$ 664,929	\$ 11,789	\$ 25,770	\$ 73,034	\$ 554,336
Operating lease obligations	7,445	522	1,085	1,129	4,709
<b>Total</b>	<b>\$ 672,374</b>	<b>\$ 12,311</b>	<b>\$ 26,855</b>	<b>\$ 74,163</b>	<b>\$ 559,045</b>

In addition, at December 31, 2005, we have contractual commitments totaling \$49.3 million for future improvements on properties we currently own. These improvements include costs to be incurred on properties during which the tenant's business continues to operate without interruption and advances for the construction of new facilities for which operations have not commenced. These improvements, the majority of which are anticipated to be completed during 2006 and 2007, will result in increases in rental revenues. These commitments are not included in the table above because they are not contracts to purchase goods or services.

#### Results of Operations

We commenced operations on August 14, 2003 and have realized significant growth in revenues and net income per share due to the substantial growth in our real estate investment portfolio. We reported a net loss of \$1.2 million during the period from inception (August 14, 2003) to December 31, 2003, or \$0.22 per common share, based on 5.1 million weighted average common shares outstanding.

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Our operations during the period from August 14 to December 31, 2003 consisted primarily of start-up and organization activities; therefore, we do not have any significant comparative operating data to present for 2003.

Net income for 2005 was \$27.8 million, or \$0.41 per diluted share, based on 67.5 million weighted average shares of common stock outstanding. Net income for 2004 was \$9.0 million or \$0.24 per diluted share, based on 37.7 million weighted average shares of common stock outstanding. The increase in net income and earnings per share was reflective of the significant growth in our investment portfolio. Since we began purchasing real estate assets in December 2003, we have completed over \$1.5 billion in real estate acquisitions and mortgage and equipment loan investments, of which \$877.3 million was completed during 2005.

The increase in the number of weighted average shares outstanding between 2005 and 2004 was primarily the result of our December 2004 initial public offering of 30 million common shares. The increase in the number of weighted average shares outstanding between 2004 and 2003 was primarily the result of our December 2003 private offering of 36 million common shares.

Periodically, we may sell real estate properties that do not meet our long-term strategic investment objectives. Such properties are typically acquired in conjunction with the acquisition of a portfolio of real estate properties. We consider these occasional sales of real estate properties to be an integral part of our long-term operating business strategy in acquiring a diversified real estate investment portfolio; consequently, proceeds from the sales of real estate properties are expected to be reinvested in additional properties such that cash flows from ongoing operations are not negatively affected by sales of individual properties. In addition, we consider the combined effect of income from continuing operations and discontinued operations in our evaluation of our ability to pay dividends.

Each time properties are sold, current accounting principles require that gains and losses from any such dispositions and all operations from the properties previously reported as part of "income from continuing operations" to be reclassified to "discontinued operations." This reclassification and presentation has no impact on net income or cash flows.

Income from continuing operations for 2005 was \$25.9 million, or \$0.38 per diluted share. Income from continuing operations for 2004 was \$8.4 million, or \$0.22 per diluted share.

We sold 43 properties during 2005 and four properties during 2004. Income from discontinued operations totaled \$1.9 million, or \$0.03 per diluted share, for 2005 and \$538,000, or \$0.02 per diluted share, for 2004. Included in income from discontinued operations were net gains on sales of real estate of \$772,000 during 2005. During 2004, income from discontinued operations included net losses on sales of real estate of \$12,000.

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

	Continuing Operations		Discontinued Operations		Total Operations	
	2005	2004	2005	2004	2005	2004
Revenues	\$ 84,501	\$ 24,953	\$ 1,989	\$ 1,275	\$ 86,490	\$ 26,228
General and administrative expenses	12,810	7,123	14	10	12,824	7,133
Depreciation and amortization	19,985	4,417	492	236	20,477	4,653
Interest	25,826	4,979	316	479	26,142	5,458

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**Revenues**

In 2005, total revenues increased to \$86.5 million from \$26.2 million in 2004. The increase in revenues during 2005 was primarily due to the growth in our investment portfolio due to property acquisitions made over the past two years.

Over 90% of the total revenues generated in 2005 were rental revenues from real estate properties we own and lease to our customers. During 2005, no single lessee represented more than 5.8% of total revenues. In comparison, during 2004 and 2003, approximately 14% and 33%, respectively, of total revenues were derived under a single master lease agreement with one customer. Our long-term leases generally provide for payments of base rents with scheduled increases, increases based on future changes in the Consumer Price Index (CPI) and/or contingent rent based on a percentage of the lessee's gross sales. For leases with scheduled rent increases, rental revenue is recognized on a straight-line basis, net of a valuation allowance, to produce a constant periodic rent over the term of the leases. Rental revenue and the related weighted average real estate investments are presented in the following table (dollars in thousands):

	<b>Years Ended December 31,</b>	
	<b>2005</b>	<b>2004</b>
Rental revenues, excluding the adjustment for straight-line rent	\$ 78,921	\$ 20,216
Straight-line rent, net	1,155	295
<b>Total rental revenues</b>	<b>\$ 80,076</b>	<b>\$ 20,511</b>
Weighted average real estate investments	\$ 918,004	\$ 225,195

The weighted average yield on our real estate acquisitions was lower during 2005 than in 2004, reflecting market lease rate compression and increased investments in properties leased to companies having higher credit profiles. Investments in properties leased to companies with higher credit profiles were designed to meet our total rate of return requirements as we were able to obtain efficient long-term borrowings at rates ranging from 5.26% to 5.90%.

During 2005 and 2004, interest income on mortgage and equipment loans receivable totaled \$4.3 million and \$3.8 million, respectively. Approximately 87% of the interest income in 2005 was generated by mortgage loans to two borrowers. The increase in interest income in 2005 over 2004 was primarily the result of the origination of \$18.6 million of new mortgage and equipment loans during 2005.

Other interest income represents income generated on interest-bearing cash accounts pending investment in real estate. Other interest income totaled \$2.1 million in 2005 compared to \$1.9 million in 2004.

**Expenses**

General and administrative expenses include employee-related expenses, professional fees, portfolio servicing costs and office and other expenses. Employee-related expenses increased as a result of the increase in our number of employees from 25 at December 31, 2004 to 37 at December 31, 2005, primarily due to the growth in our real estate investment portfolio. The large increase in the number of properties in our portfolio has resulted in increased portfolio servicing costs and higher insurance costs and franchise taxes, which costs will continue to grow proportionately with the growth in our investment portfolio.

Depreciation and amortization expense relates primarily to real estate properties and related lease intangibles. Depreciation and amortization expense was \$20.5 million in 2005 as compared to \$4.7 million in 2004. The increase in 2005 was primarily the result of the increase in the average total dollar value of the real estate investment portfolio.

Interest expense for 2005 totaled \$26.1 million, including \$3.6 million associated with the amortization of deferred financing costs, debt insurer premiums and the amortization of interest rate swap settlement costs, on weighted average outstanding debt of approximately \$414.1 million. For 2004, interest expense totaled \$5.5 million, including \$793,000 associated with the amortization of related deferred financing costs, on weighted average outstanding debt of approximately \$93.5 million. The increase in LIBOR rates of approximately two percentage points over the past year has contributed to the increase in interest expense on our short-term variable rate debt.

Due to the continued expansion of operations as a result of our real estate investment activity during 2005 and 2004, our general and administrative expenses are expected to continue to increase during 2006; however, general and administrative expenses calculated as a percent of total revenues are expected to decrease. Depreciation and amortization expense is also expected to increase in future periods with future real estate acquisition activity. Interest expense is expected to increase in future periods as we continue to make investments in real estate funded with both short- and long-term debt financing.

#### **Reconciliation of Non-GAAP Financial Measures**

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

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

FFO should not be considered an alternative to net income determined in accordance with GAAP as a measure of profitability, nor should it be considered an equivalent to cash flows provided by operating activities determined in accordance with GAAP as a measure of liquidity. Spirit Finance's statements of operations and cash flows include disclosures of interest expense, capital expenditures and items excluded from the calculation of FFO, all of which should be considered when evaluating our performance.

FFO totaled \$47.4 million and \$13.6 million for the years ended December 31, 2005 and 2004, respectively, including \$1.2 million and \$0.3 million, respectively, representing the adjustment between scheduled rents and rental revenue recognized on a straight-line basis. During the period from inception (August 14, 2003) through December 31, 2003, FFO was a negative \$1.2 million.

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A reconciliation of net income calculated in accordance with GAAP to FFO for the years ended December 31, 2005 and 2004 and for the date of inception (August 14, 2003) to December 31, 2003 is presented in the following table (dollars in thousands):

	Years Ended December 31,		Date of Inception (August 14, 2003) to December 31, 2003
	2005	2004	
Net income (loss)	\$ 27,819	\$ 8,972	\$ (1,158)
Portfolio depreciation and amortization expense:			
Continuing operations	19,855	4,354	
Discontinued operations	492	236	
Net (gains) losses on sales of real estate	(772)	12	
FFO	\$ 47,394	\$ 13,574	\$ (1,158)

### Significant Accounting Estimates and Critical Accounting Policies

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

*Revenue recognition* We lease real estate to our customers under long-term net leases that are classified as operating leases. Throughout the lease term, the leases may include scheduled rent escalations or escalations based on increases in the Consumer Price Index. The leases may also provide for contingent rent based on a percentage of the lessee's gross sales. We recognize contingent rentals as revenue when the change in the factor on which the contingent lease payment is based actually occurs. For leases with scheduled rent escalations, rental revenue from operating leases is recognized on a straight-line basis so as to produce a constant periodic rent over the term of the lease, net of a portfolio valuation allowance based on management's evaluation of the risks associated with these receivables, giving consideration to industry default rates for long-term receivables. Accrued rental revenue, calculated as the aggregate difference between the scheduled rents and rental revenue recognized on a straight-line basis, represents unbilled rent receivables that we will receive only if the tenant makes all rent payments required through the expiration of the initial term of the lease. In the event a lessee's monthly lease payments become more than 60 days past due, we will suspend revenue recognition on that lease until collectibility is reasonably assured.

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

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

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

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

### Accounting Developments

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

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

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

Interest rates are highly sensitive to many factors, including governmental monetary policies, domestic and global economic and political conditions, and other factors which are beyond our control. Our operating results will depend heavily on the difference between the income earned on our assets and the interest expense incurred on our borrowings. Decreases in interest rates may lead to additional competition for the acquisition of real estate due to a reduction in desirable alternate income-producing investments. Increased competition for the acquisition of real estate may lead to a decrease

in the yields on real estate we have targeted for acquisition. In such circumstances, if we are not able to offset the decrease in yields by obtaining lower interest costs on our borrowings, our results of operations will be adversely affected. Significant increases in interest rates may also have an adverse impact on our earnings if we are unable to acquire real estate with rental rates high enough to offset the increase in interest rates on our borrowings.

In a rising interest rate environment and/or economic downturn, defaults may increase and result in credit losses which may adversely affect our liquidity and operating results; through December 31, 2005, we have not experienced any significant credit losses. In a decreasing interest rate environment, borrowers are generally more likely to prepay their loans in order to obtain financing at lower interest rates; however, our investments in mortgage loans receivable are subject to significant restrictions on prepayment in the form of yield maintenance provisions or other prepayment penalties which provide us with a certain level of yield protection in a decreasing interest rate environment.

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

At December 31, 2005, our fixed-rate debt totaled \$664.9 million as compared to \$38.7 million at December 31, 2004. Using a discounted cash flow analysis based on estimates of the amount and timing of future cash flows, market rates and credit spreads, the estimated fair value of the fixed-rate debt was approximately \$9.9 million below its carrying amount at December 31, 2005. Our mortgage loans receivable are also fixed-rate instruments. At December 31, 2005, our mortgage loans receivable (excluding equipment loans) totaled \$55.6 million as compared to \$40.4 million at December 31, 2004. Using a discounted cash flow analysis, the estimated fair value of our fixed-rate mortgage loans receivable exceeded the carrying amount by approximately \$1.9 million at December 31, 2005. It is our intent to hold our fixed-rate mortgage loans receivable and our fixed-rate mortgages and notes payable to maturity; accordingly, changes in market interest rates impact the fair value of these financial instruments but have no impact on interest recognized or cash flows.

We use variable-rate debt to fund acquisitions on a short-term basis until our long-term debt strategies can be implemented. During 2005, the weighted average outstanding balance of our variable-rate debt, which was based on spreads over one-month LIBOR, was \$102.0 million. Excluding amortization of deferred financing costs, this variable rate indebtedness had a weighted average interest rate of 5.4%. During 2005, one-month LIBOR has increased approximately two percentage points. Had the weighted average interest rate been 100 basis points higher (lower) during 2005, our 2005 net income would have been reduced (increased) by approximately \$1.0 million. This amount was determined by considering the impact of a hypothetical interest rate change on our average variable-rate borrowings outstanding during 2005 and assumes no other changes in our capital structure.

On October 4, 2004, we entered into a forward-starting interest rate swap with a notional amount of \$235 million, and on March 31, 2005, we entered into an additional forward-starting interest rate swap agreement with a notional amount of \$87 million. In July 2005, the anticipated long-term debt was issued, and the interest rate swaps were settled for a net cash payment to the swap counterparty because long-term rates had decreased since the inception of the swaps. The fair value of the interest rate swaps at the time of settlement, totaling \$15.0 million, was recorded in "Accumulated other

comprehensive loss" and is being amortized to earnings as an increase to interest expense over a period of 25 years. The unamortized balance of the settled interest rate swaps at December 31, 2005 was \$14.5 million. Because the anticipated interest payments are considered probable, the hedges continue to be effective.

As of December 31, 2005, Spirit Finance had three outstanding forward-starting interest rate swap agreements with a total notional amount of \$225 million. These derivative instruments were designated to hedge the variability of cash flows related to forecasted interest payments over a term of 15 years on long-term debt with an initial principal balance of at least \$230 million expected to be issued in 2006. As the hedging relationships are expected to be highly effective at achieving offsetting changes in cash flows, these interest rate swaps are accounted for as cash flow hedges. The fair value of the interest rate swaps resulted in a net unrealized loss of \$52,000 at December 31, 2005. Had market interest rates been 100 basis points lower at December 31, 2005, the net unrealized loss would have been approximately \$20.8 million; had market interest rates been 100 basis points higher at December 31, 2005, the fair value of the interest rate swap would have been a net unrealized gain of approximately \$18.2 million. Hedge effectiveness is assessed using the hypothetical derivative method; no hedge ineffectiveness was recognized through the income statement during 2005 or 2004.

Even with hedging strategies in place, there can be no assurance that our results of operations will remain unaffected as a result of changes in interest rates. In addition, hedging transactions using derivative instruments involve additional risks such as counterparty credit risk and basis risk. Basis risk in a hedging contract occurs when the index upon which the contract is based is more or less variable than the index upon which the hedged item is based, thereby making the hedge less effective. We address basis risk by matching, to a reasonable extent, the contract index to the index upon which the hedged item is based. To manage the risk of nonperformance by counterparties, our interest rate risk management policy requires that we deal only with major financial institutions that have credit ratings no lower than "A-" from a nationally recognized rating agency. Our counterparties at December 31, 2005 met this criteria.



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

**Spirit Finance Corporation**

**Consolidated Financial Statements**

**December 31, 2005 and 2004**

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**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders  
Spirit Finance Corporation

We have audited the accompanying consolidated balance sheets of Spirit Finance Corporation as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity, and cash flows for the years then ended and for the period from inception (August 14, 2003) to December 31, 2003. Our audits also included the financial statement schedule included at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Spirit Finance Corporation at December 31, 2005 and 2004, and the consolidated results of its operations and its cash flows for the years then ended and for the period from inception (August 14, 2003) to December 31, 2003, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Spirit Finance Corporation's internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 3, 2006 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Phoenix, Arizona  
March 3, 2006

## Spirit Finance Corporation

## Consolidated Balance Sheets

(dollars in thousands, except per share data)

	December 31, 2005	December 31, 2004
<b>Assets</b>		
Investments, at cost:		
Real estate investments:		
Land and improvements	\$ 524,196	\$ 257,233
Buildings and improvements	881,386	358,811
	<u>1,405,582</u>	<u>616,044</u>
Total real estate investments	1,405,582	616,044
Less: Accumulated depreciation	(22,729)	(4,303)
	<u>1,382,853</u>	<u>611,741</u>
Mortgage and equipment loans receivable	59,008	40,855
	<u>1,441,861</u>	<u>652,596</u>
Net investments	1,441,861	652,596
Cash and cash equivalents	30,536	113,225
Lease intangibles, net	21,395	10,742
Deferred costs and other assets, net	19,633	5,664
	<u>1,513,425</u>	<u>782,227</u>
Total assets	\$ 1,513,425	\$ 782,227
<b>Liabilities and stockholders' equity</b>		
Liabilities:		
Secured credit facilities	\$ 229,855	\$ 178,854
Mortgages and notes payable	664,929	178,854
Dividends payable	14,209	7,110
Accounts payable, accrued expenses and other liabilities	11,639	8,560
	<u>920,632</u>	<u>194,524</u>
Total liabilities	920,632	194,524
Commitments and contingencies (Note 7)		
Stockholders' equity:		
Preferred stock, \$0.01 par value per share, 125,000,000 shares authorized, no shares issued and outstanding		
Common stock, \$0.01 par value per share, 375,000,000 shares authorized, 67,663,071 (2005) and 63,506,819 (2004) shares issued and outstanding	677	635
Capital in excess of par value	640,289	599,300
Accumulated distributions in excess of net income	(33,607)	(8,650)
Accumulated other comprehensive loss	(14,566)	(3,582)
	<u>592,793</u>	<u>587,703</u>
Total stockholders' equity	592,793	587,703
Total liabilities and stockholders' equity	\$ 1,513,425	\$ 782,227

See accompanying notes.



## Spirit Finance Corporation

## Consolidated Statements of Operations

(dollars in thousands, except per share data)

	Years Ended December 31,		Date of Inception (August 14, 2003) to December 31, 2003
	2005	2004	
<b>Revenues:</b>			
Rentals	\$ 78,087	\$ 19,236	\$ 95
Interest income on mortgage and equipment loans receivable	4,276	3,775	89
Other interest income	2,138	1,942	102
<b>Total revenues</b>	<b>84,501</b>	<b>24,953</b>	<b>286</b>
<b>Expenses:</b>			
General and administrative	12,810	7,123	1,405
Depreciation and amortization	19,985	4,417	4
Interest	25,826	4,979	35
<b>Total expenses</b>	<b>58,621</b>	<b>16,519</b>	<b>1,444</b>
<b>Income (loss) from continuing operations</b>	<b>25,880</b>	<b>8,434</b>	<b>(1,158)</b>
<b>Discontinued operations:</b>			
Income from discontinued operations	1,167	550	
Net gains (losses) on sales of real estate	772	(12)	
<b>Total discontinued operations</b>	<b>1,939</b>	<b>538</b>	
<b>Net income (loss)</b>	<b>\$ 27,819</b>	<b>\$ 8,972</b>	<b>\$ (1,158)</b>
<b>Income (loss) per common share:</b>			
<b>Basic:</b>			
Continuing operations	\$ 0.38	\$ 0.22	\$ (0.22)
Discontinued operations	0.03	0.02	
<b>Net income (loss)</b>	<b>\$ 0.41</b>	<b>\$ 0.24</b>	<b>\$ (0.22)</b>
<b>Diluted:</b>			
Continuing operations	\$ 0.38	\$ 0.22	\$ (0.22)
Discontinued operations	0.03	0.02	
<b>Net income (loss)</b>	<b>\$ 0.41</b>	<b>\$ 0.24</b>	<b>\$ (0.22)</b>

Weighted average outstanding common shares:

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Basic	67,240,350	37,522,747	5,160,524
	<hr/>	<hr/>	<hr/>
Diluted	67,482,350	37,688,074	5,160,524
	<hr/>	<hr/>	<hr/>

*See accompanying notes.*

## Spirit Finance Corporation

## Consolidated Statements of Stockholders' Equity

From the Date of Inception (August 14, 2003) to December 31, 2005

(dollars in thousands, except per share data)

	Common Shares	Common Stock Par Value	Capital in Excess of Par Value	Accumulated Distributions in Excess of Net Income	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Comprehensive loss:						
Net loss		\$	\$	\$ (1,158)	\$	(1,158)
Unrealized gain on investment available-for-sale					1	1
Total comprehensive loss						(1,157)
Initial capitalization, August 14, 2003	5,000,000	50				50
Repurchase of common stock	(3,000,000)	(30)				(30)
Reverse stock split: 1-for-1.6666667	(800,000)	(8)	8			
Private offering, net	30,000,000	300	277,240			277,540
Issuance of shares in repayment of advances	52,612		489			489
Restricted stock activity	75,000	1	9			10
<b>Balances at December 31, 2003</b>	<b>31,327,612</b>	<b>313</b>	<b>277,746</b>	<b>(1,158)</b>	<b>1</b>	<b>276,902</b>
Comprehensive income:						
Net income				8,972		8,972
Unrealized loss on cash flow hedge					(3,582)	(3,582)
Reclassification of realized gain on investment available-for-sale					(1)	(1)
Total comprehensive income						5,389
Underwriters' over-allotment on private offering, net	6,000,000	60	55,640			55,700
Dividends declared on common stock (\$0.44 per share)				(16,464)		(16,464)
Initial public offering, net	26,086,957	261	264,847			265,108
Restricted stock activity, net	92,250	1	1,067			1,068
<b>Balances at December 31, 2004</b>	<b>63,506,819</b>	<b>635</b>	<b>599,300</b>	<b>(8,650)</b>	<b>(3,582)</b>	<b>587,703</b>
Comprehensive income:						
Net income				27,819		27,819
Change in net unrealized losses on cash flow hedges					(11,454)	(11,454)
Cash flow hedge losses reclassified to earnings					470	470
Total comprehensive income						16,835
Underwriters' over-allotment on public offering, net	3,913,043	39	40,028			40,067
Dividends declared on common stock (\$0.78 per share)				(52,776)		(52,776)
Exercise of stock options	5,000		50			50
Restricted stock activity, net	238,209	3	911			914
<b>Balances at December 31, 2005</b>	<b>67,663,071</b>	<b>\$ 677</b>	<b>\$ 640,289</b>	<b>\$ (33,607)</b>	<b>\$ (14,566)</b>	<b>\$ 592,793</b>

*See accompanying notes.*



## Spirit Finance Corporation

## Consolidated Statements of Cash Flows

(dollars in thousands)

	Years Ended December 31,		Date of Inception (August 14, 2003) to December 31, 2003
	2005	2004	
<b>Cash flows from operating activities</b>			
Net income (loss)	\$ 27,819	\$ 8,972	\$ (1,158)
Adjustments to net income (loss):			
Issuance of shares in payment of certain expenses			489
Depreciation and amortization	20,477	4,653	4
Stock-based compensation	911	1,067	9
Amortization of deferred financing costs	2,350	765	
Amortization of interest rate swap hedge losses	470		
Net (gains) losses on sales of real estate	(772)	12	
Other noncash items	285	19	6
Changes in operating assets and liabilities:			
Deferred costs and other assets	(2,856)	(2,061)	(492)
Accounts payable, accrued expenses and other liabilities	5,608	4,015	973
Net cash provided by (used in) operating activities	54,292	17,442	(169)
<b>Cash flows from investing activities</b>			
Acquisitions of real estate investments	(802,580)	(412,135)	(37,531)
Investment in mortgage and equipment loans receivable	(18,645)	(450)	(40,771)
Proceeds from sales of real estate investments	57,365	6,031	
Collections of principal on mortgage and equipment loans receivable	429	301	
Net cash used by investing activities	(763,431)	(406,253)	(78,302)
<b>Cash flows from financing activities</b>			
Borrowings under secured credit facilities	579,761	229,171	
Repayments under secured credit facilities	(349,906)	(229,171)	
Borrowings under mortgages and notes payable	575,300		
Repayments under mortgages and notes payable	(144,767)	(4,339)	
Deferred financing costs paid	(12,782)	(3,253)	
Payments made on forward-starting interest rate swaps	(14,984)		
Proceeds from initial capitalization			50
Proceeds from private offering, net		55,700	277,540
Proceeds from initial public offering, net	40,067	265,108	
Proceeds from exercise of stock options	50		
Repurchase of common stock			(30)
Dividends paid on common stock	(45,677)	(9,354)	
Transfers to restricted cash and escrow deposits	(612)	(915)	
Net cash provided by financing activities	626,450	302,947	277,560
Net (decrease) increase in cash and cash equivalents	(82,689)	(85,864)	199,089
Cash and cash equivalents, beginning of period	113,225	199,089	

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Cash and cash equivalents, end of period	30,536	\$	113,225	\$	199,089
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~~Years Ended December 31,~~

*See accompanying notes.*

**Spirit Finance Corporation**

**Notes to Consolidated Financial Statements**

**1. Summary of Significant Accounting Policies**

**The Company**

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

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

**Principles of Consolidation**

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

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

Spirit Finance formed several special purpose entities to acquire and hold real estate subject to mortgage notes payable and to facilitate borrowings under the Company's secured credit facilities (see Note 4). As a result, substantial amounts of the Company's consolidated assets are held in these wholly-owned special purpose entities and are subject to debt. Each special purpose entity is a separate legal entity and is the sole owner of its assets and liabilities. The assets of the special purpose entities are not available to pay, or otherwise satisfy obligations to, the creditors of any owner or affiliate of the special purpose entity. At December 31, 2005 and 2004, assets totaling \$1.4 billion and \$331.4 million, respectively, were held and liabilities totaling \$668.6 million and \$178.1 million, respectively, were owed by these special purpose entities and are included in the accompanying Consolidated Balance Sheets.

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

### **Use of Estimates**

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

### **Reclassifications**

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

### **Real Estate Investments**

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

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

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

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

*Revenue Recognition* Spirit Finance leases real estate to its customers under long-term net leases that are classified as operating leases. Lease origination fees and internal direct lease origination costs, including employee compensation directly related to time spent performing successful lease origination activities, are deferred and amortized over the related lease term as an adjustment to rental revenue. Throughout the lease term, the leases may include scheduled rent escalations or escalations based on increases in the Consumer Price Index. The leases may also provide for contingent rent based on a percentage of the lessee's gross sales. The Company recognizes contingent rentals as revenue when the change in the factor on which the contingent lease payment is based actually occurs. For leases with scheduled rent escalations, rental revenue from operating leases is recognized on a straight-line basis so as to produce a constant periodic rent over the term of the lease. Accordingly, accrued rental revenue, calculated as the aggregate difference between the scheduled rents and rental revenue recognized on a straight-line basis, represents unbilled rent receivables that the Company will receive only if the tenant makes all rent payments required through the expiration of the initial term of the lease. In the event a lessee's monthly lease payments become more than 60 days past due, Spirit Finance will suspend revenue recognition on that lease until collectibility is reasonably assured.

*Provision for Bad Debts* The Company reviews its rent receivables for collectibility on a regular basis, taking into consideration changes in factors such as the lessee's payment history, the financial condition of the lessee, business conditions in the industry in which the lessee operates, and economic conditions in the area in which the property is located. In the event that the collectibility of a receivable with respect to any lessee is in doubt, a provision for uncollectible accounts will be established or a direct write-off of the specific rent receivable will be made. For accrued rental revenues related to the straight-line method of reporting rental revenue, the Company provides a portfolio valuation allowance (\$966,000 and \$201,000 at December 31, 2005 and 2004, respectively) based on the risks and estimates of uncollectible receivables that management believes are inherent in the portfolio, giving consideration to industry default rates for long-term receivables.

### **Mortgage and Equipment Loans Receivable**

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

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

*Impairment and Provision for Bad Debts* The Company periodically evaluates the collectibility of its mortgage loans receivable, including accrued interest, by analyzing the underlying property-level economics and trends, collateral value and quality and other relevant factors in determining the adequacy of its allowance for loan losses. A loan is determined to be impaired when, in management's

judgment based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Specific allowances for loan losses are provided for impaired loans on an individual loan basis in the amount by which the carrying value exceeds the estimated fair value of the underlying collateral less disposition costs.

### **Cash and Cash Equivalents**

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

### **Restricted Cash and Escrow Deposits**

The Company classified restricted cash totaling \$1.0 million and \$790,000 at December 31, 2005 and 2004, respectively, in "Deferred costs and other assets, net." These restricted cash balances represented amounts required to be maintained in escrow under certain of the Company's debt agreements. At December 31, 2005 and 2004, Spirit Finance also had deposits in escrow totaling \$525,000 and \$124,000, respectively, pending investment in real estate.

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

Derivatives are recognized on the balance sheet at fair value as either assets or liabilities. In determining the fair values of the derivative financial instruments, the Company uses either market quotes or valuation models that are based upon the net present value of estimated future cash flows and incorporate certain market data inputs.

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

For derivatives designated as cash flow hedges, the fair value of the derivative instrument is recorded on the balance sheet as either an asset or liability. The effective portions of the corresponding gain or loss on the derivatives are recorded in accumulated other comprehensive income within stockholders' equity. When the anticipated debt is issued, the fair value of the hedge contract at that time will be recorded in accumulated other comprehensive income and amortized into earnings as a yield adjustment over the term of the new debt instrument. Any ineffective portions of the corresponding gain or loss are recognized immediately in the income statement.

## Income Taxes

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

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

## Stock-Based Compensation

Effective January 1, 2005, Spirit Finance elected to adopt the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation," under the modified prospective transition method described by SFAS No. 148, "Accounting for Stock-Based Compensation Transition and Disclosure" for all unvested stock-based awards outstanding at January 1, 2005 and for all new grants made in 2005. Prior to January 1, 2005, the Company used the intrinsic-value method prescribed by Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for its stock-based compensation. Under this method, no compensation expense was recorded with respect to stock options as the options were granted at an exercise price equal to the estimated fair value of the underlying common shares on the date of grant. The fair value of the options was estimated on the grant dates using the minimum-value method, which omits the assumption of any volatility, because the Company was not a public entity on the respective grant dates. Using the minimum-value method, the fair value of the stock options was zero on the date of grant. Compensation expense for the unvested stock options outstanding on January 1, 2005 continues to be recognized using the minimum-value method. For stock options granted in 2005, the estimated grant date fair value was calculated using the Black-Scholes-Merton formula. In accordance with SFAS No. 123, this estimated fair value will be expensed over the stock option vesting period on a straight-line basis.

The adoption of SFAS No. 123 did not have a material impact on the Company's financial position or results of operations. Had Spirit Finance adopted the fair-value based method as of its inception on August 14, 2003, the Company's net income and income per common share for the year ended December 31, 2004 and for the period from inception (August 14, 2003) to December 31, 2003 would not have changed from the reported amounts.

## New Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123R"). On April 14, 2005, the Securities and

Exchange Commission delayed the effective date of SFAS No. 123R to January 1, 2006 for calendar-year public companies. This standard requires companies to recognize compensation expense using a fair-value based method for all equity-classified awards granted, modified or settled on or after January 1, 2006. The adoption of SFAS No. 123R effective January 1, 2006 is not expected to have a material effect on the Company's financial position or results of operations.

In March 2005, the FASB issued Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations an interpretation of FASB Statement No. 143" ("FIN 47"). FIN 47 requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value can be reasonably estimated. A conditional asset retirement obligation is a legal obligation to perform an asset retirement activity as to which the timing or method of settlement are conditional upon a future event that may or may not be within the control of the entity. The Company intends to comply with FIN 47's requirements for any applicable contingent asset retirement obligations that may arise in the future.

## 2. Investments

At December 31, 2005, Spirit Finance had investments in 684 real estate properties, including 589 owned real estate properties with a gross acquisition cost of \$1,428.5 million (including \$22.9 million of total related lease intangibles, see Note 3) and mortgage loans receivable representing 95 properties with a carrying amount of \$55.6 million. At December 31, 2005, the Company also held four equipment loans with an aggregate outstanding balance of \$3.4 million secured by equipment used in the operation of certain real estate properties owned by the Company. A substantial portion of the Company's investments are pledged as collateral under debt obligations (see Note 4).

The Company's investments are geographically dispersed throughout 40 states. Including the Company's mortgage loans receivable described below and the related lease intangibles, only one state, Texas (17%), accounted for 10% or more of the total dollar amount of Spirit Finance's investment portfolio at December 31, 2005.

During the year ended December 31, 2005, the Company had the following real estate acquisition and loan origination activity (dollars in thousands):

	<b>Number of Properties Owned or Financed</b>	<b>Dollar Amount of Investments(a)</b>
Balance, December 31, 2004	374	\$ 667,927
Acquisitions and loan originations	353	877,310
Sales (see Note 11)	(43)	(57,285)
Principal payments and premium amortization		(492)
Balance, December 31, 2005	684	\$ 1,487,460

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



**Real Estate Investments**

The following table reports the amount of real estate investment (excluding related lease intangibles) and related accumulated depreciation held by the Company at December 31, 2005 (dollars in thousands):

	Number of Owned Properties	Gross Carrying Amount at December 31, 2005		
		Land and Improvements	Buildings and Improvements	Total
Restaurants	370	\$ 191,140	\$ 207,655	\$ 398,795
Movie theaters	23	60,581	127,525	188,106
Educational facilities	20	34,930	115,960	150,890
Specialty retailer properties	31	55,066	86,870	141,936
Recreational facilities	8	27,323	73,835	101,158
Automotive dealers, parts and service facilities	17	43,614	36,901	80,515
Supermarkets	19	12,379	47,723	60,102
Convenience stores/car washes	27	32,091	20,971	53,062
Distribution facilities	44	19,843	31,069	50,912
Industrial properties	9	10,141	37,610	47,751
Interstate travel plazas	4	21,434	16,101	37,535
Call centers	2	4,413	28,556	32,969
Health clubs/gyms	5	4,279	18,743	23,022
Medical offices	1	1,445	19,112	20,557
Drugstores	9	5,517	12,755	18,272
<b>Total real estate investments</b>	<b>589</b>	<b>\$ 524,196</b>	<b>\$ 881,386</b>	<b>\$ 1,405,582</b>

The Company's properties are leased to customers under long-term operating leases that typically include one or more renewal options. The weighted average remaining noncancelable lease term at December 31, 2005 was approximately 14 years. The leases are generally triple-net, which provides that the lessee is responsible for the payment of all property operating expenses, including property taxes, maintenance and insurance; therefore, Spirit Finance is generally not responsible for repairs or other capital expenditures related to the properties.

Scheduled minimum future rentals to be received under the remaining term of the noncancelable operating leases at December 31, 2005 are as follows (dollars in thousands):

2006	\$ 122,091
2007	122,314
2008	122,597
2009	123,003
2010	123,124
Thereafter	1,187,405
<b>Total future minimum rentals</b>	<b>\$ 1,800,534</b>

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Since lease renewal periods are exercisable at the option of the lessee, the above table presents future minimum lease payments due during the initial lease term only. In addition, the future minimum rentals do not include any contingent rentals based on a percentage of the lessee's gross sales or lease escalations based on future changes in the Consumer Price Index. Contingent rental revenue based on a percentage of the lessee's gross sales totaled \$486,000 and \$103,000 in 2005 and 2004, respectively. There was no contingent rental revenue in 2003.

### Mortgage and Equipment Loans Receivable

At December 31, 2005, the Company held a total of 95 first priority mortgage loans (representing three borrowers) that had an aggregate carrying amount of \$55.6 million, including an unamortized premium of \$1.2 million. The largest individual mortgage loan receivable had a carrying amount of approximately \$1 million. The loans, which are secured by single tenant commercial properties, generally provide for monthly collections of principal and interest with scheduled increases in interest rates over the life of the loans. The Company's mortgage loans receivable are pledged as collateral under the Company's debt agreements (see Note 4). At December 31, 2005, the Company also held four equipment loans with an outstanding balance of \$3.4 million. The equipment loans are secured by equipment used in the operation of certain real estate properties owned by the Company. No loan loss allowances were recorded on the loans receivable at December 31, 2005 or 2004.

The following table provides additional information on the Company's loans receivable at December 31, 2005 (dollars in thousands):

	Number of Properties Financed	Weighted- Average Contractual Interest Rate	Weighted Average Effective Interest Rate	Final Maturity Date	Carrying Amount of Loans(b)
Mortgage loans:(a)					
Restaurants	63	9.47%	9.28%	2011-2030	\$ 35,526
Automotive parts and service facilities	32	9.23%	8.94%	2021	20,108
Equipment loans		8.52%	8.52%	2012-2015	3,374
<b>Total loans</b>	<b>95</b>				<b>\$ 59,008</b>

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

(b) The aggregate cost for Federal income tax purposes approximates the carrying amount of the mortgage and equipment loans.

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The following is a reconciliation of the carrying amount of loans from the date of inception through December 31, 2005 (dollars in thousands):

	<b>Number of Properties Financed(a)</b>	<b>Carrying Amount of Loans</b>
New loans from date of inception (August 14, 2003) through December 31, 2003	67	\$ 40,771
Amortization of premium		(5)
	67	40,766
New loans		450
Collections of principal		(301)
Amortization of premium		(60)
	67	40,855
New loans	28	18,645
Collections of principal		(429)
Amortization of premium		(63)
	95	\$ 59,008

(a) Excludes the four equipment loans originated by the Company.

### 3. Lease Intangibles, Net

Lease intangibles at December 31, 2005 and 2004 included the following (dollars in thousands):

	2005			2004		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
In-place leases	\$ 22,870	\$ 1,475	\$ 21,395	\$ 10,600	\$ 268	\$ 10,332
Above-market leases				428	18	410
<b>Total</b>	<b>\$ 22,870</b>	<b>\$ 1,475</b>	<b>\$ 21,395</b>	<b>\$ 11,028</b>	<b>\$ 286</b>	<b>\$ 10,742</b>

During 2005, the Company recorded \$13.0 million of lease intangibles representing the value of in-place leases on real estate properties acquired during 2005 and sold properties which had \$1.2 million of related lease intangibles.

Aggregate amortization expense for 2005 and 2004 totaled \$1.3 million and \$288,000, respectively. Amortization related to in-place leases, totaling \$1.3 million and \$270,000 in 2005 and 2004, respectively, was included in "Depreciation and amortization." Amortization related to intangibles associated with above-market leases, totaling \$18,000 in 2004, was recorded as a reduction of rental revenue. All of the properties associated with the above-market lease intangibles were sold during 2005; the 2005 amortization, totaling \$7,000, related to these intangibles is included in discontinued operations (see Note 11). Based on the balance of the intangible assets at December 31, 2005, the aggregate amortization expense is expected to be \$1.9 million in each of the years 2006 through 2009 and \$1.8 million in 2010. The weighted average remaining amortization period of the lease intangibles is 12 years.

#### 4. Debt

##### Secured Credit Facilities

As of December 31, 2005, the Company had an aggregate borrowing capacity of \$500 million under two separate secured credit facilities with Citigroup Global Markets Realty Corp. and Credit Suisse. Outstanding borrowings on those facilities totaled \$229.9 million at December 31, 2005. These short-term credit facilities, which are described in more detail below, are used to partially fund real estate acquisitions pending the issuance of long-term, fixed-rate debt.

In September 2005, Spirit Finance established a \$200 million revolving secured credit facility with Citigroup Global Markets Realty Corp. The facility matures in September 2006, with the ability to extend the facility with the consent of the bank. Borrowings under the facility require monthly payments of interest indexed to the one-month London Interbank Offered Rate (LIBOR) plus 1.50%. In addition, on November 7, 2005, the Company established a \$200 million revolving secured credit facility with Credit Suisse. The facility matures in November 2006. Borrowings under this facility will require monthly payments of interest indexed to LIBOR plus 1.25% and a non-use fee may be incurred under certain circumstances. The facilities are structured as master loan repurchase agreements, and borrowings under the facilities are secured by mortgages on specific real estate investments that the Company owns and pledges as collateral under the facilities. On December 7, 2005, the Citigroup facility was amended to permit an additional \$100 million of borrowings, for a total borrowing capacity of \$300 million under this facility. Borrowings under this portion of the facility require monthly payments of interest based on one-month LIBOR plus 1.50% 2.75%, depending on amounts borrowed. The interest rates on these borrowings are subject to increase in the event the Company exceeds a specified leverage amount. The additional \$100 million of borrowings under the facility are secured by the Company's equity ownership interest in one of its consolidated, special purpose subsidiaries. At December 31, 2005, the one-month LIBOR rate was 4.39%.

The Company is subject to various financial and nonfinancial covenants under the secured credit facilities, including maintaining a minimum tangible net worth of \$400 million, a maximum total debt to tangible net worth ratio and a minimum liquidity requirement of \$15 million. As of December 31, 2005, Spirit Finance was in compliance with these covenants. At December 31, 2005, real estate properties and mortgage notes receivable with an aggregate investment of \$389.6 million were pledged as collateral for borrowings under the secured credit facilities.

The Company's previously existing \$125 million secured credit facility with Citigroup Global Markets Realty Corporation and its \$250 million secured facility with Bank of America Mortgage Capital Corp. expired in July 2005 and September 2005, respectively.

**Mortgages and Notes Payable**

The Company's mortgages and notes payable at December 31, 2005 and 2004 are summarized below (dollars in thousands):

	<b>December 31, 2005</b>	<b>December 31, 2004</b>
Net-lease mortgage notes payable, Series 2005-1:		
Class A-1 amortizing mortgage note, 5.05%, due 2020	\$ 179,778	\$
Class A-2 interest-only mortgage note, 5.37%, due 2020	258,300	
Secured fixed-rate mortgage notes payable:		
8.44% Note, effective interest rate 6.62%, balloon due 2010	16,617	16,783
8.60% Note, effective interest rate 6.20%, balloon due 2010	6,854	6,971
9.02% Note, effective interest rate 6.19%, balloon due 2010	6,420	6,522
9.02% Note, effective interest rate 6.25%, balloon due 2010	2,777	2,821
5.78% Note, balloon due 2010	15,500	
6.50% Note, balloon due 2012	14,228	
5.90% Note, balloon due 2012	8,500	
5.40% Notes, balloons due 2014	35,202	
5.30% Note, balloon due 2015	38,993	
5.62% Note, balloon due 2015	35,629	
5.26% Note, balloon due 2015	30,108	
5.62% Note, balloon due 2015	6,232	
5.40% Note, balloon due 2015	4,785	
Secured variable-rate promissory notes, interest only, 1-month LIBOR + 3.0%, paid March 2005		140,135
Unsecured fixed-rate promissory note, 7.00%, due 2021	2,257	2,330
	662,180	175,562
Unamortized debt premium	2,749	3,292
Total mortgages and notes payable	\$ 664,929	\$ 178,854

On July 26, 2005, a consolidated special purpose subsidiary of Spirit Finance issued \$441.3 million aggregate principal amount of net-lease mortgage notes payable segregated in two classes as noted in the table above. The payment of scheduled interest and ultimate payment of principal on the notes are guaranteed under an insurance policy issued by Ambac Assurance Corporation. The collateral pool securing the notes is comprised of 408 single tenant commercial real estate properties. The notes may be prepaid at any time, subject to a yield maintenance prepayment premium, and the notes permit substitution of real estate investments from time to time subject to certain conditions. In addition, the note structure allows for the addition of collateral to the pool and the issuance of additional series of notes secured by the increased collateral pool of properties. The net-lease mortgage notes are secured by real estate properties and mortgage notes receivable with an aggregate investment value of \$641.2 million at December 31, 2005 and the member interest of this special purpose entity is pledged as collateral under one of the Company's secured credit facilities.

The Company's secured fixed-rate mortgage notes payable, which are obligations of its consolidated special purpose subsidiaries as described in Note 1, contain various covenants customarily found in mortgage notes, including a limitation on Spirit Finance's ability to incur additional indebtedness on the underlying real estate collateral. As of December 31, 2005 and 2004, Spirit Finance was in compliance with these covenants. At December 31, 2005 and 2004, the fixed-rate mortgages and notes payable were secured by real estate properties with an aggregate investment of \$340.7 million and \$243.4 million, respectively.

The mortgages and notes payable require monthly principal and interest payments; the notes payable also require balloon payments totaling \$44.8 million due in 2010, \$19.5 million due in 2012, \$29.7 million due in 2014, \$96.5 million due in 2015 and \$258.3 million due 2020. The debt premium is amortized to interest expense using the effective interest method over the terms of the related notes. Scheduled annual debt maturities, including balloon payments, in the next five years are as follows (dollars in thousands):

2006	\$ 11,789
2007	12,519
2008	13,251
2009	14,101
2010	58,933
Thereafter	554,336
	<hr/>
	\$ 664,929
	<hr/>

The financing costs related to the establishment of the secured credit facilities and mortgages and notes payable are deferred and amortized to interest expense using either the effective interest or straight-line method over the initial term of the related debt instrument. Unamortized financing costs totaled \$12.9 million and \$2.5 million at December 31, 2005 and 2004, respectively, and are included in the caption, "Deferred costs and other assets, net."

## 5. Derivatives and Hedging Activities

The Company uses interest rate derivative contracts (interest rate swaps) to manage its exposure to changes in interest rates on forecasted debt transactions. Spirit Finance does not enter into derivative contracts for speculative or trading purposes. As of December 31, 2005, Spirit Finance had three outstanding forward-starting interest rate swap agreements with an aggregate notional amount of \$225 million. These derivative instruments were designated to hedge the variability of cash flows related to forecasted interest payments over a term of 15 years on long-term debt with an initial principal balance of at least \$230 million expected to be issued in 2006. As the hedging relationships are expected to be highly effective at achieving offsetting changes in future cash flows, these interest rate swaps are accounted for as cash flow hedges. Hedge effectiveness is assessed using the hypothetical derivative method. During 2005 and 2004, no hedge ineffectiveness was recognized and there were no gains and losses on derivative transactions or portions thereof that were excluded from the assessment of hedge effectiveness. Further, no hedge relationships were discontinued during the years ended December 31, 2005 and 2004.

At December 31, 2005, the fair value of two of the outstanding forward-starting interest rate swaps was an asset totaling approximately \$975,000 which is included in "Deferred costs and other assets, net" with a corresponding amount recorded in "Accumulated other comprehensive loss." In addition, the fair value of one of the outstanding forward-starting interest rate swaps in place at December 31, 2005 and one swap in place at December 31, 2004 was a liability of approximately \$1.0 million and \$3.6 million, respectively, and are included in "Accounts payable, accrued expenses and other liabilities" with a corresponding amount recorded in "Accumulated other comprehensive loss."

In conjunction with the issuance of the net-lease mortgage notes payable in July 2005 (see Note 4), the Company settled two forward-starting interest rate swap agreements. The fair value of the interest rate swaps at the time of settlement was a liability totaling \$15.0 million and is being amortized to earnings, using the effective interest method, as an increase to interest expense over a period of 25 years. During the year ended December 31, 2005, this amortization totaled \$470,000. At December 31, 2005, the Company expects to reclassify approximately \$965,000 of net losses (including an estimated amount for outstanding swaps) on derivative instruments from accumulated other comprehensive income as an increase in interest expense over the next twelve months. The unamortized balance of the settled interest rate swaps at December 31, 2005 was \$14.5 million and is included in "Accumulated other comprehensive loss."

## **6. Stockholders' Equity**

On December 31, 2005, there were 67,663,071 shares of common stock outstanding. Of the common shares authorized but unissued at December 31, 2005, 2,399,541 shares were reserved and available for issuance under the employee stock plan.

Under the terms of a stockholder agreement, 180,000 shares held by Spirit Finance Holdings, LLC ("Spirit Holdings"), an Arizona limited liability company owned primarily by certain executive officers of Spirit Finance, are restricted at December 31, 2005 and subject to repurchase by the Company for \$0.01 per share. Spirit Finance will repurchase 60,000 shares of its common stock covered by the agreement from Spirit Holdings for each year that the Company does not meet the performance criteria specified in the agreement on a cumulative basis through 2008.

During 2005, the Company made distributions to its stockholders, aggregating \$0.76 per common share. Of this amount, \$0.44 per share was taxable as ordinary income and \$0.32 per share represented a return of capital (to the extent that the Company makes distributions in excess of current and accumulated earnings and profits, these distributions are treated as a tax free return of capital). During 2004, the Company made distributions to its stockholders, aggregating \$0.25 per common share, all of which were taxable as ordinary income. No dividends were declared during 2003.

## **7. Commitments and Contingencies**

At December 31, 2005, Spirit Finance has contractual commitments totaling \$49.3 million for future improvements on properties the Company currently owns. These improvements include costs to be incurred on facilities during which the tenant's business continues to operate without interruption and advances for the construction of new facilities for which operations have not commenced. In accordance with the underlying lease agreements, these improvements, the majority of which are anticipated to be completed during 2006 and 2007, will result in increases in related contractual rent.

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The Company leases its current corporate office space and certain operating equipment under noncancelable agreements from unrelated third parties. The Company is also a lessee under three noncancelable ground leases under which it is obligated to pay monthly rent. Total rental expense amounted to \$328,000, \$217,000 and \$87,000 during 2005, 2004 and 2003, respectively. At December 31, 2005, the Company's minimum aggregate rental commitment under all noncancelable operating leases was: \$522,000 in 2006, \$535,000 in 2007, \$550,000 in 2008, \$563,000 in 2009, \$566,000 in 2010 and \$4.7 million thereafter.

The Company has entered into employment agreements with its six senior officers. The current terms of the employment agreements will end in December 2006, and will automatically extend for one additional year unless either party terminates the agreement. The agreements provide for annual base salaries and maximum bonuses. For 2006, the maximum aggregate annual cash compensation under these agreements totals approximately \$4.3 million. Under these agreements, in the event of a change in control or if an executive officer were to be terminated without cause, Spirit Finance would be liable for a lump-sum severance payment at rates ranging from one and one-half to two times the sum of the officer's base salary plus maximum target bonus and other termination benefits. In addition, in the event of a change in control, Spirit Finance would provide to other officers of the Company certain termination benefits and a lump-sum severance payment equal to (i) the officers' annual base salary, plus (ii) either (a) the officers' highest annual bonus received in any one of the immediately preceding three years, or (b) \$100,000 in the case of certain officers.

The Company may be subject to claims or litigation in the ordinary course of business. At December 31, 2005, there were no outstanding claims against the Company that are expected to have a material adverse effect on the Company's financial position or results of operations.

### **8. Fair Value of Financial Instruments**

The fair values of financial instruments are estimates based upon market conditions and perceived risks at December 31, 2005 and 2004. These estimates require management's judgment and may not be indicative of their future fair values.

Financial assets and liabilities for which the carrying values approximate their fair values include: cash and cash equivalents, restricted cash and escrow deposits, secured credit facilities, variable-rate mortgage notes payable and derivative financial instruments (see Note 5 for fair values of derivative assets and liabilities). Generally these assets and liabilities are short-term in duration or are recorded at fair value on the Consolidated Balance Sheets. The estimated fair values of the fixed-rate mortgage and equipment loans receivable and the fixed-rate mortgages and notes payable have been derived based on a discounted cash flow analysis using estimates of the amount and timing of future cash flows, market rates and credit spreads. At December 31, 2005 and 2004, the estimated fair value of the Company's fixed-rate mortgage and equipment loans receivable exceeded the carrying amounts by approximately \$1.9 million and \$1.7 million, respectively. The estimated fair value of the Company's fixed-rate mortgages and notes payable was approximately \$9.9 million below its carrying amount at December 31, 2005 and exceeded carrying amounts by approximately \$400,000 at December 31, 2004.



## 9. Significant Credit and Revenue Concentrations

The Company's properties are operated by 106 customers that provide retail, distribution or service activities in various industries with no individual credit exposure greater than 5.7% of the Company's total investment portfolio at December 31, 2005. Approximately 14% of the Company's 2004 revenues and 33% of its 2003 revenues were derived under a single master lease agreement with one customer. As a result of the growth in the investment portfolio due to the acquisition of properties during 2005, rental revenue generated from this customer represented less than 5% of revenues in 2005. Interest income on mortgage loans receivable was primarily generated equally from two customers during 2005, 2004 and 2003. Interest income generated from both of these customers represented approximately 4%, 7% and 16% of revenues in 2005, 2004 and 2003, respectively.

## 10. Stock-Based Compensation Plan and Other Employee Benefits

In May 2005, the Company's stockholders approved the Amended and Restated 2003 Stock Option and Incentive Plan that provides for the issuance of (1) nonqualified stock options; (2) incentive stock options; (3) dividend equivalent rights; (4) stock appreciation rights; (5) phantom stock rights; and (6) restricted stock to employees and non-employee directors. The plan provides for a total of 4,100,000 shares available for grant; shares remaining available for grant under the plan at December 31, 2005 totaled 2,399,541.

The following table summarizes stock option grants and related information for 2005, 2004 and 2003:

	Year Ended December 31, 2005		Year Ended December 31, 2004		Period of Inception (August 14, 2003) through December 31, 2003	
	Shares	Weighted Average Exercise Price per Share	Shares	Weighted Average Exercise Price per Share	Shares	Weighted Average Exercise Price per Share
Outstanding at beginning of period	1,290,000	\$ 10.00	1,230,000	\$ 10.00		
Granted	30,000	\$ 11.81	60,000	\$ 10.00	1,230,000	\$ 10.00
Exercised	(5,000)	\$ 10.00				
Forfeited	(25,000)	\$ 11.09				
Outstanding at end of year	1,290,000	\$ 10.02	1,290,000	\$ 10.00	1,230,000	\$ 10.00
Options exercisable at end of year	577,000	\$ 10.00	282,000	\$ 10.00		
Weighted average remaining contractual life of options outstanding and exercisable	8 years		9 years		10 years	
Weighted average fair value of options granted during the period		\$ 1.09(a)		\$ 0.00(b)		\$ 0.00(b)

(a) The fair value of these options was estimated on the date of grant using a Black-Scholes-Merton option-pricing model with the following weighted average assumptions: (i) expected life of stock options of 6.5 years, (ii) expected volatility of 19.5%, (iii) dividend yield of 6.4%, and (iv) risk free rate of return of 4.1%.

(b) As described in Note 1, Spirit Finance used the minimum-value method to determine the fair value of these options because it was not a public company on the dates the options were granted.

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Each option has an exercise price equal to the market price (or estimated fair value, for options granted prior to the Company becoming a public entity) of the Company's common stock on the date of grant. Stock options vest ratably each year over a three- or five-year period, subject to continued employment, and will expire ten years after the date of the grant. Compensation expense related to stock options granted in 2005 is recognized on a straight-line basis over the stock option vesting period. There was no compensation expense related to stock options granted in 2004 and 2003 as the fair value was zero on the date of grant.

The following table summarizes restricted stock activity and related information for 2005, 2004 and 2003:

	Year Ended December 31, 2005		Year Ended December 31, 2004		Period of Inception (August 14, 2003) through December 31, 2003	
	Shares	Weighted Average Grant Date Fair Value per Share	Shares	Weighted Average Grant Date Fair Value per Share	Shares	Weighted Average Grant Date Fair Value per Share
Outstanding at beginning of period	167,250	\$ 10.00	75,000	\$ 10.00		
Granted	268,227	\$ 11.71	93,000	\$ 10.00	75,000	\$ 10.00
Vested	(52,974)	\$ 10.00				
Forfeited	(30,018)	\$ 10.93	(750)			
<b>Outstanding at end of year</b>	<b>352,485</b>	<b>\$ 11.22</b>	<b>167,250</b>	<b>\$ 10.00</b>	<b>75,000</b>	<b>\$ 10.00</b>

Restricted stock awards, which are granted and valued based on the fair value of Spirit Finance common stock on the date of grant, vest ratably over a three- or five-year period. In general, fifty percent of the restricted shares granted to employees vest solely over time and the other fifty percent vest over time based on meeting yearly performance criteria. The performance criteria include meeting total return targets each year (or on a cumulative basis) over the full three- or five-year period. Restricted shares granted to non-employee directors and certain employees vest solely over time. Compensation expense related to restricted stock awards granted in 2005 is recognized on a straight-line basis over the vesting period. Compensation expense related to restricted stock awards granted prior to 2005 is recognized on a graded (accelerated) vesting schedule over the vesting period.

Stock-based compensation is included in "General and administrative" expenses in the Consolidated Statements of Operations. The Company's aggregate stock-based compensation expense, net of forfeitures, during 2005, 2004 and 2003 was \$911,000, \$1,067,000 and \$9,000, respectively.

In 2004, Spirit Finance established a defined contribution retirement savings plan qualified under section 401(a) of the Internal Revenue Code (the "401(k) Plan"). The 401(k) Plan is available to full-time employees who have completed at least six months of service with the Company. Spirit Finance provides a matching contribution in cash, up to a maximum of 4% of compensation, which vests immediately. The matching contributions totaled \$97,000 and \$49,000 in 2005 and 2004, respectively.

## 11. Discontinued Operations

Periodically, Spirit Finance may sell real estate properties that do not meet its long-term strategic investment objectives. Such properties are typically acquired in conjunction with the purchase of a portfolio of real estate properties. The Company considers these occasional sales of real estate properties to be a part of its long-term operating business strategy of acquiring and holding a diversified real estate investment portfolio; consequently, proceeds from the sales of real estate properties are expected to be reinvested in additional real estate properties such that cash flows from ongoing operations are not negatively affected by sales of individual properties. SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," requires that gains and losses from any such dispositions of properties and all operations from these properties be reclassified as "discontinued operations" in the Consolidated Statements of Operations. As a result of this reporting requirement, each time a property is sold, previously reported "income from continuing operations" will be restated to reclassify the operations of such property into discontinued operations. This presentation has no impact on net income or cash flow.

During the year ended December 31, 2005, the Company sold 43 properties for \$57.4 million in net sales proceeds, resulting in an aggregate net gain of \$772,000. During 2004, Spirit Finance sold four properties for \$6.0 million in net sale proceeds, resulting in an aggregate net loss of \$12,000. All of the current and prior period operations and net gains (losses) realized from these real estate dispositions have been reclassified into discontinued operations.

The following table sets forth the components of discontinued operations related to the 47 properties sold subsequent to January 1, 2004 (dollars in thousands).

	<b>Years Ended December 31,</b>	
	<b>2005</b>	<b>2004</b>
Rental revenues	\$ 1,989	\$ 1,275
Expenses:		
General and administrative	14	10
Depreciation and amortization	492	236
Interest	316	479
Total expenses	822	725
Income from discontinued operations	1,167	550
Net gains (losses) on sales of real estate	772	(12)
Total income from discontinued operations	\$ 1,939	\$ 538

**12. Income per Common Share**

A reconciliation of the numerators and denominators used in the computation of basic and diluted net income per common share is as follows (dollars in thousands):

	Years Ended December 31,		Date of Inception (August 14, 2003) to December 31, 2003
	2005	2004	
<b>Income available to common shareholders:</b>			
Continuing operations	\$ 25,880	\$ 8,434	\$ (1,158)
Discontinued operations	1,939	538	
Net income (loss)	\$ 27,819	\$ 8,972	\$ (1,158)
<b>Weighted average shares:</b>			
Weighted average outstanding common shares used in the calculation of basic income per common share	67,240,350	37,522,747	5,160,524
Effect of unvested restricted stock	84,845	151,958	
Effect of stock options(a)	137,555	13,369	
Weighted average outstanding common shares used in the calculation of diluted income per common share	67,462,750	37,688,074	5,160,524

- (a) Options to purchase 15,000 shares of common stock at December 31, 2005 were outstanding but were not included in the computation of diluted net income per common share for the year ended December 31, 2005 because the effect was not dilutive. Options to purchase 1,230,000 shares of common stock and 75,000 shares of restricted stock were outstanding at December 31, 2003, but were not included in the computation of diluted net loss per common share from the date of inception (August 14, 2003) to December 31, 2003 because the effect was not dilutive.

**13. Related Party Transactions**

Spirit Finance purchased four interstate travel plaza facilities for approximately \$37.5 million in December 2003 in a sale-leaseback transaction under which the properties were leased back to the seller under an operating lease. The Company's Chairman of the Board is a member of the board of directors of the seller. Rental revenues totaled \$3.6 million, \$3.6 million and \$96,000 in 2005, 2004 and 2003, respectively, under this lease.

One of the Company's independent directors has been an active member of the board of directors of a customer operating the underlying properties that collateralize approximately one-third of the mortgage loans receivable held at December 31, 2005. In addition, during 2004, Spirit Finance acquired four properties under a sale-leaseback transaction for an aggregate purchase price of \$3.4 million from the customer. Interest income on the mortgage loans receivable and rental revenue on the lease aggregated \$2.2 million, \$2.0 million and \$46,000 in 2005, 2004 and 2003, respectively.

Prior to the closing of the private offering in December 2003, Spirit Finance's organizational and start-up expenses, including costs incurred by Spirit Holdings on behalf of Spirit Finance before its incorporation, were paid on its behalf by Spirit Holdings under an intercompany advance agreement. Spirit Holdings charged Spirit Finance interest at 8% on funds advanced, which totaled \$35,000 from

the date of inception (August 14, 2003) through December 31, 2003. Upon completion of the private offering, Spirit Finance issued 52,612 shares of common stock to Spirit Holdings in repayment of \$489,291 of amounts advanced, with the balance of amounts advanced, totaling \$1.0 million, paid in cash in accordance with the agreement. Spirit Holdings is a holding company owned equally by the Company's Chairman of the Board and the Chief Executive Officer.

On October 1, 2003, Spirit Finance repurchased 3,000,000 shares of its common stock for \$30,000, or \$0.01 per share, from Spirit Holdings. In exchange, Spirit Finance issued a note payable for \$30,000, accruing interest at 8% per annum, payable upon demand. The note was paid on December 17, 2003.

Prior to the relocation to its current headquarters, Spirit Finance paid a company that is wholly owned by its Chairman of the Board for the rental of its prior office space. The amount Spirit Finance paid is equal to the amount the affiliate paid to a third party lessor. Spirit Finance paid rent of \$81,000 in 2004 and \$87,000 in 2003 for its prior office space.

#### **14. Supplemental Cash Flow Information**

Spirit Finance assumed existing mortgages and notes payable (including debt premium) of \$56.1 million and \$39.2 million on real estate investments acquired during 2005 and 2004, respectively. In addition, in conjunction with the acquisition of certain real estate investments during 2004, Spirit Finance entered into interim seller financing of \$144.3 million in mortgage notes payable. Interest paid during 2005, 2004 and 2003 totaled \$20.2 million, \$4.1 million and \$36,000, respectively. Income and franchise taxes paid during 2005 and 2004 were \$523,000 and \$94,000, respectively. No income or franchise taxes were paid during 2003.

#### **15. Quarterly Financial Information (Unaudited)**

The following table summarizes the unaudited consolidated quarterly results of operations for the years ended December 31, 2005 and 2004. As discussed in Note 11, SFAS No. 144 requires that gains and losses from any sales of properties and all operations from these properties be reclassified as "discontinued operations" in the Consolidated Statements of Operations. As a result of this reporting requirement, each time a property is sold, previously reported "income from continuing operations" will be restated to reclassify the operations of such property into discontinued operations. This presentation has no impact on net income. Quarterly income or loss per share may not add to the respective annual amounts due to the weighting of shares outstanding.

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	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
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(Dollars in thousands, except per share data)

<b>2005</b>				
Revenues	\$ 14,505	\$ 17,402	\$ 23,353	\$ 29,241
Income from continuing operations	6,210	6,780	6,139	6,751
Net income	6,819	7,478	6,652	6,870
Basic income per common share:				
Continuing operations	0.09	0.10	0.09	0.10
Net income	0.10	0.11	0.10	0.10
Diluted income per common share:				
Continuing operations	0.09	0.10	0.09	0.10
Net income	0.10	0.11	0.10	0.10
Cash dividends declared per common share	0.19	0.19	0.19	0.21

<b>2004</b>				
Revenues	\$ 2,553	\$ 3,305	\$ 7,652	\$ 11,443
Income from continuing operations	812	1,262	2,981	3,379
Net income	812	1,282	3,221	3,657
Basic income per common share:				
Continuing operations	0.02	0.03	0.08	0.08
Net income	0.02	0.03	0.09	0.09
Diluted income per common share:				
Continuing operations	0.02	0.03	0.08	0.08
Net income	0.02	0.03	0.09	0.09
Cash dividends declared per common share			0.06	0.38(a)

(a) During the fourth quarter of 2004, the Company declared dividends of \$0.19 per common share related to the third quarter and \$0.19 related to the fourth quarter.

**16. Subsequent Events**

In February 2006, the Company completed a public offering of 13,800,000 additional shares of common stock which raised aggregate proceeds of \$154.2 million, after deducting the underwriters' discounts but before offering expenses. Of the net proceeds from the stock offering, \$110.3 million was used to reduce borrowings under one of the secured credit facilities. In addition, subsequent to December 31, 2005, the Company granted 402,568 shares of restricted stock to officers and employees.

**Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure**

None.

**Item 9A. Controls and Procedures**

***Controls and Procedures***

As of December 31, 2005, we carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Our disclosure controls and procedures are designed with the objective of ensuring that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in our periodic SEC reports.

Our internal control over financial reporting is designed with the objective of providing reasonable assurance regarding the reliability of our financial reporting and preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our Chief Executive Officer and our Chief Financial Officer also concluded that during the fiscal quarter ended December 31, 2005, there has been no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

It should be noted that the design of any system of controls is based in part upon assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote. However, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective under circumstances where our disclosure controls and procedures should reasonably be expected to operate effectively.

***Management's Report on Internal Control over Financial Reporting***

Spirit Finance Corporation's management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) under the Exchange Act. Under the supervision and with the participation of our management, our Chief Executive Officer and Chief Financial Officer conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in the report entitled "Internal Control Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO Report").

Based on our evaluation and criteria set forth in the COSO Report, management concluded that our internal control over financial reporting was effective as of December 31, 2005. Management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2005 has been audited by Ernst & Young LLP, an independent registered public accounting firm who also audited our consolidated financial statements, as stated in their attestation report, which is included herein.

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders  
Spirit Finance Corporation

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Spirit Finance Corporation maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Spirit Finance Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Spirit Finance Corporation maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Spirit Finance Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Spirit Finance Corporation as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity, and cash flows for the years then ended and for the period from inception (August 14, 2003) to December 31, 2003 of Spirit Finance Corporation and our report dated March 3, 2006 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Phoenix, Arizona  
March 3, 2006



**Item 9B. Other Information**

None.

**PART III**

**Item 10. Directors and Executive Officers of the Registrant**

The information required by this item with respect to the Registrant's directors and executive officers, audit committee financial expert and filings under Section 16(a) of the Exchange Act is incorporated herein by reference to the Registrant's definitive proxy statement for the Annual Meeting of Shareholders presently scheduled to be held on May 19, 2006, to be filed pursuant to Regulation 14A.

The Registrant has adopted a code of business conduct and ethics (the "Code of Business Conduct and Ethics") applicable to the Registrant's principal executive officer, principal financial officer, principal accounting officer or controller, and to all officers, directors and employees of the Registrant. The Code of Business Conduct and Ethics is available on the Company's website, [www.spiritfinance.com](http://www.spiritfinance.com), and is available in print to any stockholder who requests it.

The Company has filed, as exhibits to this Annual Report on Form 10-K for the year ended December 31, 2005, the certifications of its Chief Executive Officer and Chief Financial Officer required pursuant to Section 302 of the Sarbanes-Oxley Act of 2004.

On January 17, 2006, the Company submitted to the New York Stock Exchange the Annual CEO Certification required pursuant to Section 303A.12(a) of the New York Stock Exchange Listed Company Manual.

**Item 11. Executive Compensation**

This item is incorporated by reference to the Registrant's definitive proxy statement for the Annual Meeting of Shareholders presently scheduled to be held on May 19, 2006, to be filed pursuant to Regulation 14A.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

This item is incorporated by reference to the Registrant's definitive proxy statement for the Annual Meeting of Shareholders presently scheduled to be held on May 19, 2006, to be filed pursuant to Regulation 14A.

**Item 13. Certain Relationships and Related Transactions**

This item is incorporated by reference to the Registrant's definitive proxy statement for the Annual Meeting of Shareholders presently scheduled to be held on May 19, 2006, to be filed pursuant to Regulation 14A.

**Item 14. Principal Accounting Fees and Services**

This item is incorporated by reference to the Registrant's definitive proxy statement for the Annual Meeting of Shareholders presently scheduled to be held on May 19, 2006, to be filed pursuant to Regulation 14A.

## PART IV

## Item 15. Exhibits, Financial Statement Schedules

(a)

**Documents filed as part of this Report:**

1. **Financial Statements.** See Index to Financial Statements under Item 8 of this report.
2. **Financial Statements Schedules.** See Schedule III on page S-1 of this Report. All other financial statement schedules are omitted since they are not required, are inapplicable or the required information is included in the financial statements or notes thereto.
3. **Exhibits.** The following is a complete list of exhibits filed as part of this Form 10-K. Exhibit numbers correspond to the numbers in the Exhibit Table of Item 601 of Regulation S-K.

Exhibit No.	Description
3.1	Articles of Amendment and Restatement.(1)
3.2	Bylaws.(2)
4.1	Form of Common Stock Certificate.(2)
4.2	Master Indenture dated as of July 26, 2005, between Spirit Master Funding, LLC and Citibank, N.A., as indenture trustee.(3)
4.3	Series 2005-1 Indenture Supplement dated as of July 26, 2005, between Spirit Master Funding, LLC and Citibank, N.A., as indenture trustee.(3)
10.1	Amended and Restated Employment Agreement between the Registrant and Morton H. Fleischer.
10.2	Amended and Restated Employment Agreement between the Registrant and Christopher H. Volk.
10.3	Employment Agreement between the Registrant and Catherine F. Long.(2)
10.4	Employment Agreement between the Registrant and Jeffrey M. Fleischer.(2)
10.5	Employment Agreement between the Registrant and Gregg A. Seibert.(2)
10.6	Employment Agreement between the Registrant and Michael T. Bennett.(4)
10.7	Amended and Restated Spirit Finance Corporation 2003 Stock Option and Incentive Plan.(1)
10.8	Stockholder Agreement between the Registrant and Spirit Finance Holdings, LLC dated as of October 15, 2003.(2)
10.9	Master Lease Agreement dated as of December 23, 2003 between the Registrant and Flying J Inc.(5)
10.10	Master Repurchase Agreement among Bank of America Mortgage Capital Corporation, Spirit Funding Company, LLC and the Registrant dated as of August 9, 2004.(2)
10.11	Amended and Restated Master Repurchase Agreement between Citigroup Global Markets Realty Corp. and the Registrant dated as of December 7, 2005.(6)
10.12	Master Repurchase Agreement among the Registrant and Alpine Securitization Corp., Credit Suisse, New York Branch, as

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Exhibit No.	Description
10.13	buyers, and Credit Suisse, New York Branch, as agent for the buyers, dated as of November 7, 2005.(7) Second Amended and Restated Servicing Agreement Dated as of August 9, 2004 between the Registrant and Midland Loan Services, Inc.(2)

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- 10.14 Property Management and Servicing Agreement dated as of July 26, 2005, among Spirit Master Funding, LLC, Spirit Finance Corporation and Midland Loan Services, Inc.(3)
  - 12.1 Computation of Ratio of Earnings to Fixed Charges.
  - 21.1 Subsidiaries of the Registrant.
  - 23.1 Consent of Ernst & Young LLP, Independent Registered Public Accounting Firm.
  - 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
  - 32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 

- (1) Incorporated by reference to the Registrant's Current Report on Form 8-K dated May 20, 2005.
- (2) Incorporated by reference to the Registrant's Registration Statement on Form S-11, Registration No. 333-116408.
- (3) Incorporated by reference to the Registrant's Current Report on Form 8-K dated August 1, 2005.
- (4) Incorporated by reference to the Registrant's Current Report on Form 8-K dated April 5, 2005.
- (5) Incorporated by reference to the Registrant's Registration Statement on Form S-11, Registration No. 333-119810.
- (6) Incorporated by reference to the Registrant's Current Report on Form 8-K dated December 7, 2005.
- (7) Incorporated by reference to the Registrant's Current Report on Form 8-K dated November 7, 2005.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SPIRIT FINANCE CORPORATION

Date: March 6, 2006

By:           /s/ CHRISTOPHER H. VOLK          

Christopher H. Volk  
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant in the capacities and on the dates indicated.

<b>Signature</b>	<b>Title</b>	<b>Date</b>
<u>          /s/ MORTON H. FLEISCHER          </u> Morton H. Fleischer	Chairman of the Board	March 6, 2006
<u>          /s/ CHRISTOPHER H. VOLK          </u> Christopher H. Volk	President, Chief Executive Officer and Director	March 6, 2006
<u>          /s/ CATHERINE LONG          </u> Catherine Long	Chief Financial Officer, Senior Vice President and Treasurer	March 6, 2006
<u>          /s/ CATHERINE L. STEVENSON          </u> Catherine L. Stevenson	Vice President and Controller	March 6, 2006
<u>          /s/ WILLIE R. BARNES          </u> Willie R. Barnes	Director	March 6, 2006
<u>          /s/ LINDA BLESSING          </u> Linda Blessing	Director	March 6, 2006
<u>          /s/ DENNIS E. MITCHEM          </u> Dennis E. Mitchem	Director	March 6, 2006
<u>          /s/ PAUL F. OREFFICE          </u> Paul F. Oreffice	Director	March 6, 2006



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<hr/> <i>/s/ JAMES R. PARISH</i> James R. Parish	Director	March 6, 2006
<hr/> <i>/s/ KENNETH B. ROATH</i> Kenneth B. Roath	Director	March 6, 2006
<hr/> <i>/s/ CASEY J. SYLLA</i> Casey J. Sylla	Director	March 6, 2006
<hr/> <i>/s/ SHELBY YASTROW</i> Shelby Yastrow	Director	March 6, 2006

## Spirit Finance Corporation

## Schedule III Real Estate Investments and Accumulated Depreciation

Initial Cost to Company and Gross Carrying Amount at  
December 31, 2005

Description (Note 1)	Encumbrances	Land and Improvements	Building and Improvements	Total (Note 4)	Accumulated Depreciation (Note 5)	Date Acquired
(Dollars in thousands)						
Birmingham, AL	Note 2	\$ 229	\$ 512	\$ 741	\$ (28)	2004
Birmingham, AL	Note 2	245	471	716	(24)	2004
Daphne, AL	Note 2	576	276	852	(13)	2004
Geneva, AL	Note 2	278	141	419	(10)	2004
Huntsville, AL	\$	2,722	5,153	7,875	(89)	2005
Huntsville, AL	Note 2	451	1,555	2,006	(71)	2004
Mobile, AL		522	464	986	(18)	2004
Mobile, AL		631	367	998	(15)	2004
Mobile, AL	Note 2	655	290	945	(13)	2004
Troy, AL	Note 2	357	440	797	(19)	2004
Bentonville, AR	Note 3	469	1,196	1,665	(18)	2005
Fort Smith, AR	Note 3	1,523	1,652	3,175	(15)	2005
Little Rock, AR	Note 3	532	1,391	1,923	(21)	2005
North Little Rock, AR	Note 3	1,659	1,312	2,971	(13)	2005
Tontitown, AR	Note 2	231	78	309	(10)	2004
Fountain Hills, AZ	Note 2	719	515	1,234	(28)	2004
Glendale, AZ		1,221	1,067	2,288	(50)	2004
Glendale, AZ	Note 2	1,270	547	1,817	(34)	2004
Goodyear, AZ	Note 3	3,780	4,820	8,600	(11)	2005
Mesa, AZ	Note 2	1,359	531	1,890	(35)	2004
Mesa, AZ	Note 2	787	789	1,576	(32)	2005
Phoenix, AZ	19,800	3,635	25,063	28,698	(382)	2005
Phoenix, AZ	7,820	2,432	8,871	11,303	(142)	2005
Phoenix, AZ	Note 2	2,372	10,043	12,415	(402)	2004
Phoenix, AZ	Note 2	8,568	24,466	33,034	(886)	2004
Phoenix, AZ	Note 2	1,671	1,585	3,256	(48)	2005
Phoenix, AZ	Note 2	1,517	3,404	4,921	(100)	2005
Tucson, AZ	Note 2	962	5,149	6,111	(130)	2005
Wilcox, AZ		354	559	913	(22)	2004
Covina, CA	17,772	2,978	22,001	24,979	(836)	2004
La Mesa, CA	Note 2	1,237	114	1,351	(12)	2004
Moreno Valley, CA		904	3,207	4,111	(100)	2004
Ontario, CA	10,528	10,623	4,617	15,240	(135)	2005
Reedley, CA	Note 3	1,437	3,842	5,279	(10)	2005
Riverside, CA	Note 2	1,058	5,764	6,822	(183)	2004
Aurora, CO	Note 2	853	819	1,672	(51)	2004
Colorado Springs, CO	Note 3	1,537	2,656	4,193	(23)	2005
Denver, CO	Note 3	615	702	1,317	(7)	2005
Ft. Collins, CO	Note 3	1,430	2,460	3,890	(21)	2005
Lakewood, CO	Note 3	926	1,113	2,039	(11)	2005
Lone Tree, CO	Note 3	1,895	3,145	5,040	(25)	2005
Apopka, FL	Note 2	965	152	1,117	(19)	2004
Apopka, FL	Note 2	698	323	1,021	(21)	2004
Brandon, FL	Note 3	2,394	1,565	3,959		2005
Casselberry, FL	Note 2	257	1,169	1,426	(51)	2004
Deerfield Beach, FL	Note 2	567	214	781	(14)	2004
Eustis, FL	Note 2	342	262	604	(10)	2004
Fort Lauderdale, FL	Note 2	468	119	587	(11)	2004
Fort Myers, FL	Note 2	1,010	582	1,592	(33)	2004
Fort Myers, FL	Note 2	809	946	1,755	(36)	2004
Fort Pierce, FL	Note 2	300	400	700	(21)	2004





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Gulf Breeze, FL	Note 2	373	419	792	(25)	2004
Jacksonville, FL	Note 2	382	523	905	(24)	2004
Jacksonville, FL	Note 2	702	799	1,501	(34)	2004
Jacksonville, FL	Note 2	731	299	1,030	(17)	2004
Jacksonville, FL	Note 2	399	488	887	(17)	2004
Jacksonville, FL	12,478	7,946	10,089	18,035	(187)	2005
Jacksonville, FL	Note 2	386	872	1,258	(46)	2004
Jacksonville, FL	Note 2	376	178	554	(10)	2004
Jacksonville, FL	Note 2	826	1,730	2,556	(56)	2004
Jacksonville, FL	Note 2	762	1,360	2,122	(54)	2004
Jacksonville, FL	Note 3	2,183	1,576	3,759		2005
Lakeland, FL	Note 2	1,160	1,302	2,462	(53)	2004
Leesburg, FL		402	113	515	(7)	2004
Mary Esther, FL	Note 2	549	369	918	(21)	2004
Miami, FL	Note 2	392	105	497	(7)	2004
Miami, FL	Note 2	425	144	569	(10)	2004
Ocala, FL	Note 2	418	672	1,090	(38)	2004
Orange City, FL	Note 2	381	640	1,021	(29)	2004
Orlando, FL	Note 2	1,011	408	1,419	(29)	2004
Orlando, FL	Note 2	356	181	537	(8)	2004
Pensacola, FL	Note 2	629	363	992	(22)	2004
Pompano Beach, FL	8,188	7,229	4,294	11,523	(97)	2005
Pompano Beach, FL	Note 2	966	415	1,381	(23)	2004
Port Richey, FL	Note 2	630	769	1,399	(32)	2004
Quincy, FL	Note 2	509	379	888	(30)	2004
Riviera Beach, FL	Note 2	444	195	639	(10)	2004
Saint Augustine, FL	Note 2	5,288	4,220	9,508	(500)	2003
Saint Cloud, FL	Note 2	739	607	1,346	(33)	2004
Sebring, FL	Note 2	470	926	1,396	(53)	2004
Sebring, FL	Note 2	245	360	605	(14)	2004
Tallahassee, FL	Note 2	303	51	354	(6)	2004
Tavares, FL	Note 2	890	4,701	5,591	(190)	2004
Winter Springs, FL	Note 2	499	155	654	(10)	2004
Alpharetta, GA	Note 2	2,167	1,325	3,492	(76)	2004
Alpharetta, GA	Note 2	3,405	1,071	4,476	(78)	2004
Athens, GA	Note 2	938	648	1,586	(29)	2004
Atlanta, GA	Note 2	3,858	273	4,131	(36)	2004
Blakely, GA	Note 2	158	288	446	(15)	2004
Brunswick, GA	Note 2	405	731	1,136	(28)	2004
Canton, GA	Note 2	2,470	284	2,754	(35)	2004
Carnesville, GA	Note 2	3,782	3,728	7,510	(401)	2003
Conyers, GA	Note 2	316	324	640	(13)	2004
Cumming, GA	Note 2	817	648	1,465	(31)	2004
East Ellijay, GA	Note 3	498	292	790		2005
Jonesboro, GA		676	761	1,437	(33)	2004
Lawrenceville, GA	Note 2	586	162	748	(12)	2004
Marietta, GA	Note 2	572	759	1,331	(34)	2004
Marietta, GA	Note 2	3,455	529	3,984	(53)	2004
Marietta, GA	Note 2	2,282	325	2,607	(34)	2004
Marietta, GA	Note 2	2,707	8,974	11,681	(320)	2004
McDonough, GA	Note 2	707	620	1,327	(29)	2004
Millen, GA	Note 2	143	1,667	1,810	(46)	2004

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Norcross, GA		551	1,052	1,603	(41)	2004
Snellville, GA	Note 2	844	611	1,455	(35)	2004
Statesboro, GA	Note 2	357	962	1,319	(33)	2004
Thomasville, GA	Note 2	414	1,936	2,350	(54)	2004
Tucker, GA		5,065	1,503	6,568	(6)	2005
Valdosta, GA	Note 2	760	267	1,027	(16)	2004
Valdosta, GA	Note 2	194	267	461	(10)	2004
Algona, IA	Note 2	51	262	313	(4)	2005
Burlington, IA	Note 3	215	401	616	(4)	2005
Burlington, IA	Note 3	258	350	608	(3)	2005
Cedar Rapids, IA	Note 2	2,429	4,884	7,313	(190)	2004
Clear Lake, IA	Note 2	244	418	662	(7)	2005
Clinton, IA	Note 3	402	521	923	(5)	2005
Cresco, IA	Note 2	131	427	558	(7)	2005
Creston, IA		93	197	290	(1)	2005
De Witt, IA	Note 3	229	464	693	(4)	2005
Decorah, IA	Note 3	139	114	253	(1)	2005
Des Moines, IA	Note 3	129	226	355	(2)	2005
Dubuque, IA	Note 3	399	178	577	(2)	2005
Dyersville, IA	Note 3	212	366	578	(4)	2005
Forest City, IA	Note 2	250	308	558	(8)	2005
Independence, IA	Note 3	178	345	523	(3)	2005
Johnston, IA	7,107	2,614	8,619	11,233	(358)	2004
Manchester, IA	Note 3	250	393	643	(4)	2005
Maquoketa, IA	Note 3	170	80	250	(1)	2005
Mason City, IA	Note 2	150	483	633	(8)	2005
Tipton, IA	Note 3	220	278	498	(3)	2005
Vinton, IA	Note 3	100	120	220	(2)	2005
Boise, ID	Note 2	837	532	1,369	(29)	2004
Garden City, ID		518	695	1,213	(23)	2004
Nampa, ID	Note 2	609	577	1,186	(20)	2004
Bolingbrook, IL	Note 3	573	744	1,317	(6)	2005
Burr Ridge, IL	Note 2	738	890	1,628	(52)	2004
Charleston, IL	Note 3	309	128	437	(1)	2005
Chicago, IL	Note 2	319	222	541	(4)	2005
Chicago, IL	Note 2	294	228	522	(5)	2005
Chicago, IL	Note 2	234	218	452	(5)	2005
Chicago, IL	Note 2	237	225	462	(5)	2005
Chicago, IL	Note 2	331	191	522	(5)	2005
Chicago, IL	Note 2	209	342	551	(7)	2005
Chicago, IL	Note 2	467	283	750	(6)	2005
Chicago, IL	Note 2	640	81	721	(3)	2005
Chicago, IL	Note 2	255	253	508	(5)	2005
Chicago, IL	Note 3	763	402	1,165	(3)	2005
Cicero, IL	Note 2	279	232	511	(5)	2005
Decatur, IL	Note 3	546	456	1,002	(5)	2005
East St. Louis, IL	Note 2	102	320	422	(6)	2005
Effingham, IL	Note 3	477	603	1,080	(5)	2005
Effingham, IL	Note 3	272	279	551	(3)	2005
Elmwood Park, IL	Note 3	742	267	1,009	(2)	2005
Gilman, IL	Note 3	278	391	669	(5)	2005
Gurnee, IL	Note 2	583	525	1,108	(29)	2004

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Harvey, IL	Note 2	355	246	601	(5)	2005
Joliet, IL	Note 2	205	207	412	(5)	2005
Lincoln, IL	Note 3	189	580	769	(5)	2005
Mattoon, IL	Note 2	226	266	492	(14)	2004
Pana, IL	Note 3	154	106	260	(1)	2005
Paxton, IL	Note 3	412	431	843		2005
Peoria, IL	Note 2	132	310	442	(6)	2005
Rock Falls, IL	Note 3	292	810	1,102	(7)	2005
Romeoville, IL	Note 3	1,101	281	1,382	(3)	2005
Salem, IL	Note 2	419		419		2004
Savanna, IL	Note 3	69	416	485	(3)	2005
Shelbyville, IL	Note 3	257	111	368	(2)	2005
Springfield, IL	Note 3	880	685	1,565	(7)	2005
Springfield, IL	Note 3	523	587	1,110	(6)	2005
Taylorville, IL	Note 3	135	290	425	(2)	2005
Vandalia, IL	Note 3	325	237	562	(4)	2005
Warrenville, IL	Note 3	2,307	3,234	5,541	(28)	2005
Washington Park, IL	Note 2	111	301	412	(6)	2005
Westmont, IL	Note 3	1,284	4,350	5,634		2005
Auburn, IN	Note 3	404	178	582	(3)	2005
Crawfordsville, IN	Note 3	436	543	979	(5)	2005
Evansville, IN	Note 2	563		563		2004
Fort Wayne, IN	Note 3	649	272	921	(3)	2005
Fort Wayne, IN	Note 3	6,828	5,245	12,073	(59)	2004
Ft. Wayne, IN	Note 3	1,023	2,141	3,164	(10)	2005
Gary, IN	Note 2	94	408	502	(7)	2005
Gary, IN	Note 2	179	332	511	(7)	2005
Gary, IN	Note 2	126	555	681	(10)	2005
Indianapolis, IN	Note 2	342	517	859	(21)	2004
Indianapolis, IN	Note 2	157	315	472	(6)	2005
Indianapolis, IN	Note 2	221	281	502	(6)	2005
Indianapolis, IN	Note 2	206	375	581	(7)	2005
Indianapolis, IN	Note 2	157	732	889	(12)	2005
Indianapolis, IN	Note 2	379	203	582	(6)	2005
Indianapolis, IN	Note 2	324	178	502	(5)	2005
Indianapolis, IN	Note 2	662	416	1,078	(18)	2004
Indianapolis, IN	Note 3	1,974	2,441	4,415	(12)	2005
Marion, IN	Note 2	336	310	646	(14)	2004
Mooreville, IN	Note 3	423	499	922	(5)	2005
New Albany, IN	Note 2	325	459	784	(22)	2004
North Vernon, IN	2,202	748	2,305	3,053	(56)	2005
Plymouth, IN	Note 3	1,129	946	2,075	(8)	2005
Spiceland, IN	Note 2	6,530	3,479	10,009	(648)	2003
Whitestown, IN	Note 2	222	87	309	(6)	2004
Emporia, KS	Note 2	301	787	1,088	(33)	2004
Leawood, KS	Note 3	1,764	3,277	5,041	(27)	2005
Overland Park, KS	Note 3	5,274	12,226	17,500	(30)	2005
Wichita, KS	Note 2	965	1,806	2,771	(72)	2004
Bowling Green, KY	Note 2	152	212	364	(8)	2004
Catlettsburg, KY	Note 2	5,834	4,675	10,509	(563)	2003
Florence, KY	Note 2	462	176	638	(15)	2004
Lexington, KY	Note 2	409	306	715	(13)	2004

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Lexington, KY	Note 2	502	242	744	(9)	2005
Louisville, KY		318	265	583	(11)	2004
Louisville, KY	Note 2	404	329	733	(12)	2004
Louisville, KY	Note 3	760	684	1,444	(4)	2005
Louisville, KY	Note 3	457	471	928	(3)	2005
Louisville, KY	Note 3	720	448	1,168	(3)	2005
Madisonville, KY	Note 2	389	1,270	1,659	(49)	2004
Mayfield, KY	Note 2	146	256	402	(18)	2004
Owensboro, KY	Note 2	606		606		2004
Baker, LA	Note 2	186	530	716	(22)	2004
Baker, LA	Note 2	261	349	610	(19)	2004
Baton Rouge, LA	Note 2	543	370	913	(24)	2004
Baton Rouge, LA	Note 2	508	239	747	(18)	2004
Baton Rouge, LA	Note 2	321	333	654	(21)	2004
Baton Rouge, LA	Note 2	608	557	1,165	(28)	2004
Baton Rouge, LA	Note 2	698	282	980	(25)	2004
Baton Rouge, LA	Note 2	367	594	961	(29)	2004
Baton Rouge, LA	Note 2	451	476	927	(27)	2004
Baton Rouge, LA		297	538	835	(27)	2004
Denham Springs, LA	Note 2	414	500	914	(26)	2004
New Orleans, LA	Note 2	337	310	647	(18)	2004
New Orleans, LA	Note 2	271	239	510	(14)	2004
Pineville, LA	Note 2	476	917	1,393	(43)	2004
Port Allen, LA	Note 2	515	476	991	(31)	2004
Cummington, MA	Note 3	936	4,502	5,438	(10)	2005
West Harwich, MA	Note 2	623	156	779	(22)	2004
Worcester, MA	8,500	2,376	9,267	11,643		2005
Allegan, MI		128	467	595		2005
Alpena, MI		236	2,402	2,638	(50)	2004
Canton, MI	Note 2	1,954	1,056	3,010	(68)	2004
Detroit, MI	Note 2	382	179	561	(4)	2005
Detroit, MI	Note 2	307	235	542	(5)	2005
Detroit, MI	Note 2	403	218	621	(5)	2005
Detroit, MI	Note 2	387	234	621	(5)	2005
Detroit, MI	Note 2	262	240	502	(5)	2005
Detroit, MI	Note 2	248	283	531	(5)	2005
Detroit, MI	Note 2	261	151	412	(4)	2005
Detroit, MI	Note 2	333	288	621	(6)	2005
Detroit, MI	Note 2	412	180	592	(4)	2005
Edmore, MI		127	419	546	(6)	2005
Escanaba, MI	Note 3	618	766	1,384		2005
Farwell, MI		99	503	602		2005
Flint, MI	Note 2	276	285	561	(6)	2005
Flint, MI	Note 2	640	5,827	6,467	(189)	2004
Fraser, MI	5,550	1,798	6,329	8,127	(122)	2005
Green Oak, MI	1,166	462	1,238	1,700	(28)	2005
Livonia, MI	1,425	1,233	848	2,081	(22)	2005
Lowell, MI	Note 3	337	300	637	(4)	2005
Mason, MI		356	931	1,287		2005
Middleville, MI	2,331	414	2,889	3,303	(57)	2005
Monroe, MI	Note 3	1,447	14,681	16,128	(32)	2005
Mount Pleasant, MI	Note 3	437	535	972		2005

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St. Clair Shores, MI	Note 2	1,106	571	1,677	(11)	2005
Stanton, MI		56	482	538		2005
Sterling Heights, MI	Note 3	555	1,030	1,585		2005
Warren, MI	Note 2	455	216	671	(5)	2005
Westland, MI	Note 2	1,645	2,255	3,900	(63)	2005
Albert Lea, MN	Note 2	339	398	737	(8)	2005
Apple Valley, MN	Note 2	912	974	1,886	(44)	2004
Buffalo, MN	Note 2	156	317	473	(6)	2005
Cloquet, MN	Note 2	330	275	605	(6)	2005
Columbia Heights, MN	Note 2	227	217	444	(4)	2005
Coon Rapids, MN	Note 2	1,071	625	1,696	(38)	2004
Crystal, MN	Note 2	168	267	435	(5)	2005
Duluth, MN	Note 2	58	500	558	(7)	2005
Duluth, MN	Note 2	254	313	567	(5)	2005
Eagan, MN	Note 2	486	524	1,010	(10)	2005
Eden Prairie, MN	Note 2	956	549	1,505	(31)	2004
Elk River, MN	Note 2	332	292	624	(6)	2005
Ely, MN	Note 2	57	340	397	(5)	2005
Fergus Falls, MN		246	830	1,076		2005
Grand Rapids, MN	Note 2	132	473	605	(7)	2005
Hermantown, MN	Note 2	1,957	7,647	9,604	(167)	2005
Hibbing, MN	Note 2	239	356	595	(7)	2005
Hutchinson, MN	Note 2	358	284	642	(6)	2005
Lakeville, MN	Note 2	283	548	831	(9)	2005
Maple Grove, MN	Note 2	951	553	1,504	(31)	2004
Maple Grove, MN	Note 2	1,643	975	2,618	(54)	2004
Maplewood, MN	Note 2	157	335	492	(6)	2005
Marshall, MN	Note 2	97	320	417	(6)	2005
Minneapolis, MN	Note 2	164	262	426	(4)	2005
New Hope, MN	Note 2	244	200	444	(4)	2005
Rochester, MN	Note 2	269	458	727	(9)	2005
Rochester, MN	Note 3		534	534	(3)	2005
Rosemount, MN	Note 2	428	366	794	(7)	2005
Sauk Centre, MN	Note 2	171	208	379	(4)	2005
Sauk Rapids, MN	Note 2	203	185	388	(4)	2005
Shakopee, MN	Note 2	280	428	708	(8)	2005
Stillwater, MN	Note 2	1,071	967	2,038	(59)	2004
Two Harbors, MN	Note 2	125	310	435	(5)	2005
Virginia, MN	Note 2	272	437	709	(8)	2005
Woodbury, MN	Note 2	474	503	977	(11)	2005
Blue Springs, MO	Note 3		665	665	(4)	2005
Branson, MO	Note 3	1,333	2,148	3,481	(18)	2005
Ferguson, MO	Note 2	349	113	462	(4)	2005
Jefferson City, MO	Note 3	380	131	511	(2)	2005
Kansas City, MO	Note 2	1,950	6,050	8,000	(246)	2004
Lees Summit, MO	Note 2	2,470	7,630	10,100	(304)	2004
Lees Summit, MO	Note 3		600	600	(4)	2005
Maplewood, MO	Note 2	196	167	363	(4)	2005
Normandy, MO	Note 2	236	316	552	(7)	2005
Overland, MO	Note 2	197	583	780	(10)	2005
Saint Ann, MO	Note 3	482	579	1,061	(6)	2005
Saint Louis, MO	Note 2	813	367	1,180	(25)	2004

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Saint Louis, MO	Note 2	434	617	1,051	(27)	2004
Saint Louis, MO	Note 2	436	549	985	(25)	2004
Springfield, MO	Note 3	1,694	1,685	3,379	(16)	2005
St. Charles, MO	Note 3	1,724	958	2,682	(11)	2005
St. Louis, MO	Note 2	279	202	481	(5)	2005
St. Louis, MO	Note 2	185	347	532	(6)	2005
St. Louis, MO	Note 2	176	226	402	(5)	2005
St. Louis, MO	Note 2	419	212	631	(6)	2005
Columbus, MS	Note 2	223	280	503	(16)	2004
DIberville, MS	Note 2	187	408	595	(14)	2004
Gulfport, MS	Note 2	603	418	1,021	(20)	2004
Gulfport, MS	Note 2	185	499	684	(17)	2004
Hattiesburg, MS	Note 2	237	563	800	(20)	2004
Jackson, MS	Note 2	474	2,576	3,050	(65)	2005
Moss Point, MS	Note 2	342	275	617	(13)	2004
Tupelo, MS		139	259	398	(11)	2004
Great Falls, MT	Note 2	1,174	3,570	4,744	(169)	2004
Miles City, MT		443	692	1,135		2005
Missoula, MT	3,072	2,062	2,824	4,886	(131)	2004
Durham, NC	Note 3	2,037	2,514	4,551	(23)	2005
Greensboro, NC	Note 3	2,710	2,213	4,923	(20)	2005
Hendersonville, NC	Note 3	556	2,074	2,630	(5)	2005
Hickory, NC	Note 2	174	297	471	(11)	2004
Morganton, NC		419	620	1,039	(25)	2004
New Bern, NC	Note 2	608	411	1,019	(24)	2004
Pineville, NC		365	764	1,129	(26)	2004
Raleigh, NC	7,467	3,407	8,481	11,888	(367)	2004
Raleigh, NC	Note 2	518	368	886	(21)	2004
Stateville, NC	Note 2	230	732	962	(24)	2004
Wilmington, NC	Note 2	384	95	479	(11)	2004
Wilmington, NC	Note 3	1,500	3,029	4,529	(21)	2005
Winston-Salem, NC		1,510	2,036	3,546	(12)	2005
Fargo, ND	Note 2	2,118	6,212	8,330	(200)	2004
Grand Forks, ND		421	831	1,252		2005
Omaha, NE	Note 3	416	373	789	(4)	2005
West Caldwell, NJ	Note 2	421	288	709	(19)	2004
Albuquerque, NM	Note 2	644		644		2004
Albuquerque, NM	Note 2	286	1,215	1,501	(32)	2004
Albuquerque, NM	Note 2	939	1,763	2,702	(58)	2004
Roswell, NM	Note 2	893	2,819	3,712	(113)	2004
Battle Mountain, NV		257	302	559	(2)	2005
Battle Mountain, NV		923	1,609	2,532	(12)	2005
Carson City, NV		2,172	1,072	3,244	(8)	2005
Carson City, NV		1,612	548	2,160	(4)	2005
Carson City, NV		501		501		2005
Carson City, NV		499	53	552	(1)	2005
Elko, NV		501		501		2005
Elko, NV		501		501		2005
Elko, NV		488	65	553	(1)	2005
Fallon, NV		435	122	557	(2)	2005
Gardnerville, NV		865	1,017	1,882	(7)	2005
Lovelock, NV		481	72	553	(1)	2005

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Minden, NV		502	50	552	(1)	2005
Reno, NV		1,291	1,568	2,859	(12)	2005
Reno, NV		501		501		2005
Reno, NV		3,064	1,503	4,567	(11)	2005
Reno, NV		895	546	1,441	(4)	2005
Reno, NV		2,631	1,299	3,930	(9)	2005
Reno, NV		1,242	1,030	2,272	(7)	2005
Reno, NV		1,279	7,372	8,651		2005
Sparks, NV		1,909	1,043	2,952	(8)	2005
Sparks, NV		1,209	362	1,571	(3)	2005
Sparks, NV		1,238	563	1,801	(4)	2005
Sparks, NV		2,028	619	2,647	(5)	2005
Wells, NV		402	156	558	(3)	2005
Buffalo, NY	Note 2	409	939	1,348	(26)	2004
Buffalo, NY	Note 3	557	621	1,178	(3)	2005
Buffalo, NY	Note 3	622	983	1,605	(5)	2005
Cheektowaga, NY	Note 3	464	494	958	(3)	2005
Cicero, NY	Note 2	2,837	5,819	8,656	(203)	2004
Colonie, NY	Note 2	666	649	1,315	(31)	2004
East Aurora, NY	Note 3	354	529	883	(3)	2005
Evans, NY	Note 3	455	297	752	(2)	2005
Jamestown, NY	Note 3	348	569	917	(3)	2005
New Hartford, NY	Note 2	2,257	4,775	7,032	(222)	2004
Niagara Falls, NY	Note 3	1,036	754	1,790	(5)	2005
Oneida, NY	Note 2	1,072	1,282	2,354	(36)	2004
Springville, NY	Note 3	513	543	1,056	(3)	2005
Utica, NY	Note 2	452	598	1,050	(31)	2004
Akron, OH	Note 2	876	191	1,067	(24)	2004
Akron, OH	Note 2	221	210	431	(5)	2005
Akron, OH	Note 2	176	286	462	(5)	2005
Akron, OH	Note 2	274	427	701	(8)	2005
Akron, OH		468	513	981	(3)	2005
Canal Fulton, OH	1,554	915	1,351	2,266	(39)	2005
Canton, OH	Note 2	168	532	700	(9)	2005
Cincinnati, OH	Note 2	829	519	1,348	(31)	2004
Columbus, OH	Note 2	576	580	1,156	(32)	2004
Columbus, OH	Note 2	564	496	1,060	(25)	2004
Columbus, OH	Note 2	630	575	1,205	(29)	2004
Columbus, OH	Note 2	689	564	1,253	(29)	2004
Columbus, OH	Note 2	747	769	1,516	(34)	2004
Columbus, OH		590	5,455	6,045	(154)	2004
Columbus, OH		1,295	3,594	4,889	(102)	2004
Columbus, OH	Note 2	225	376	601	(7)	2005
Columbus, OH	Note 2	237	305	542	(6)	2005
Dayton, OH	Note 2	2,048	612	2,660	(35)	2004
Edon, OH	Note 2	529	421	950	(26)	2004
Fairborn, OH	Note 2	843	333	1,176	(25)	2004
Hilliard, OH	Note 2	869	1,409	2,278	(63)	2004
Lewis Center, OH	Note 2	567	489	1,056	(28)	2004
Lima, OH		508	379	887	(3)	2005
Mansfield, OH	Note 2	202	329	531	(6)	2005
Mason, OH	Note 2	718	534	1,252	(31)	2004



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Maumee, OH	Note 2	1,242	1,858	3,100	(87)	2004
Sidney, OH	Note 3	923	3,984	4,907		2005
Uhrichsville, OH	Note 2	242	2,198	2,440	(61)	2004
Zanesville, OH	Note 3	334	874	1,208	(7)	2005
Ada, OK	Note 3	315	291	606	(3)	2005
Bixby, OK	Note 2	4,350	8,150	12,500	(275)	2004
Chickasa, OK	Note 3	411	815	1,226	(7)	2005
Edmond, OK	Note 3	1,179	464	1,643	(6)	2005
Madill, OK	Note 2	168	214	382	(16)	2004
Shawnee, OK	Note 3	371	1,104	1,475	(15)	2005
Tulsa, OK	Note 2	157	498	655	(15)	2004
Tulsa, OK	Note 3	876	633	1,509		2005
Yukon, OK	Note 2	502	348	850	(22)	2004
Portland, OR		661	524	1,185	(24)	2004
Prineville, OR	Note 3	480	4,083	4,563		2005
Salem, OR	Note 3	594	2,392	2,986	(6)	2005
Salem, OR	Note 3	1,019	4,916	5,935	(11)	2005
Salem, OR	Note 3	805	4,307	5,112	(10)	2005
Salem, OR	Note 3	829	3,597	4,426	(8)	2005
Salem, OR	Note 3	1,032	3,531	4,563	(8)	2005
Carlisle, PA	Note 2	630	1,032	1,662	(53)	2004
Mars, PA	Note 2	481	2,449	2,930	(109)	2004
Philadelphia, PA	Note 2	552	986	1,538	(28)	2004
Philadelphia, PA	Note 2	1,324	1,982	3,306	(47)	2005
Pittsburgh, PA	Note 2	1,028	2,182	3,210	(94)	2004
Tannersville, PA	Note 3	10,265	37,807	48,072	(1,433)	2005
Aiken, SC	Note 2	120	265	385	(8)	2004
Columbia, SC	Note 3	2,288	2,239	4,527	(17)	2005
Florence, SC	Note 2	229	179	408	(10)	2004
Forest Acres, SC	15,500	2,036	19,289	21,325	(161)	2005
Greenville, SC	Note 2	378	192	570	(11)	2004
Greenville, SC	Note 3	2,183	1,576	3,759		2005
Greer, SC	Note 2	388	112	500	(9)	2004
Moncks Corner, SC	Note 2	452	399	851	(21)	2004
Rock Hill, SC	Note 3	365	641	1,006		2005
West Columbia, SC	Note 2	300	132	432	(8)	2004
West Columbia, SC	Note 2	265	595	860	(20)	2004
Alcoa, TN	Note 3	250	443	693	(4)	2005
Athens, TN	Note 2	322	623	945	(34)	2004
Athens, TN	Note 3	612	390	1,002		2005
Bristol, TN	Note 2	382	131	513	(14)	2004
Chattanooga, TN		327	575	902	(26)	2004
Clinton, TN	Note 2	401	112	513	(14)	2004
Crossville, TN	Note 3	307	489	796	(5)	2005
Elizabethton, TN	Note 2	456	98	554	(12)	2004
Erwin, TN	Note 2	271	216	487	(15)	2004
Greenville, TN	Note 3	260	443	703	(4)	2005
Harriman, TN	Note 3	334	659	993	(6)	2005
Jackson, TN	Note 2	194	218	412	(9)	2004
Kingsport, TN	Note 2	445	185	630	(19)	2004
Knoxville, TN	Note 2	246	119	365	(8)	2004
Knoxville, TN	Note 2	510	225	735	(18)	2004

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Knoxville, TN	Note 2	616	180	796	(18)	2004
Knoxville, TN	Note 2	457	135	592	(13)	2004
Knoxville, TN	Note 3	454	135	589	(2)	2005
Knoxville, TN	Note 3	270	348	618	(4)	2005
Knoxville, TN	Note 3	300	300	600	(3)	2005
Knoxville, TN	Note 3	458	544	1,002	(5)	2005
Lenoir City, TN	Note 3	594	240	834	(3)	2005
Maryville, TN	Note 2	399	128	527	(15)	2004
Maryville, TN	Note 2	606	135	741	(11)	2004
Milan, TN		130	431	561		2005
Morristown, TN	Note 3	475	1,073	1,548	(10)	2005
Morristown, TN	Note 3	354	498	852	(5)	2005
Oak Ridge, TN	Note 2	344	645	989	(32)	2004
Oak Ridge, TN	Note 2	417	225	642	(18)	2004
Oak Ridge, TN	Note 3	523	855	1,378	(8)	2005
Red Bank, TN	Note 2	523	506	1,029	(36)	2004
Abilene, TX	Note 2	1,105	2,837	3,942	(47)	2005
Addison, TX	Note 2	1,277	2,737	4,014	(99)	2004
Alvin, TX	Note 2	307	520	827	(17)	2004
Amarillo, TX	2,211	827	2,047	2,874	(46)	2005
Amarillo, TX	6,143	1,639	6,256	7,895	(129)	2005
Amarillo, TX	2,156	968	1,844	2,812	(51)	2005
Amarillo, TX	2,203	584	2,275	2,859	(46)	2005
Amarillo, TX	Note 2	447	403	850	(23)	2004
Arlington, TX	Note 2	2,006	1,998	4,004	(76)	2004
Arlington, TX	Note 3	1,816	2,090	3,906	(20)	2005
Austin, TX	Note 2	735	864	1,599	(44)	2004
Austin, TX	8,195	3,656	7,033	10,689	(55)	2005
Austin, TX		1,750		1,750		2005
Bryan, TX	Note 2	564	844	1,408	(26)	2004
Bryan, TX	Note 2	319	450	769	(30)	2004
Burkburnett, TX	3,474	939	3,512	4,451	(73)	2005
Childress, TX	813	522	565	1,087	(21)	2005
Cleveland, TX	1,558	286	1,909	2,195	(4)	2005
Conroe, TX	Note 2	409	786	1,195	(31)	2004
Conroe, TX	5,701	2,656	5,959	8,615	(44)	2005
Copperas Cove, TX	Note 2	492	490	982	(19)	2004
Corrigan, TX	810	214	935	1,149	(2)	2005
Dallas, TX	Note 2	1,072	374	1,446	(17)	2004
Dallas, TX	Note 2	1,487	1,426	2,913	(54)	2004
Dallas, TX	Note 3	1,444	19,113	20,557	(167)	2005
Denison, TX	Note 2	266	584	850	(26)	2004
Diboll, TX	1,059	434	1,098	1,532	(3)	2005
Eagle Pass, TX	Note 2	891	2,195	3,086	(50)	2005
Edinburg, TX	Note 2	1,000	2,020	3,020	(47)	2005
El Paso, TX	Note 2	614	1,658	2,272	(35)	2005
El Paso, TX	Note 2	1,464	3,328	4,792	(110)	2004
Fort Worth, TX	5,344	2,162	5,700	7,862	(42)	2005
Granbury, TX	Note 2	1,068	2,042	3,110	(50)	2005
Grapevine, TX	5,344	2,207	5,718	7,925	(42)	2005
Greenville, TX	Note 3	200	358	558		2005
Houston, TX	Note 2	1,723	699	2,422	(39)	2004

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Houston, TX	Note 2	877	675	1,552	(47)	2004
Houston, TX	Note 2	1,134	684	1,818	(45)	2004
Houston, TX	Note 2	930	718	1,648	(46)	2004
Houston, TX		575	351	926	(14)	2004
Houston, TX	Note 2	677	342	1,019	(13)	2004
Houston, TX	Note 3	2,203	3,984	6,187	(70)	2005
Kingwood, TX	Note 2	888	736	1,624	(47)	2004
Lake Jackson, TX	Note 2	906	2,365	3,271	(49)	2005
Levelland, TX	2,851	953	2,738	3,691	(63)	2005
Lewisville, TX	4,632	1,768	4,966	6,734	(36)	2005
Live Oak, TX	Note 2	1,738	4,490	6,228	(176)	2004
Longview, TX	Note 3	1,495	3,078	4,573	(25)	2005
Lubbock, TX	Note 2	391	641	1,032	(21)	2004
Lubbock, TX	2,874	1,125	2,614	3,739	(63)	2005
Lubbock, TX	Note 3	504	1,164	1,668	(18)	2005
Lubbock, TX	Note 2	408	442	850	(25)	2004
Lufkin, TX	997	549	840	1,389	(3)	2005
Novasota, TX	1,433	77	1,935	2,012	(4)	2005
Pasadena, TX	Note 2	526	929	1,455	(28)	2004
Pasadena, TX	Note 2	1,123	333	1,456	(15)	2004
Pasadena, TX		514	419	933	(19)	2004
Perryton, TX	955	816	458	1,274	(28)	2005
Plainview, TX	4,785	714	5,092	5,806	(46)	2005
Plano, TX	6,413	2,860	6,653	9,513	(48)	2005
Rio Grande City, TX	Note 2	604	1,284	1,888	(32)	2005
San Antonio, TX	Note 3	1,808	5,092	6,900	(75)	2005
Snyder, TX	3,814	658	4,229	4,887	(75)	2005
Timpson, TX	374	257	270	527	(1)	2005
Tyler, TX	Note 2	399	1,066	1,465	(48)	2004
Vernon, TX	3,182	817	3,271	4,088	(67)	2005
Waco, TX	Note 2	331	370	701	(18)	2004
Weslaco, TX	Note 2	830	2,126	2,956	(49)	2005
Wichita Falls, TX	4,525		5,835	5,835	(85)	2005
American Fork, UT	Note 2	884	433	1,317	(24)	2004
Sandy, UT	Note 2	760	820	1,580	(43)	2004
Tooele, UT	Note 2	443	524	967	(27)	2004
Chesapeake, VA	Note 2	784	477	1,261	(35)	2004
Christiansburg, VA	Note 2	512	151	663	(17)	2004
Midlothian, VA	7,799	6,363	4,961	11,324	(112)	2005
Newport News, VA	Note 2	906	500	1,406	(38)	2004
Pulaski, VA	Note 2	360	214	574	(18)	2004
Radford, VA	Note 2	383	220	603	(21)	2004
Roanoke, VA	Note 2	282	187	469	(10)	2004
Wytheville, VA	Note 2	357	149	506	(13)	2004
Colchester, VT	Note 2	832	823	1,655	(42)	2004
Manchester Center, VT	Note 3	912	4,479	5,391	(11)	2005
Spokane, WA	Note 2	513	204	717	(16)	2004
DePere, WI	Note 2	1,668	3,903	5,571	(110)	2005
Eau Claire, WI	Note 2	1,572	7,019	8,591	(145)	2005
Glendale, WI		675	45	720	(3)	2005
Grand Chute, WI	2,489	1,667	2,195	3,862	(37)	2005
Greenfield, WI		351	363	714	(3)	2005

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Greenfield, WI		343	424	767	(4)	2005
Kenosha, WI	Note 2	3,081	7,692	10,773	(288)	2004
Menasha, WI	Note 3		469	469	(3)	2005
Oshkosh, WI	Note 3	718	580	1,298		2005
Sturtevant, WI	Note 3	494	534	1,028		2005
Superior, WI	Note 2	244	624	868	(10)	2005
Martinsburg, WV	Note 2	109	98	207	(5)	2004
Martinsburg, WV	Note 3	2,241	3,117	5,358	(27)	2005
Martinsburg, WV	Note 3	572	934	1,506		2005
Moundsville, WV	Note 2	254	1,194	1,448	(33)	2004
Miscellaneous Real Estate Investments		11,709	1,694	13,403	(9)	2005
		<u>\$ 224,594</u>	<u>\$ 524,196</u>	<u>\$ 881,386</u>	<u>\$ 1,405,582</u>	<u>\$ (22,729)</u>

- (1) All properties are free standing, single tenant real estate properties that are leased to retail, distribution and service-oriented companies operating in various industries.
- (2) Assets listed above with an aggregate real estate carrying amount totaling \$590.6 million were pledged as collateral against \$438.1 million in borrowings outstanding under the Company's net-lease mortgage notes payable at December 31, 2005.
- (3) Assets listed above with an aggregate real estate carrying amount totaling \$368.0 million were pledged as collateral against \$229.9 million in borrowings outstanding under the Company's secured credit facilities at December 31, 2005.
- (4) At December 31, 2005, the book basis of net assets, including the related lease intangibles, exceeded the tax basis by approximately \$39 million.
- (5) Depreciation is generally computed using the straight-line method over an estimated useful life of 40 years for buildings and 20 years for land improvements.

The following table presents a reconciliation of real estate investment transactions (excluding related lease intangibles) from the date of inception through December 31, 2005 (dollars in thousands):

	Real Estate Investments		
	Number of Owned Properties	Cost	Accumulated Depreciation
<b>2003 Activity:</b>			
Acquisitions from date of inception (August 14, 2003) and balance at December 31, 2003(a)	4	\$ 37,531	\$
<b>2004 Activity:</b>			
Acquisitions(a)	307	584,429	
Depreciation			(4,320)
Sales	(4)	(5,916)	17
Balance, December 31, 2004	307	616,044	(4,303)
<b>2005 Activity:</b>			
Acquisitions	325	845,643	
Depreciation			(19,090)
Sales	(43)	(56,105)	664
Balance, December 31, 2005	589	\$ 1,405,582	\$ (22,729)

(a)

See Note 13 to the Consolidated Financial Statements for a description of related party transactions.

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## EXHIBIT INDEX

Exhibit No.	Description
3.1	Articles of Amendment and Restatement.(1)
3.2	Bylaws.(2)
4.1	Form of Common Stock Certificate.(2)
4.2	Master Indenture dated as of July 26, 2005, between Spirit Master Funding, LLC and Citibank, N.A., as indenture trustee.(3)
4.3	Series 2005-1 Indenture Supplement dated as of July 26, 2005, between Spirit Master Funding, LLC and Citibank, N.A., as indenture trustee.(3)
10.1	Amended and Restated Employment Agreement between the Registrant and Morton H. Fleischer.
10.2	Amended and Restated Employment Agreement between the Registrant and Christopher H. Volk.
10.3	Employment Agreement between the Registrant and Catherine F. Long.(2)
10.4	Employment Agreement between the Registrant and Jeffrey M. Fleischer.(2)
10.5	Employment Agreement between the Registrant and Gregg A. Seibert.(2)
10.6	Employment Agreement between the Registrant and Michael T. Bennett.(4)
10.7	Amended and Restated Spirit Finance Corporation 2003 Stock Option and Incentive Plan.(1)
10.8	Stockholder Agreement between the Registrant and Spirit Finance Holdings, LLC dated as of October 15, 2003.(2)
10.9	Master Lease Agreement dated as of December 23, 2003 between the Registrant and Flying J Inc.(5)
10.10	Master Repurchase Agreement among Bank of America Mortgage Capital Corporation, Spirit Funding Company, LLC and the Registrant dated as of August 9, 2004.(2)
10.11	Amended and Restated Master Repurchase Agreement between Citigroup Global Markets Realty Corp. and the Registrant dated as of December 7, 2005.(6)
10.12	Master Repurchase Agreement among the Registrant and Alpine Securitization Corp., Credit Suisse, New York Branch, as buyers, and Credit Suisse, New York Branch, as agent for the buyers, dated as of November 7, 2005.(7)
10.13	Second Amended and Restated Servicing Agreement Dated as of August 9, 2004 between the Registrant and Midland Loan Services, Inc.(2)
10.14	Property Management and Servicing Agreement dated as of July 26, 2005, among Spirit Master Funding, LLC, Spirit Finance Corporation and Midland Loan Services, Inc.(3)
12.1	Computation of Ratio of Earnings to Fixed Charges.
21.1	Subsidiaries of the Registrant.
23.1	Consent of Ernst & Young LLP, Independent Registered Public Accounting Firm.
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

- (1) Incorporated by reference to the Registrant's Current Report on Form 8-K dated May 20, 2005.
- (2) Incorporated by reference to the Registrant's Registration Statement on Form S-11, Registration No. 333-116408.
- (3) Incorporated by reference to the Registrant's Current Report on Form 8-K dated August 1, 2005.
- (4)

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Incorporated by reference to the Registrant's Current Report on Form 8-K dated April 5, 2005.

- (5) Incorporated by reference to the Registrant's Registration Statement on Form S-11, Registration No. 333-119810.
  - (6) Incorporated by reference to the Registrant's Current Report on Form 8-K dated December 7, 2005.
  - (7) Incorporated by reference to the Registrant's Current Report on Form 8-K dated November 7, 2005.
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