SPIRIT FINANCE CORP
Form 10-K
March 01, 2007

United States
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2006

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

For the transition period from ____________ to____________

Commission file number: 01-32386

SPIRIT FINANCE CORPORATION

(Exact name of registrant as specified in its charter)

Maryland	**20-0175773**
(State of incorporation)	(I.R.S. Employer Identification No.)
14631 N. Scottsdale Road, Suite 200	
Scottsdale, Arizona	**85254**
(Address of Principal Executive Offices)	(Zip Code)

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

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

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

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x   No o

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

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

Large accelerated filer x   Accelerated filer o   Non-accelerated filer o

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

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

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

DOCUMENTS INCORPORATED BY REFERENCE

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

PART I

Item 1. Business

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

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

Overview

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

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

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

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

Business Developments

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

- We expanded our real estate investment portfolio by $1.4 billion in 2006, a gross increase of 62% over our prior year investment activity. At December 31, 2006, our investment portfolio was over $2.8 billion, nearly doubling the size of our investment portfolio since December 31, 2005. Acquisitions during 2006 included the acquisition of 178 real estate properties from SKO Group Holding Corp. (SKO) through a purchase of ShopKo Stores, Inc., where we entered into long-term triple-net master lease arrangements with subsidiaries of SKO for these general merchandise retail locations operating under the ShopKo and Pamida names at the time of acquisition this was the largest single retail sale-leaseback transaction in U.S. history.

- We built a pipeline of targeted potential investment opportunities that has consistently exceeded $2 billion since the end of 2005, which forms the basis for our strategic initiatives in 2007.

- In March 2006, we issued $301.8 million aggregate principal amount of net-lease mortgage notes payable. This was the second issuance under our master funding debt program. Under this program, we match-fund our cash flows for fifteen years on a diverse pool of our real estate assets aggregating $1.1 billion at December 31, 2006. We are able to add collateral to the pool in the future and issue new notes secured by an increasing collateral pool of properties.

- In October, we obtained a $400 million short-term, variable-rate secured credit facility that replaced other expiring facilities. In conjunction with the acquisition of real estate, we also entered into new long-term, fixed-rate commercial mortgage financing arrangements totaling over $700 million during 2006. At December 31, 2006, our total fixed-rate debt, including the net-lease mortgage notes, had a weighted average stated interest rate of 6.1%.

- At December 31, 2006, we had match-funded 83% of our long-term, fixed-rate real estate investment portfolio with long-term, fixed-rate debt and had hedged an additional $199.5 million of long-term debt expected to be issued in early 2007.

- We completed public offerings aggregating approximately 39.5 million shares of common stock, which raised $428 million in net equity proceeds. Including these common stock offerings, our gross equity proceeds raised since inception totals over $1.1 billion.

- We generated net income of $52 million and declared dividends of $0.85 per common share. As a result, we generated an annual total return to stockholders (distributions plus stock price appreciation) of 18.2%, including the reinvestment of dividends, during 2006.

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

Our core strengths include:

- Experienced management team with a clear vision of how the company should operate for the mutual benefit of our stockholders and customers;

- Demonstrated capacity to originate investments which are accretive to our funds from operations;

- Proven credit and investment evaluation techniques and methods that focus on real estate unit-level cash flows, tenant corporate credit discipline, real estate fundamentals and tenant management depth and experience;

- A highly efficient, scalable operating business model with state-of-the-art servicing and reporting capability; and

- Structured finance expertise and an effective liability strategy that provides greater operational flexibility for both Spirit Finance and our customers.

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

Real Estate Investment Portfolio

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

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

Our real estate properties are leased to our customers under long-term operating leases that typically include one or more renewal options. The weighted average remaining noncancelable lease term at December 31, 2006 was approximately 16 years. The leases are generally triple-net, which provides that the lessee is responsible for the payment of all property operating expenses, including insurance, real estate taxes and repairs and maintenance; therefore, we generally are not responsible for repairs and are not required to make other significant capital expenditures on our properties.

Business and Investment Strategy

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Product Lines

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

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

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

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

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

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

Competition

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

We believe that we have the following competitive advantages:

- *Experienced Management.* Our senior management team has over 100 years of combined experience in the real estate investment and finance business and has a track record in the origination and management of single tenant, commercial real estate assets since 1980. Our strategy for generating attractive returns on our real estate investments combines our ability to originate, underwrite, structure and close accretive transactions, with an efficient servicing function designed to actively monitor our portfolio.

- *Flexibility.* Owners of single tenant, operationally essential real estate require flexibility that permits them to efficiently operate their businesses over a long period of time. We offer our customers lease terms that provide operating flexibility and the potential for lease modifications. This operating flexibility might include the ability to substitute real estate locations in the event a business is sold or a tenant determines that a location is no longer strategic. It might also include the ability to sell, sublease or improve a property at a later date with financing provided by us.

- *Financing Options.* We provide our clients with the convenience of having a one-stop shop for real estate financing needs, by offering sale-leaseback transactions and mortgage loans, and, where appropriate, unsecured corporate loans and construction and equipment financing.

- *Strong Industry Relationships.* Our industry and financial institution relationships provide us with the ability to source and selectively choose real estate investment opportunities. A majority of our investments are sourced by our internal acquisitions staff. We also have sourcing relationships with other real estate industry participants. We believe these arrangements will assist us, from time to time, in originating real estate investment opportunities.

- *Access To and Cost of Capital.* We have elected to be taxed as a REIT. As a REIT, we generally do not have to pay federal corporate income tax on our REIT taxable income to the extent distributed to our stockholders. Therefore, our cost of capital is lower than the targeted rates of return of the companies and private equity firms who comprise our target market for real estate. This lower cost of capital, combined with our leverage strategies, allows us to hold long-term real estate more efficiently than our customers to the mutual benefit of Spirit Finance and our customers.

Regulation

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

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

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

Federal regulations require building owners and those exercising control over a building s management to identify and warn, through signs and labels, of potential hazards posed by workplace exposure to installed asbestos-containing materials and potentially asbestos-containing materials in their building. The regulations also have employee training, record keeping and due diligence requirements pertaining to asbestos-containing materials and potentially asbestos-containing materials. Significant fines can be assessed for violation of these regulations. As a result of these regulations, building owners and those exercising control over a building s management may be subject to an increased risk of personal injury lawsuits by workers and others exposed to asbestos-containing materials and potentially asbestos-containing materials. The regulations may affect the value of a building containing asbestos-containing materials and potentially asbestos-containing materials in which we have invested. Federal, state and local laws and regulations also govern the removal, encapsulation, disturbance, handling and/or disposal of asbestos-containing materials and potentially asbestos-containing materials when those materials are in poor condition or in the event of construction, remodeling, renovation or demolition of a building. These laws may impose liability for improper handling or a release into the environment of asbestos-containing materials and potentially asbestos-containing materials and may provide for fines to, and for third parties to seek recovery from, owners or operators of real properties for personal injury or improper work exposure associated with asbestos-containing materials and potentially asbestos-containing materials.

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

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

Employees

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

Facilities

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

Website Access to Reports and Other Documents

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

Item 1A. Risk Factors

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

Risks Related to Our Business

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

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

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

- The retail industry in which ShopKo and Pamida operate is highly competitive, which could limit growth opportunities and reduce profitability for ShopKo and Pamida. ShopKo and Pamida compete with other discount retail merchants as well as mass merchants, catalog merchants, internet retailers and other general merchandise, apparel and household merchandise retailers. ShopKo and Pamida face strong competition from large national discount retailers, such as Wal-Mart, Kmart and Target;

- ShopKo and Pamida stores are geographically located in a limited region, particularly the Midwest, Western Mountain and Pacific Northwest regions. Adverse economic conditions in these regions may materially and adversely affect ShopKo s and Pamida s results of operations and retail sales;

- Fluctuations in quarterly performance and seasonality in retail operations may cause ShopKo s and Pamida s results of operations to vary considerably from quarter to quarter and could adversely affect cash flows;

- The failure to maintain the existing ShopKo and Pamida stores or to carry out any remodeling plans in a cost-effective manner could have a material adverse affect on ShopKo s and Pamida s results of operations, financial condition, anticipated sales and profitability;

- ShopKo and Pamida stores are dependent on the efficient functioning of their distribution networks. Problems that cause delays or interruptions in the distribution networks could have a material adverse impact on the results of their operations; and

- ShopKo and Pamida stores depend on attracting and retaining quality employees. Many employees are entry level or part-time employees with historically high rates of turnover.

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

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

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

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

We may not be able to obtain debt financing at favorable rates. In addition, if interest rates increase, any variable rate borrowings we have would result in our expenses increasing. Some of our borrowings require the payment of the principal amount in a balloon payment at maturity. We may not have sufficient funds available to make all of our balloon payments at maturity, which would require us to refinance that debt at maturity. If we have to refinance our debt as it matures in a rising interest rate environment, our expenses will increase. An increase in our expenses would reduce the funds we have available to pay distributions.

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

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

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

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

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

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

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

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

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

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

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

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

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