

NATIONAL RETAIL PROPERTIES, INC.
Form 10-Q
August 03, 2006
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2006.

OR

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

For the transition period from _____ to _____.

Commission File Number 001-11290

NATIONAL RETAIL PROPERTIES, INC.

(Exact name of registrant as specified in its charter)

Maryland
(State of other jurisdiction or

incorporation organization)

450 South Orange Avenue, Suite 900, Orlando, Florida 32801

(Address of principal executive offices, including zip code)

56-1431377
(I.R.S. Employment

Identification No.)

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(407) 265-7348

(Registrant's telephone number, including area code)

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

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

Large accelerated filer Accelerated filer Non-accelerated filer .

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date.

58,130,296 shares of Common Stock, \$0.01 par value, outstanding as of July 31, 2006.

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NATIONAL RETAIL PROPERTIES, INC.

and SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(dollars in thousands, except per share data)

	June 30, 2006 (unaudited)	December 31, 2005
<u>ASSETS</u>		
Real estate, Investment Portfolio:		
Accounted for using the operating method, net of accumulated depreciation and amortization and impairment	\$ 1,254,077	\$ 1,296,793
Accounted for using the direct financing method	89,061	95,704
Held for sale, net of impairment	1,180	1,600
Real estate, Inventory Portfolio, held for sale	193,471	131,074
Mortgages, notes and accrued interest receivable, net of allowance of \$634 and \$676, respectively	24,328	51,086
Mortgage residual interests, net of impairment of \$3,669 and \$2,382, respectively	41,925	55,184
Cash and cash equivalents	4,682	8,234
Restricted cash	33,959	30,191
Receivables, net of allowance of \$772 and \$847, respectively	7,797	8,547
Accrued rental income, net of allowance of \$2,146 and \$2,057, respectively	27,215	27,999
Debt costs, net of accumulated amortization of \$10,531 and \$9,567, respectively	5,138	6,096
Other assets	17,689	20,908
Total assets	\$ 1,700,522	\$ 1,733,416
<u>LIABILITIES AND SHAREHOLDERS' EQUITY</u>		
Line of credit payable	\$ 149,700	\$ 162,300
Mortgages payable	36,758	151,133
Notes payable - secured	26,250	28,250
Notes payable, net of unamortized discount of \$1,067 and \$1,133, respectively, and an unamortized interest rate hedge gain of \$3,653 at December 31, 2005	489,733	493,321
Financing lease obligation	26,041	26,041
Accrued interest payable	4,178	5,539
Other liabilities	20,904	20,058
Income tax liability	11,517	13,748
Total liabilities	765,081	900,390
Minority interest	4,979	4,939
Shareholders' equity:		
Preferred stock, \$0.01 par value. Authorized 15,000,000 shares		
Series A, 1,781,589 shares issued and outstanding, stated liquidation value of \$25 per share	44,540	44,540
Series B Convertible, 10,000 shares issued and outstanding at December 31, stated liquidation value of \$2,500 per share		25,000
Common stock, \$0.01 par value. Authorized 190,000,000 shares; 57,997,666 and 55,130,876 shares issued and outstanding June 30 and December 31, respectively	580	551
Excess stock, \$0.01 par value. Authorized 205,000,000 shares; none issued or outstanding		
Capital in excess of par value	837,630	778,485

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Retained earnings (deficit)	43,929	(20,489)
Accumulated other comprehensive income	3,783	
Total shareholders' equity	930,462	828,087
	\$ 1,700,522	\$ 1,733,416

See accompanying notes to condensed consolidated financial statements.

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NATIONAL RETAIL PROPERTIES, INC.

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CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(dollars in thousands, except per share data)

(unaudited)

	Quarter Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenues:				
Rental income from operating leases	\$ 30,630	\$ 23,064	\$ 60,112	\$ 44,840
Earned income from direct financing leases	2,356	2,518	4,692	5,055
Contingent rental income	55	57	511	450
Real estate expense reimbursement from tenants	914	794	1,910	1,807
Gain on disposition of real estate, Inventory Portfolio	563	378	7,007	846
Interest and other income from real estate transactions	1,668	2,124	3,127	3,432
Interest income on mortgage residual interests	1,947	1,922	4,244	1,922
	38,133	30,857	81,603	58,352
Operating expenses:				
General and administrative	7,088	5,739	14,258	10,518
Real estate	1,359	996	2,697	2,272
Depreciation and amortization	5,358	3,872	10,709	7,497
Impairment real estate		741		1,328
Impairment mortgage residual interests	842		2,662	
Restructuring costs	1,580		1,580	
	16,227	11,348	31,906	21,615
Earnings from operations	21,906	19,509	49,697	36,737
Other expenses (revenues):				
Interest and other income	(1,015)	(308)	(1,831)	(764)
Interest expense	11,217	7,566	23,152	14,261
	10,202	7,258	21,321	13,497
Earnings from continuing operations before income tax benefit, minority interest and equity in earnings of unconsolidated affiliates	11,704	12,251	28,376	23,240
Income tax benefit	3,535	343	5,428	946
Minority interest	(255)	2	(3,452)	16
Equity in earnings of unconsolidated affiliates	228	100	195	1,180
Earnings from continuing operations	15,212	12,696	30,547	25,382
Earnings from discontinued operations:				
Real estate, Investment Portfolio	62,510	2,301	68,831	14,225
Real estate, Inventory Portfolio, net of income tax expense and minority interest	2,479	1,891	4,271	3,285

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	64,989	4,192	73,102	17,510
Earnings before extraordinary gain	80,201	16,888	103,649	42,892
Extraordinary gain, net of income tax expense		11,805		11,805
Net earnings	80,201	28,693	103,649	54,697
Series A preferred stock dividends	(1,002)	(1,002)	(2,004)	(2,004)
Series B convertible preferred stock dividends		(419)	(419)	(838)
Net earnings available to common shareholders basic	79,199	27,272	101,226	51,855
Series B convertible preferred stock dividends, if dilutive		419	419	838
Net earnings available to common shareholders diluted	\$ 79,199	\$ 27,691	\$ 101,645	\$ 52,693

See accompanying notes to condensed consolidated financial statements.

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NATIONAL RETAIL PROPERTIES, INC.

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CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS CONTINUED

(dollars in thousands, except per share data)

(unaudited)

	Quarter Ended		Six Months Ended	
	2006	June 30, 2005	2006	June 30, 2005
Net earnings per share of common stock:				
Basic:				
Continuing operations	\$ 0.25	\$ 0.22	\$ 0.50	\$ 0.43
Discontinued operations	1.13	0.08	1.30	0.34
Extraordinary gain		0.22		0.23
Net earnings	\$ 1.38	\$ 0.52	\$ 1.80	\$ 1.00
Diluted:				
Continuing operations	\$ 0.25	\$ 0.21	\$ 0.50	\$ 0.43
Discontinued operations	1.12	0.08	1.27	0.33
Extraordinary gain		0.22		0.22
Net earnings	\$ 1.37	\$ 0.51	\$ 1.77	\$ 0.98
Weighted average number of common shares outstanding:				
Basic	57,258,741	52,164,198	56,368,311	52,034,597
Diluted	57,784,835	53,913,934	57,376,485	53,732,987

See accompanying notes to condensed consolidated financial statements.

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NATIONAL RETAIL PROPERTIES, INC.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands)

(unaudited)

	Six Months Ended June 30,	
	2006	2005
Cash flows from operating activities:		
Net earnings	\$ 103,649	\$ 54,697
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Stock compensation expense	2,297	732
Depreciation and amortization	12,160	9,414
Impairment real estate	420	3,306
Impairment mortgage residual interests	2,662	
Amortization of notes payable discount	66	(30)
Amortization of deferred interest rate hedge gains	(170)	(80)
Equity in earnings of unconsolidated affiliates	(195)	190
Distributions received from unconsolidated affiliates	751	3,094
Minority interests	4,115	(932)
Gain on disposition of real estate, Investment Portfolio	(64,452)	(9,801)
Extraordinary gain, net of income tax expense		(11,805)
Deferred income taxes	(4,470)	(662)
Change in operating assets and liabilities, net of assets acquired and liabilities assumed in business combinations:		
Additions to real estate, Inventory Portfolio	(99,480)	(34,801)
Proceeds from disposition of real estate, Inventory Portfolio	47,234	20,169
Gain on disposition of real estate, Inventory Portfolio	(10,733)	(5,500)
Decrease in real estate leased to others using the direct financing method	1,518	1,430
Decrease (increase) in work in process	(360)	819
Increase in mortgages, notes and accrued interest receivable	1,185	352
Decrease in receivables	759	2,139
Decrease in mortgage residual interests	10,897	3,279
Increase in accrued rental income	(4,106)	(974)
Decrease in other assets	592	262
Increase in accrued interest payable	(1,361)	(258)
Decrease in other liabilities	(236)	(84)
Increase (decrease) in current tax liability	2,239	(224)
Net cash provided by operating activities	4,981	34,732
Cash flows from investing activities:		
Proceeds from the disposition of real estate, Investment Portfolio	149,740	32,220
Additions to real estate, Investment Portfolio, accounted for using the operating method	(134,859)	(65,938)
Increase in mortgages and notes receivable	(9,617)	(6,193)
Mortgage and notes payments received	34,951	9,290
Business combinations, net of cash acquired		19,610
Restricted cash	(3,768)	(23,751)
Acquisition of 1.3 percent interest in Services		(829)
Payment of lease costs	(1,146)	(329)
Other	916	(20)

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Net cash provided by (used in) investing activities	\$ 36,217	\$ (35,940)
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See accompanying notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS CONTINUED

(dollars in thousands)

(unaudited)

	Six Months Ended June 30,	
	2006	2005
Cash flows from financing activities:		
Proceeds from line of credit payable	\$ 193,800	\$ 104,100
Repayment of line of credit payable	(206,400)	(45,800)
Repayment of mortgages payable	(19,376)	(3,930)
Repayment of notes payable - secured	(2,000)	
Repayment of notes payable		(9,400)
Payment of debt costs	(14)	
Proceeds from issuance of common stock	31,887	1,176
Payment of Series A Preferred Stock dividends	(2,004)	(2,004)
Payment of Series B Convertible Preferred Stock dividends	(419)	(838)
Payment of common stock dividends	(36,813)	(33,889)
Minority interest distributions	(3,311)	(802)
Minority interest contributions	1	
Stock issuance costs	(101)	(6)
Net cash provided by (used in) financing activities	(44,750)	8,607
Net increase (decrease) in cash and cash equivalents	(3,552)	7,399
Cash and cash equivalents at beginning of period	8,234	1,947
Cash and cash equivalents at end of period	\$ 4,682	\$ 9,346
Supplemental disclosure of cash flow information:		
Interest paid, net of amount capitalized	\$ 26,919	\$ 17,333
Taxes paid (received)	\$ (585)	\$ 856
Supplemental disclosure of non-cash investing and financing activities:		
Issued 79,500 and 102,900 shares of restricted common stock in 2006 and 2005, respectively, pursuant to the Company's 2000 Performance Incentive Plan	\$ 1,763	\$ 1,940
Converted 10,000 shares of Series B Convertible Preferred Stock to 1,293,996 shares of common stock	\$ 25,000	\$
Issued 28,589 shares of common stock in 2006 pursuant to the Company's Deferred Director Fee Plan	\$ 571	\$
Issued 6,566 shares of common stock in 2006 to directors pursuant to the Company's 2000 Performance Incentive Plan	\$ 144	\$
Note and mortgage notes accepted in connection with real estate transactions	\$	\$ 1,015

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Mortgage note received in connection with real estate disposition	\$	\$ 1,000
Issued 1,636,532 shares of common stock in connection with the acquisition of National Properties Corporation (NAPE)	\$	\$ 31,160
Disposition of real estate held for sale and transfer of related mortgage payable	\$ 95,000	\$ 406
Surrender 5,850 shares of restricted common stock in 2005	\$	\$ 93
Change in other comprehensive income	\$ 3,783	\$

See accompanying notes to condensed consolidated financial statements.

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NATIONAL RETAIL PROPERTIES, INC.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2006

(unaudited)

Note 1 Organization and Summary of Significant Accounting Policies:

Organization and Nature of Business National Retail Properties, Inc., a Maryland corporation, formerly known as Commercial Net Lease Realty, Inc., is a fully integrated real estate investment trust (REIT) formed in 1984. The term Company refers to National Retail Properties, Inc. and its majority owned and controlled subsidiaries. These subsidiaries include the wholly owned qualified REIT subsidiaries of National Retail Properties, Inc., as well as the taxable REIT subsidiaries and their majority owned and controlled subsidiaries (collectively, NNN TRS). Effective May 1, 2006, Commercial Net Lease Realty, Inc. changed its name to National Retail Properties, Inc.

Prior to January 1, 2005, the Company held a 98.7 percent, non-controlling and non-voting interest in Commercial Net Lease Realty Services, Inc. and its majority owned and controlled subsidiaries (Services). Kevin B. Habicht, an officer and director of the Company, James M. Seneff, Jr. and Gary M. Ralston, each a former officer and director of the Company, (collectively the Services Investors) owned the remaining 1.3 percent interest, which was 100 percent of the voting interest in Services. Effective January 1, 2005, the Company acquired the remaining 1.3 percent interest in Services increasing the Company s ownership in Services to 100 percent. Effective November 1, 2005, Commercial Net Lease Realty Services, Inc. merged into National Retail Properties, Inc. CNLRS Exchange I, Inc., a taxable REIT subsidiary (TRS), became the TRS holding company for the Company s development and exchange activities.

The Company s operations are divided into two primary business segments: (i) investment assets, including real estate assets, structured finance investments (included in mortgages and notes receivable on the condensed consolidated balance sheet), and mortgage residual interests (collectively, Investment Assets), and (ii) inventory real estate assets (Inventory Assets). The Investment Assets are operated through National Retail Properties, Inc. and its majority owned and controlled qualified REIT subsidiaries. The Company acquires, owns, invests in, manages and develops properties that are leased primarily to retail tenants under long-term commercial net leases (the Investment Properties or Investment Portfolio). As of June 30, 2006, the Company owned 607 Investment Properties, with aggregate gross leasable area of 8,872,000 square feet, which are located in 41 states. In addition to the Investment Properties, as of June 30, 2006, the Company had \$8,886,000 and \$41,925,000 in structured finance investments and mortgage residual interests, respectively. The Inventory Assets are operated through the NNN TRS. The NNN TRS, directly and indirectly, through investment interests, acquires and develops real estate primarily for the purpose of selling the real estate (Inventory Properties or Inventory Portfolio). As of June 30, 2006, the NNN TRS owned 91 Inventory Properties.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and note disclosures required by accounting principles generally accepted in the United States of America. The unaudited condensed consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods presented. Operating results for the quarter and six months ended June 30, 2006 may not be indicative of the results that may be expected for the

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year ending December 31, 2006. Amounts as of December 31, 2005, included in the condensed consolidated financial statements, have been derived from the audited consolidated financial statements as of that date. These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements, Management's Discussion and Analysis and notes thereto included in the Form 10-K for the year ended December 31, 2005.

Principles of Consolidation In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities (FIN 46R). This Interpretation of Accounting Research Bulletin No. 51,

Consolidated Financial Statements, addresses consolidation by business enterprises of variable interest entities. A variable interest entity refers to certain entities subject to consolidation according to the provisions of this interpretation. This interpretation required existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the variable interest entities do not effectively disperse risks among parties involved. Effective January 1, 2004, the Company implemented FIN 46R. The adoption of this interpretation did not have a significant impact on the financial position or results of operations of the Company.

The Company's condensed consolidated financial statements include the accounts of each of the respective majority owned and controlled affiliates. All significant intercompany account balances and transactions have been eliminated. The Company applies the equity method of accounting to investments in partnerships and joint ventures that are not subject to control by the Company due to the significance of rights held by other parties.

The NNN TRS develops real estate through various joint venture development affiliate agreements. The NNN TRS consolidates the joint venture development entities listed in the table below based upon either the Company being the primary beneficiary of the respective variable interest entity or the Company having a controlling interest over the respective entity. The Company eliminates significant intercompany balances and transactions and records a minority interest for its other partners' ownership percentage. The following table summarizes each of the investments entered into during the six months ended June 30, 2006:

Date of Agreement	Entity Name	Ownership %
February 2006	CNLRs BEP, LP	50%
February 2006	CNLRs Rockwall, LP	50%

The Company holds a variable interest in, but is not the primary beneficiary of, CNL Plaza Ltd., a variable interest entity. The Company's maximum exposure to loss as a result of its involvement with CNL Plaza Ltd. as of June 30, 2006, is \$4,707,000. As of June 30, 2006, CNL Plaza, Ltd. had total assets and liabilities of \$54,548,000 and \$61,682,000, respectively.

In May 2005, the Company exercised its option to purchase 78.9 percent of the common shares of Orange Avenue Mortgage Investments, Inc. (OAMI). As a result, the Company has consolidated OAMI in its condensed consolidated financial statements.

Investment in Unconsolidated Affiliate The Company accounts for its investment in an unconsolidated affiliate under the equity method of accounting (see Note 4). The Company exercises influence over this unconsolidated affiliate, but does not control the affiliate.

Investment Portfolio Intangible Assets and Liabilities In connection with real estate acquisitions, a value is assigned to the intangible asset or liability: the difference between contractual rent and market value rent and value assigned to in-place leases. Deferred revenue/expense or deferred assets/liabilities recorded in connection with the difference between

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contractual rent and market rent value for acquired properties are amortized into rental revenue over the life of the leases. The value assigned to in-place leases is amortized over the life of the leases. For the quarter and six months ended June 30, 2005, the Company recorded an impairment of intangible assets of \$741,000 and \$1,328,000, respectively. The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Events or circumstances that may occur include changes in real estate market conditions, the ability of the Company to re-lease properties that are currently vacant or become vacant, and the ability to sell properties at an attractive return. The Company determines if an impairment should be recognized if the undiscounted future cash flows expected to result from the use or sale of the long-lived asset are less than the current net book value. Generally, the Company calculates a possible impairment by comparing the future cash flows and the current net book value. Impairments are measured as the amount by which the current book value of the intangible asset exceeds the fair value of the asset.

Mortgage Residual Interests, at Fair Value Mortgage residual interests, classified as available for sale, are reported at their market values with unrealized gains and losses reported as other comprehensive income in shareholders' equity. The Company had unrealized gains of \$300,000 at June 30, 2006. The mortgage residual interests were acquired in connection with the acquisition of 78.9 percent equity interest of OAMI. The Company recognizes the excess of all cash flows attributable to the mortgage residual interests estimated at the acquisition/transaction date over the initial investment (the accretable yield) as interest income over the life of the beneficial interest using the effective yield method. Losses are considered permanent if and when there has been a change in the timing or amount of estimated cash flows that leads to a loss in value. The Company recognized an impairment of \$2,662,000 for the six months ended June 30, 2006, of which \$842,000 was recognized during the quarter ended June 30, 2006. Certain of the mortgage residual interests have been pledged as security for notes payable.

Other Comprehensive Income The components for other comprehensive income for the six months ended June 30, 2006 (dollars in thousands):

Balance at beginning of period	\$
Treasury lock gain on swaps ⁽¹⁾	4,148
Treasury lock amortization	(665)
Mortgage residual interests unrealized gain ⁽²⁾	300
Balance at end of period	\$ 3,783

(1) Fair value of interest rate swaps reclassified from the Company's unsecured notes payable from the unamortized interest rate hedge gain resulting from the termination of the \$94,000,000 swap in June 2004.

(2) Unrealized gain on mortgage residual interests based upon a third party valuation analysis.

The Company's total comprehensive income (dollars in thousands):

	Quarter Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net earnings	\$ 80,201	\$ 28,693	\$ 103,649	\$ 54,697
Other comprehensive income	187	1,254	3,783	1,254
Total comprehensive income	\$ 80,388	\$ 29,947	\$ 107,432	\$ 55,951

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Revenue Recognition Rental revenues for non-development real estate assets are recognized when earned in accordance with Statement of Financial Accounting Standards (SFAS) No. 13, Accounting For Leases, based on the terms of the lease at the time of acquisition of the leased asset. Rental revenues for properties under construction commence upon completion of construction of the leased asset and delivery of the leased asset to the tenant. Some leases provide for scheduled rent increases throughout the lease term. Such amounts are recognized on a straight-line basis over the terms of the leases.

Earnings Per Share - Basic net earnings per share is computed by dividing net earnings available to common shareholders by the weighted average number of common shares outstanding during each period. Diluted net earnings per common share is computed by dividing net earnings available to common shareholders for the period by the number of common shares that would have been outstanding assuming the issuance of common shares for all potentially dilutive common shares outstanding during the periods.

The following is a reconciliation of the denominator of the basic net earnings per common share computation to the denominator of the diluted net earnings per common share computation:

	Quarter Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Weighted average number of common shares outstanding	57,546,465	52,477,106	56,627,526	52,298,715
Unvested restricted stock	(287,724)	(312,908)	(259,215)	(264,118)
Weighted average number of common shares outstanding used in basic earnings per share	57,258,741	52,164,198	56,368,311	52,034,597
Weighted average number of common shares outstanding used in basic earnings per share	57,258,741	52,164,198	56,368,311	52,034,597
Effect of dilutive securities:				
Restricted stock	77,822	312,908	59,290	264,118
Common stock options	93,402	130,596	114,608	128,740
Directors' deferred fee plan	27,816	12,236	26,422	11,536
Assumed conversion of Series B Convertible Preferred Stock to common stock	327,054	1,293,996	807,854	1,293,996
Weighted average number of common shares outstanding used in diluted earnings per share	57,784,835	53,913,934	57,376,485	53,732,987

Stock-Based Compensation On January 1, 2006, the Company adopted the provisions of SFAS No. 123 (R), Share-Based Payments (SFAS 123R), under the modified prospective method. Under the modified prospective method, compensation cost is recognized for all awards granted after the adoption of this standard and for the unvested portion of previously granted awards that are outstanding as of that date. In accordance with SFAS 123R, the Company will estimate the fair value of restricted stock and stock option grants at the date of grant and amortize those amounts into expense on a straight line basis or amount vested, if greater, over the appropriate vesting period. Adoption of SFAS 123R did not have a significant impact on the Company's earnings from continuing operations, net earnings, cash flow from operations, cash flow from financing activities and basic and diluted earnings per share for the quarter and six months ended June 30, 2006.

Income Taxes The Company has made an election to be taxed as a REIT under Sections 856 through 860 of the Internal Revenue Code of 1986, as amended, and related regulations. The Company generally will not be subject to federal income taxes on amounts distributed to shareholders, providing it distributes at least 100 percent of its real estate investment trust taxable

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income and meets certain other requirements for qualifying as a REIT. Notwithstanding the Company's qualification for federal taxation as a REIT, the Company is subject to certain state and local taxes on its income and real estate.

The Company and the NNN TRS have made timely TRS elections pursuant to the provisions of the REIT Modernization Act. A TRS is able to engage in activities resulting in income that previously would have been disqualified from being eligible REIT income under the federal income tax regulations. As a result, certain activities of the Company which occur within its TRS entities are subject to federal and state income taxes (See Real Estate Inventory Portfolio). All provisions for federal income taxes in the accompanying condensed consolidated financial statements are attributable to the NNN TRS and to OAMI's built-in-gain tax liability.

Income taxes are accounted for under the asset and liability method as required by SFAS No. 109, Accounting for Income Taxes. Deferred tax assets and liabilities are recognized for the temporary differences based on estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry-forwards. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

New Accounting Standards In March 2006, FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets. This statement amends FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, with respect to the accounting for separately recognized servicing assets and servicing liabilities. This statement requires prospective application to all transactions after the effective date of this statement. SFAS No. 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into certain servicing contracts. This Statement also requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable, and permits, but does not require, the subsequent measurement of servicing assets and servicing liabilities at fair value. This statement is effective for the fiscal years beginning after September 15, 2006. The adoption of this statement is not expected to have a significant impact on the financial position or results of operations of the Company.

In June 2006, FASB issued an Emerging Issues Task Force (EITF) Consensus in Issue 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation). The consensus includes any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer and may include, but is not limited to, sales, use, value added, and some excise taxes. The consensus states that the presentation of taxes within the scope on either a gross (included in revenues and costs) or a net (excluded from revenues) basis is an accounting policy decision that should be disclosed pursuant to Accounting Principles Board (APB) Opinion No. 22 Disclosure of Accounting Policies. In addition, for any such taxes that are reported on a gross basis, a company should disclose the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amounts are significant. The disclosure of those taxes can be done on an aggregate basis. The consensus should be applied to financial reports for interim and annual reporting periods beginning after December 15, 2006. The adoption of this consensus is not expected to have a significant impact on the financial position or results of operations of the Company.

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Use of Estimates The preparation of the Company's condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and judgments on assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates include impairments and allowances for certain assets, accruals, useful lives of assets and capitalization of costs. Actual results could differ from those estimates.

Reclassification Certain items in the prior year's condensed consolidated financial statements and notes to condensed consolidated financial statements have been reclassified to conform to the 2006 presentation. These reclassifications had no effect on shareholders' equity or net earnings.

Note 2 Real Estate Investment Portfolio:

Leases As of June 30, 2006, 541 of the Investment Property leases have been classified as operating leases and 66 leases have been classified as direct financing leases. For the Investment Property leases classified as direct financing leases, the building portions of the property leases are accounted for as direct financing leases while the land portions of 43 of these leases are accounted for as operating leases. Substantially all leases have initial terms of 10 to 20 years (expiring between 2006 and 2026) and provide for minimum rentals. In addition, the majority of the leases provide for contingent rentals and/or scheduled rent increases over the terms of the leases. Generally, the tenant is also required to pay all property taxes and assessments, substantially maintain the interior and exterior of the building and carry property and liability insurance coverage. Certain of the Company's Investment Properties are subject to leases under which the Company retains responsibility for certain costs and expenses of the property. As of June 30, 2006, the weighted average remaining lease term was approximately 12 years. Generally, the leases of the Investment Properties provide the tenant with one or more multi-year renewal options subject to generally the same terms and conditions as the initial lease.

Accounted for Using the Operating Method Real estate subject to operating leases consisted of the following (dollars in thousands):

	June 30, 2006	December 31, 2005
Land	\$ 602,357	\$ 574,572
Buildings and improvements	724,965	797,832
Leasehold interests	2,532	2,532
	1,329,854	1,374,936
Less accumulated depreciation and amortization	(78,850)	(79,198)
	1,251,004	1,295,738
Work in progress	4,656	3,012
	1,255,660	1,298,750
Less impairment	(1,583)	(1,957)
	\$ 1,254,077	\$ 1,296,793

In connection with the development of the six Investment Properties, the Company has agreed to fund construction commitments of \$11,173,000, of which \$7,774,000, including land costs, has been funded as of June 30, 2006.

In May 2006, the Company disposed of two office buildings containing an aggregate of 555,000 rentable square feet and a related parking garage with approximately 1,000 parking spaces (DC Office Properties). The carrying value of the DC Office Properties was \$163,723,000 at

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December 31, 2005. The sale of the DC Office Properties yielded \$227,876,000 of proceeds which included the assumption of a \$95,000,000 mortgage secured by the DC Office Properties and the Company recognized a gain of \$59,496,000 during the quarter and six months ended June 30, 2006.

Held for Sale The Investment Portfolio included certain properties that were held for sale, which consisted of the following (dollars in thousands):

	June 30, 2006	December 31, 2005
Land	\$ 717	\$ 717
Buildings and improvements	1,459	1,459
	2,176	2,176
Less impairment	(996)	(576)
	\$ 1,180	\$ 1,600

Impairments The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Events or circumstances that may occur include changes in real estate market conditions, the ability of the Company to re-lease properties that are currently vacant or become vacant, and the ability to sell properties at an attractive return. Generally, the Company makes a provision for impairment loss if estimated future undiscounted operating cash flows plus estimated disposition proceeds are less than the current book value. Impairment losses are measured as the amount by which the current book value of the asset exceeds the estimated fair value of the asset. After such review, the Company recognized a \$420,000 impairment loss during the quarter and six months ended June 30, 2006. During the quarter and six months ended June 30, 2005, the Company recognized impairment losses of \$575,000 and \$1,978,000, respectively.

Note 3 Real Estate Inventory Portfolio:

As of June 30, 2006, the Company owned 91 Inventory Properties: 69 completed inventory, 10 under construction and 12 land parcels. As of December 31, 2005, the Company owned 63 Inventory Properties: 47 completed inventory, 12 under construction and four land parcels. The Inventory Portfolio consisted of the following (dollars in thousands):

	June 30, 2006	December 31, 2005
Inventory:		
Land	\$ 41,364	\$ 26,430
Building	62,545	37,081
	103,909	63,511
Construction Projects:		
Land	56,745	44,168
Work in process	32,817	23,395
	89,562	67,563
	\$ 193,471	\$ 131,074

In connection with the development of 10 of the Inventory Properties, the Company has agreed to fund construction commitments, including land costs, of \$68,297,000, of which \$50,514,000 has been funded as of June 30, 2006.

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The following table summarizes the number of Inventory Properties sold and the corresponding gain recognized on the disposition of Inventory Properties included in continuing and discontinued operations (dollars in thousands):

	Quarter Ended				Six Months Ended			
	June 30,		June 30,		June 30,		June 30,	
	2006	2005	2006	2005	2006	2005	2006	2005
	# of Properties	Gain	# of Properties	Gain	# of Properties	Gain	# of Properties	Gain
Continuing operations	1	\$ 563	1	\$ 378	2	\$ 7,007	2	\$ 846
Minority interest		(282)				(3,504)		
Total continuing operations		281		378		3,503		846
Discontinued operations	18	2,478	7	2,506	26	3,602	11	4,515
Intersegment eliminations		88		86		124		139
Minority interest		(505)				(505)		
Total discontinued operations		2,061		2,592		3,221		4,654
	19	\$ 2,342	8	\$ 2,970	28	\$ 6,724	13	\$ 5,500

Note 4 Investments in Unconsolidated Affiliate:

In May 2002, the Company purchased a combined 25 percent partnership interest in CNL Plaza, Ltd. and CNL Plaza Venture, Ltd. (collectively, Plaza) for \$750,000. Plaza owns a 346,000 square foot office building and an interest in an adjacent parking garage. The Company has severally guaranteed 41.67 percent of a \$14,000,000 unsecured promissory note on behalf of Plaza. The maximum obligation of the Company under this guarantee is \$5,834,000, plus interest. Interest accrues based on a tiered rate structure with a maximum of 300 basis points above LIBOR (the current rate is 175 basis points above LIBOR). This guarantee will continue through the loan maturity in December 2010. The fair value of the Company's guarantee is \$47,000. During the six months ended June 30, 2006 and 2005, the Company received \$751,000 and \$198,000, respectively, in distributions from Plaza. For the six months ended June 30, 2006, the Company recognized earnings of \$195,000 of which \$228,000 was recognized during the quarter ended June 30, 2006. For the six months ended June 30, 2005 the Company recognized a loss from Plaza of \$82,000, of which a loss \$52,000 was recognized during the quarter ended June 30, 2005.

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Note 5 Business Combination:

Between June 2001 and July 2003, a wholly owned subsidiary of the Company, Net Lease Funding, Inc. (NLF), entered into five limited liability company agreements with OAMI to create five limited liability companies (collectively, the LLCs). Kevin B. Habicht, an officer and director of the Company is an officer, director and indirect shareholder of OAMI. Craig Macnab, an officer and director of the Company and Julian E. Whitehurst, an officer of the Company, are each an officer and director of OAMI. Each of the LLCs holds an interest in mortgage loans and is 100 percent equity financed. Prior to the May 2005 acquisition of the 78.9 percent equity interest in OAMI, the Company held a non-voting and non-controlling interest in each of the LLCs ranging between 36.7 and 44.0 percent and accounted for its investment under the equity method of accounting. For the six months ended June 30, 2005, the Company recognized \$1,467,000 of earnings, of which \$342,000 was recognized during the quarter ended June 30, 2005, from the LLCs and is recorded in equity in earnings from unconsolidated affiliates on the condensed consolidated statements of earnings. The Company received \$2,749,000 in distributions from the LLCs during the six months ended June 30, 2005.

In May 2005, the Company acquired a 78.9 percent equity interest in OAMI which resulted in an extraordinary gain of \$11,805,000, net of income tax expense of \$7,223,000 for the quarter and six months ended June 30, 2005. During the quarter ended December 31, 2005, the Company finalized the purchase price allocation based on the fair value of the assets acquired which resulted in a reduction to the extraordinary gain of \$4,242,000. The adjustment to the extraordinary gain was recorded in accordance with SFAS No. 141, Business Combinations. Additionally, in November 2005, Commercial Net Lease Realty Services, Inc. merged into National Retail Properties, Inc. resulting in a tax benefit of \$7,223,000 related to the acquisition of OAMI. The extraordinary gain for the year ended December 31, 2005 related to the OAMI acquisition after all adjustments was \$14,786,000.

Also as a result of the acquisition of a 78.9 percent equity interest in OAMI, the Company s interest in the LLCs is no longer accounted for as an equity investment and is now part of OAMI in the Company s condensed consolidated financial statements. Certain officers and directors own preferred shares of OAMI.

Note 6 Notes Receivable:

The structured finance investments bear a weighted average interest rate of 15.4% per annum, of which 10.2% is payable monthly and the remaining 5.2% accrues and is due at maturity. The principal balance of each structured finance investment is due in full at maturity, which range between October 2007 and August 2008. The structured finance investments are generally structured as loans secured by the borrowers pledge of their respective membership interests in the entities which own real estate. As of June 30, 2006 and December 31, 2005, the outstanding principal balance of the structured finance investments was \$8,886,000 and \$27,805,000, respectively.

During the six months ended June 30, 2006, the Company entered into structured finance investments of \$9,117,000. In addition, the Company received principal payments of \$28,036,000 on certain structured finance investments plus accrued interest and prepayment penalties during the six months ended June 30, 2006.

Table of Contents**Note 7 Mortgage Residual Interests:**

OAMI holds the mortgage residual interests (Residuals) from seven securitizations (See Note 5 Business Combination). The following table summarizes the investment interests in each of the transactions:

Securitization	Investment Interest		
	Company ⁽¹⁾	OAMI ⁽²⁾	3 rd Party
BYL 99-1		59.0%	41.0%
CCMH I, LLC	42.7%	57.3%	
CCMH II, LLC	44.0%	56.0%	
CCMH III, LLC	36.7%	63.3%	
CCMH IV, LLC	38.3%	61.7%	
CCMH V, LLC	38.4%	61.6%	
CCMH VI, LLC		100.0%	

⁽¹⁾ The Company owned these investment interests prior to its acquisition of the equity interest in OAMI.

⁽²⁾ The Company owns 78.9 percent of OAMI's investment interest.

Each of the Residuals is recorded at fair value based upon a third party valuation. Unrealized gains and losses are reported as other comprehensive income in shareholders' equity, and permanent losses as a result of a change in the timing or amount of estimated cash flows are recorded as an impairment. At June 30, 2006, the Company had unrealized gains of \$300,000 recorded in other comprehensive income and recorded an impairment of \$2,662,000 for the six months ended June 30, 2006, of which an impairment of \$842,000 was recorded during the quarter ended June 30, 2006.

Note 8 Mortgages Payable:

In February 2006, upon maturity, the Company repaid the outstanding principal balance of its long-term, fixed rate loan with an original principal balance of \$39,450,000, which was secured by a first mortgage on certain of the Company's Investment Properties. Upon repayment of the loan, the Investment Properties were released from the mortgage. As of December 31, 2005, the outstanding principal balance was \$18,538,000.

In May 2006, the Company disposed of the DC Office Properties that were subject to a first mortgage with an original and outstanding principal balance of \$95,000,000. Upon disposition of these Investment Properties, the buyer assumed the mortgage.

Note 9 Common Stock:

During the six months ended June 30, 2006, the Company issued 1,396,396 shares of common stock pursuant to the Company's Dividend Reinvestment and Stock Purchase Plan and received net proceeds of \$30,231,000.

During the six months ended June 30, 2006 and 2005, the Company declared and paid dividends to its common shareholders of \$36,813,000 and \$33,889,000, respectively or \$0.65 per share, of common stock.

Table of Contents**Note 10 Preferred Stock:**

Holders of each of the Company's preferred stock issuances are entitled to receive, when and as authorized by the board of directors, cumulative preferential cash distributions based on the stated rate and liquidation preference per annum. The following table outlines each issuance of the Company's preferred stock:

	Shares Outstanding At June 30, 2006	Liquidation Preference (per share)	Fixed Annual Cash Distribution (per share)	Dividends Declared and Paid For the Six Months Ended June 30,			
				2006		2005	
				Total	Per Share	Total	Per Share
Non-Voting Preferred Stock Issuance							
9% Series A	1,781,589	\$ 25	\$ 2.25	\$ 2,004,000	\$ 1.125	\$ 2,004,000	\$ 1.125
6.7% Series B Cumulative Convertible Perpetual ⁽¹⁾		\$ 2,500	167.50	419,000	41.875	838,000	83.750

⁽¹⁾ In April 2006, the holder of the Company's Series B Convertible Preferred Stock elected to convert those 10,000 shares into 1,293,996 shares of common stock.

Note 11 Restructuring Costs:

During the quarter and six months ended June 30, 2006, the Company recorded restructuring costs of \$1,580,000, which included severance costs and accelerated vesting of restricted stock in connection with the workforce reduction in April 2006.

Note 12 Income Taxes:

For income tax purposes, the Company has Taxable REIT Subsidiaries in which certain real estate activities are conducted. Additionally, the Company has its 78.9 percent equity interest in OAMI which the Company has consolidated in its financial statements as a result of the Company's acquisition in May 2005. OAMI, upon making its REIT conversion, has remaining tax liabilities relating to the built-in-gain of its assets. The Company treats some depreciation expense and certain other items differently for tax than for financial reporting purposes. The principal differences between the Company's effective tax rates for the quarters ended June 30, 2006 and 2005 and the statutory rates, relate to state taxes and nondeductible expenses such as meals and entertainment expenses.

The components of the net income tax asset (liability) consist of the following (dollars in thousands):

	June 30, 2006	December 31, 2005
Temporary differences:		
Built-in-gain	\$ (11,856)	\$ (14,551)
Depreciation	(451)	(315)
Stock based compensation	159	35
Other	(106)	(180)
Net operating loss carryforward	2,255	544
Net deferred income tax asset (liability)	\$ (9,999)	\$ (14,467)
Current income tax asset (payable)	(1,518)	719
Income tax asset (liability)	\$ (11,517)	\$ (13,748)

In assessing the ability to realize a deferred tax asset, management considers whether it is more likely than not that some portion or all of the deferred tax asset will not be realized. The ultimate

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realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. The net operating loss carryforwards were generated by the Company's Taxable REIT Subsidiaries. The net operating loss carryforwards completely expire in 2026. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Company will realize all of the benefits of these deductible differences that existed as of June 30, 2006. The income tax (expense) benefit consists of the following components (dollars in thousands):

	Quarter Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net earnings (loss) before income taxes	\$ 78,181	\$ 36,730	\$ 100,834	\$ 62,984
Provision for income taxes: benefit (expense)				
Current:				
Federal	(411)	(535)	(1,392)	(698)
State and local	(78)	(100)	(261)	(131)
Deferred:				
Federal	1,966	(150)	3,470	(198)
Extraordinary Gain - Federal		(6,081)		(6,081)
State and local	543	(29)	998	(37)
Extraordinary Gain - State		(1,142)		(1,142)
Total provision for income taxes	2,020	(8,037)	2,815	(8,287)
Total net earnings	\$ 80,201	\$ 28,693	\$ 103,649	\$ 54,697

In 2005 the Company elected to convert OAMI to a REIT. As a result, effective January 1, 2005, OAMI was taxed as a REIT under Sections 856 through 860 of the Internal Revenue Code of 1986, as amended, and related regulations. Upon making the REIT conversion, a portion of OAMI's tax liability was eliminated and recorded as an adjustment to the net assets acquired at the time of the option exercise. The remaining tax liability will be reduced over the next ten years in proportion to the reduction of the basis of the respective mortgage residual assets. During the six months ended June 30, 2006, an additional \$2,695,000 of OAMI's tax liability was reduced, of which \$1,337,000 was reduced during the quarter ended June 30, 2006, and is included in the income tax benefit on the condensed consolidated statement of earnings.

Table of Contents**Note 13 Earnings from Discontinued Operations:**

Real Estate Investment Portfolio In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the Company has classified the revenues and expenses related to (i) all Investment Properties that were sold and leasehold interests that expired subsequent to December 31, 2001, the effective date of SFAS No. 144 and (ii) any Investment Property that was held for sale as of June 30, 2006, as discontinued operations.

	Quarter Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenues:				
Rental income from operating leases	\$ 4,827	\$ 6,028	\$ 9,619	\$ 12,491
Earned income from direct financing leases		144	66	289
Real estate expense reimbursement from tenants	231	586	709	1,230
Interest and other income from real estate transactions	112	153	188	214
	5,170	6,911	10,582	14,224
Operating expenses:				
General and administrative	67	68	97	101
Real estate	804	1,775	2,276	3,371
Depreciation and amortization	31	947	1,284	1,896
Impairments real estate	420	575	420	1,978
	1,322	3,365	4,077	7,346
Other expenses (revenues):				
Interest expense	672	1,261	1,959	2,454
Earnings before gain on disposition of real estate and loss on extinguishment of mortgage payable				
	3,176	2,285	4,546	4,424
Gain on disposition of real estate	59,501	16	64,452	9,801
Loss on extinguishment of mortgage payable	(167)		(167)	
Earnings from discontinued operations	\$ 62,510	\$ 2,301	\$ 68,831	\$ 14,225

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Events or circumstances that may occur include changes in real estate market conditions, the ability of the Company to re-lease properties that are currently vacant or become vacant, and the ability to sell properties at an attractive return. Generally, the Company makes a provision for impairment loss if estimated future undiscounted operating cash flows plus estimated disposition proceeds are less than the current book value. Impairment losses are measured as the amount by which the current book value of the asset exceeds the estimated fair value of the asset. After such review, the Company recognized a \$420,000 impairment in discontinued operations during the quarter and six months ended June 30, 2006 and impairment losses for the quarter and six months ended June 30, 2005 of \$575,000 and \$1,978,000, respectively.

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Real Estate Inventory Portfolio The Company has classified the revenues and expenses related to (i) its Inventory Properties, which generated rental revenues prior to disposition, and (ii) the Inventory Properties which had generated rental revenues and were held for sale as of June 30, 2006, as discontinued operations.

	Quarter Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenues:				
Rental income from operating leases	\$ 2,076	\$ 711	\$ 4,002	\$ 1,145
Real estate expense reimbursement from tenants	102	7	150	38
Gain on disposition of real estate held for sale	2,566	2,592	3,726	4,654
Interest and other from real estate transactions		64		191
	4,744	3,374	7,878	6,028
Operating expenses:				
General and administrative	53	4	57	13
Real estate	108	37	133	136
Depreciation and amortization		10		21
	161	51	190	170
Other expenses:				
Interest expense	5	252	141	520
Earnings before income tax expense and minority interest	4,578	3,071	7,547	5,338
Income tax expense	(1,515)	(1,157)	(2,613)	(2,010)
Minority interest	(584)	(23)	(663)	(43)
Earnings from discontinued operations	\$ 2,479	\$ 1,891	\$ 4,271	\$ 3,285

Note 14 Performance Incentive Plan:

The Company's 2000 Performance Incentive Plan (2000 Plan) allows the Company to award or grant to key employees, directors and persons performing consulting or advisory services for the Company or its affiliates stock options, stock awards, stock appreciation rights, Phantom Stock Awards, Performance Awards and Leveraged Stock Purchase Awards, each as defined in the 2000 Plan. The 2000 Plan permits the issuance of up to 3,900,000 shares of common stock. The following summarizes the Company's stock-based compensation activity for the six months ended June 30, 2006:

	Number of Shares	Weighted Average Exercise Price
Options outstanding, beginning of period	461,175	\$ 15.66
Options granted		
Options exercised	(61,804)	15.64
Options surrendered		
Options outstanding, end of period	399,371	15.66
Exercisable, end of period	399,371	15.66

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The following summarizes the outstanding and exercisable options at June 30, 2006:

	Option Price Range		Total
	\$10.1875 to \$13.6875	\$14.5700 to \$17.8750	
Outstanding options:			
Number of shares	55,734	343,637	399,371
Weighted-average exercise price	\$ 11.32	\$ 16.36	\$ 15.66
Weighted-average remaining contractual life in years	4.2	3.5	3.6
Exercisable options:			
Number of shares	55,734	343,637	399,371
Weighted-average exercise price	\$ 11.32	\$ 16.36	\$ 15.66

One-third of the option grant to each individual becomes exercisable at the end of each of the first three years of service following the date of the grant and the options maximum term is 10 years. At June 30, 2006, the intrinsic value of options outstanding was \$1,787,000. All options outstanding at June 30, 2006, were exercisable. During the six months ended June 30, 2006 and 2005, the Company received proceeds totaling \$967,000 and \$670,000, respectively, in connection with the exercise of options, of which \$174,000 and \$501,000 were received during the quarters ended June 30, 2006 and 2005, respectively. The Company issued new common stock to satisfy share option exercises. The total intrinsic value of options exercised during the six months ended June 30, 2006 and 2005, was \$429,000 and \$260,000, respectively. The total intrinsic value of options exercised during the quarters ended June 30, 2006 and 2005 was \$166,000 and \$200,000, respectively.

Pursuant to the 2000 Plan, the Company has granted and issued shares of restricted stock to certain officers, directors and key associates of the Company. The following summarizes the activity for the six months ended June 30, 2006 of such grants.

	Number of Shares	Weighted Average Share Price
Non-vested restricted shares, beginning of period	398,441	\$ 17.02
Restricted shares granted	79,500	22.18
Restricted shares vested	(193,252)	17.06
Restricted shares forfeited		
Non-vested restricted shares, end of period	284,689	18.44

In May 2006, the Company accelerated the vesting and immediately vested 33,661 shares of restricted stock held by certain officers and resulted in the recognition of \$557,000 of additional compensation expense during the quarter and six months ended June 30, 2006. These shares would have otherwise vested through January 2009.

Compensation expense for the restricted stock which is not tied to performance goals is determined based upon the fair value at the date of grant, assuming a 1.3% forfeiture rate, and is recognized as the greater of the amount amortized over a straight lined basis or the amount vested over the vesting periods. Vesting periods for officers and key associates of the Company range from four to seven years and generally vest yearly on a straight line basis. Vesting periods for directors are over a two year period and vest yearly on a straight line basis. Compensation expense for the restricted stock grants whose vesting is contingent upon certain performance goals of the Company is based upon the fair value of the grant calculated by a third party using a Monte Carlo Simulation model coupled with a binomial lattice model using the following assumptions:

(i) average interest rate of 4.43%, (ii) \$0.01 increase in annual dividend, (iii) expected life of five years, and (iv) volatility of 21.26%. Volatility is based upon the historical volatility of the Company's stock and other factors. The term is assumed to be the vesting date for each tranche. Vesting of these shares is contingent upon achievement of certain performance goals by January 1, 2010.

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The following summarizes other grants made during the six months ended June 30, 2006, pursuant to the 2000 Plan.

	Shares	Weighted Average Share Price
Other share grants under the 2000 Plan:		
Directors' fees	6,566	21.94
Deferred Directors' fees	5,889	22.15
	12,455	22.04
Shares available under the 2000 Plan for grant, end of period	1,168,292	

The total compensation cost for share-based payments for the six months ended June 30, 2006 and 2005, totaled \$2,580,000 and \$849,000, respectively, of such compensation expense \$2,037,000 and \$501,000 was for the quarter ended June 30, 2006 and 2005, respectively. At June 30, 2006, the Company had \$4,253,000 of unrecognized compensation cost related to non-vested share-based compensation arrangements under the 2000 Plan. This cost is expected to be recognized over a weighted average period of 3.6 years.

Note 15 - Segment Information:

The Company has identified two primary business segments: (i) Investment Assets and (ii) Inventory Assets. The following tables represent the segment data and a reconciliation to the Company's condensed consolidated totals for the quarters ended June 30 (dollars in thousands):

	Investment Assets	Inventory Assets	Eliminations (Intercompany)	Condensed Consolidated Totals
2006				
External revenues	\$ 43,529	\$ 5,535	\$	\$ 49,064
Intersegment revenues	2,911	(88)	(2,823)	
Earnings from continuing operations	17,691	(3,592)	1,113	15,212
Net earnings	80,201	(1,113)	1,113	80,201
Total assets	1,689,253	205,570	(194,301)	1,700,522
2005				
External revenues	\$ 36,797	\$ 4,655	\$	\$ 41,452
Intersegment revenues	597	(34)	(563)	
Earnings from continuing operations	26,392	10,893	(12,784)	24,501
Net earnings	30,101	10,862	(12,270)	28,693
Total assets	1,506,281	123,975	(128,887)	1,501,369

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The following table represents the segment data and reconciliation to the Company's condensed consolidated totals for the six months ended June 30, (dollars in thousands):

	Investment Assets	Inventory Assets	Eliminations (Intercompany)	Condensed Consolidated Totals
2006				
External revenues	\$ 151,072	\$ 15,275	\$	\$ 166,347
Intersegment revenues	5,220	(124)	(5,096)	
Earnings from continuing operations	34,818	(4,466)	195	30,547
Net earnings	103,649	(195)	195	103,649
Total assets	1,689,253	205,570	(194,301)	1,700,522
2005				
External revenues	\$ 71,404	\$ 7,964	\$	\$ 79,368
Intersegment revenues	1,024		(1,024)	
Earnings from continuing operations	40,472	9,881	(13,166)	37,187
Net earnings	56,105	11,244	(12,652)	54,697
Total assets	1,506,281	123,975	(128,887)	1,501,369

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

The following discussion and analysis should be read in conjunction with the consolidated financial statements and related notes included elsewhere in the Annual Report on Form 10-K of National Retail Properties, Inc. for the year ended December 31, 2005. This information contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements generally are characterized by the use of terms such as believe, expect and may.

The term Company refers to National Retail Properties, Inc. and its majority owned and controlled subsidiaries. These subsidiaries include the wholly owned qualified REIT subsidiaries of the Company, as well as the taxable REIT subsidiaries and their majority owned and controlled subsidiaries (collectively, NNN TRS). Effective May 1, 2006, Commercial Net Lease Realty, Inc. changed its name to National Retail Properties, Inc.

Overview

The Company's operations are divided into two primary business segments: (i) investment assets, including real estate assets, structured finance investments (included in mortgages and notes receivable on the condensed consolidated balance sheet) and mortgage residual interests (collectively, Investment Assets), and (ii) inventory real estate assets (Inventory Assets). The Investment Assets are operated through National Retail Properties, Inc. and its majority owned and controlled subsidiaries. The Company acquires, owns, invests in, manages and develops properties that are leased primarily to retail tenants under long-term commercial net leases (the Investment Properties or Investment Portfolio). As of June 30, 2006, the Company owned 607 Investment Properties, with an aggregate gross leasable area of 8,872,000 square feet, which are located in 41 states. In addition to the Investment Properties, as of June 30, 2006, the Company had \$8,886,000 and \$41,925,000 in structured finance investments and mortgage residual interests, respectively.

As of October 31, 2005, the Inventory Assets were operated through Commercial Net Lease Realty Services, Inc. (Services) and its majority owned and controlled subsidiaries. Effective November 1, 2005, Services merged with and into National Retail Properties, Inc., and a former Services subsidiary, CNLRS Exchange I, Inc., became the holding company for the Company's development and exchange activities. The NNN TRS, directly and indirectly, through investment interests, owns real estate primarily for the purpose of selling the real estate (Inventory Properties or Inventory Portfolio). The NNN TRS develops Inventory Properties (Development Properties or Development Portfolio) and also acquires existing Inventory Properties (Exchange Properties or Exchange Portfolio). As of June 30, 2006 the NNN TRS owned 24 Development Properties (two completed, 10 under construction and 12 land parcels) and 67 Exchange Properties.

The Company's management team focuses on certain key indicators to evaluate the financial condition and operating performance of the Company. The key indicators for the Company include items such as: the composition of the Company's Investment Portfolio and structured finance investments (such as tenant, geographic and industry classification diversification), the occupancy rate of the Company's Investment Portfolio, certain financial performance ratios and profitability measures, industry trends and performance compared to that of the Company, and returns the Company receives on its invested capital.

Table of Contents**Liquidity**

General. Historically, the Company's demand for funds has been primarily for (i) payment of operating expenses and dividends, (ii) property acquisitions, structured finance investments, capital expenditures and development, either directly or through investment interests, (iii) payment of principal and interest on its outstanding indebtedness, and (iv) other investments.

Contractual Obligations and Commercial Commitments. The information in the following table summarizes the Company's contractual obligations and commercial commitments outstanding as of June 30, 2006. The table presents principal cash flows by year-end of the expected maturity for debt obligations and commercial commitments outstanding as of June 30, 2006. As the table incorporates only those exposures that exist as of June 30, 2006, it does not consider those exposures or positions which may arise after that date.

	Expected Maturity Date						
	Total	2006	2007	2008	2009	2010	Thereafter
	(dollars in thousands)						
Long-term debt ⁽¹⁾	\$ 579,848	\$ 2,615	\$ 20,913	\$ 113,190	\$ 21,800	\$ 21,022	\$ 400,308
Revolving credit facility	149,700				149,700		
Operating lease	11,334	603	1,236	1,273	1,311	1,351	5,560
Total contractual cash obligations ⁽²⁾	\$ 740,882	\$ 3,218	\$ 22,149	\$ 114,463	\$ 172,811	\$ 22,373	\$ 405,868

⁽¹⁾ Includes amounts outstanding under the mortgages payable, secured notes payable, notes payable and financing lease obligation and excludes unamortized note discounts.

⁽²⁾ Excludes \$4,178 of accrued interest payable.

In addition to the contractual obligations outlined above, the Company has agreed to fund construction commitments in connection with the development of additional properties as outlined below (dollars in thousands):

	# of Properties	Total Construction Commitment ⁽¹⁾	Amount Funded at June 30, 2006
Investment Portfolio	6	\$ 11,173	\$ 7,774
Inventory Portfolio	10	68,297	50,514
	16	\$ 79,470	\$ 58,288

⁽¹⁾ Including land costs.

Management anticipates satisfying these obligations with a combination of the Company's current capital resources, cash on hand, borrowings under its revolving credit facility and debt or equity financings.

As of June 30, 2006 the Company had outstanding letters of credit totaling \$10,280,000 under its credit facility.

In addition, the Company has one series of preferred stock with cumulative preferential cash distributions (see *Liquidity - Dividends*). As of June 30, 2006, the Company does not have any other contractual cash obligations, such as purchase obligations, financing lease obligations or other long-term liabilities other than those reflected above.

Off Balance Sheet Arrangements. The Company has guaranteed 41.67 percent of a \$14,000,000 unsecured promissory note on behalf of an unconsolidated affiliate. The maximum obligation to the Company is \$5,834,000 plus interest, and the guarantee continues through the loan maturity in December 2010. In the event the Company is required to perform under this guarantee, the Company would use proceeds from its

revolving credit facility to fulfill any obligation.

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Liquidity / Business Risk Management

The Company's Investment Properties are generally net leased; therefore, management anticipates that capital demands to meet obligations with respect to these Investment Properties will be modest for the foreseeable future and can be met with funds from operations and working capital. The leases typically provide that the tenant bears responsibility for substantially all property costs and expenses associated with ongoing maintenance and operation, including utilities, property taxes and insurance. In addition, the Company's leases generally provide that the tenant is responsible for roof and structural repairs. Certain of the Company's Investment Properties are subject to leases under which the Company retains responsibility for certain costs and expenses associated with the Investment Property. Management anticipates the costs associated with the Company's vacant Investment Properties or those Investment Properties that become vacant will also be met with funds from operations and working capital. The Company may be required to borrow under the Company's revolving credit facility or use other sources of capital in the event of unforeseen significant capital expenditures.

The lost revenues and increased property expenses resulting from the rejection by any bankrupt tenant of any of their respective leases with the Company could have a material adverse effect on the liquidity and results of operations of the Company if the Company is unable to re-lease the Investment Properties at comparable rental rates and in a timely manner. As of July 31, 2006, the Company owns nine vacant, unleased Investment Properties which account for approximately 1.6 percent of the total gross leasable area of the Company's Investment Portfolio and four unleased land parcels. Additionally, less than one percent of the total gross leasable area of the Company's Investment Portfolio is leased to two tenants that have filed a voluntary petition for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. As a result, the tenants have the right to reject or affirm its leases with the Company.

Dividends. The Company has made an election to be taxed as a REIT under Sections 856 through 860 of the Internal Revenue Code of 1986, as amended, and related regulations. The Company generally will not be subject to federal income tax on income that it distributes to its shareholders, provided that it distributes 100 percent of its REIT taxable income and meets certain other requirements for qualifying as a REIT. If the Company fails to qualify as a REIT in any taxable year, it will be subject to federal income tax on its taxable income at regular corporate rates and will not be permitted to qualify for treatment as a REIT for federal income tax purposes for four years following the year during which qualification is lost. Such an event could materially affect the Company's income and its ability to pay dividends. The Company believes it has been organized as, and its past and present operations qualify the Company as, a real estate investment trust. Additionally, the Company intends to continue to operate so as to remain qualified as a REIT for federal income tax purposes.

One of the Company's primary objectives, consistent with its policy of retaining sufficient cash for reserves and working capital purposes and maintaining its status as a REIT, is to distribute a substantial portion of its funds available from operations to its shareholders in the form of dividends. During the six months ended June 30, 2006 and 2005, the Company declared and paid dividends to its common shareholders of \$36,813,000 and \$33,889,000, respectively or \$0.65 per share of common stock.

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Holders of each of the Company's preferred stock issuances are entitled to receive, when and as authorized by the board of directors, cumulative preferential cash distributions based on the stated rate and liquidation preference per annum. The following table outlines each issuance of the Company's preferred stock:

	Shares Outstanding At June 30, 2006	Liquidation Preference (per share)	Fixed Annual Cash Distribution (per share)	Dividends Declared and Paid			
				For the Six Months Ended June 30, 2006		2005	
Non-Voting Preferred Stock Issuance				Total	Per Share	Total	Per Share
9% Series A	1,781,589	\$ 25	\$ 2.25	\$ 2,004,000	\$ 1.125	\$ 2,004,000	\$ 1.125
6.7% Series B Cumulative Convertible Perpetual ⁽¹⁾		2,500	167.50	419,000	41.875	838,000	83.750

⁽¹⁾ In April 2006, the holder of the Company's Series B Cumulative Convertible Preferred Stock elected to convert those 10,000 shares into 1,293,996 shares of common stock.

Restricted Cash. Restricted cash consists of amounts held in restricted accounts in connection with the sale of certain assets of Orange Avenue Mortgage Investments, Inc. (OAMI) to a third party (the Buyer). The use of the cash is restricted pursuant to agreements with the Buyer and will be released to OAMI in December 2007 subject to any pending indemnity claims. The amount held in these accounts at June 30, 2006 was \$34,235,000. The carrying value of \$33,959,000 is calculated as the present value of the expected release of monies.

Capital Resources

Generally, cash needs for property acquisitions, structured finance investments, capital expenditures, development and other investments have been funded by equity and debt offerings, bank borrowings, the sale of properties and, to a lesser extent, from internally generated funds. Cash needs for other items have been met from operations. Potential future sources of capital include proceeds from the public or private offering of the Company's debt or equity securities, secured or unsecured borrowings from banks or other lenders, proceeds from the sale of properties, as well as undistributed funds from operations. For the six months ended June 30, 2006, and 2005, the Company generated \$4,981,000 and \$34,732,000, respectively, of net cash from operating activities. The change in cash provided by operations for the six months ended June 30, 2006 and 2005 is primarily the result of changes in revenues and expenses as discussed in Results of Operations. Cash generated from operations could be expected to fluctuate in the future.

Indebtedness. The Company expects to use indebtedness primarily for property acquisitions and development of single-tenant retail properties, either directly or through investment interests and structured finance investments. As of June 30, 2006, there were no material changes in the Company's indebtedness except as noted below.

Mortgage Payable. In February 2006, upon maturity, the Company repaid the outstanding principal balance of its long-term, fixed rate loan with an original principal balance of \$39,450,000, which was secured by a first mortgage on certain of the Company's Investment Properties. Upon repayment of the loan, the Investment Properties were released from the mortgage. As of December 31, 2005, the outstanding principal balance was \$18,538,000.

In May 2006, the Company disposed of the three Investment Properties that were subject to a first mortgage with an original and outstanding principal balance of \$95,000,000. Upon disposition of these Investment Properties, the buyers assumed the mortgage.

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Payments of principal on the mortgage debt, notes payable and on advances outstanding under the credit facility are expected to be met from borrowings under the credit facility, proceeds from public or private offerings of the Company's debt or equity securities, the Company's secured or unsecured borrowings from banks or other lenders or proceeds from the sale of one or more of its properties.

Debt and Equity Securities. The Company has used, and expects to use in the future, issuances of debt and equity securities primarily to pay down its outstanding indebtedness and to finance investment acquisitions. The Company has maintained investment grade debt ratings from Standard and Poor's, Moody's Investors Service and Fitch Ratings on its senior, unsecured debt since 1998. In February 2006, the Company filed a shelf registration statement with the Securities and Exchange Commission which permits the issuance by the Company of an indeterminate amount of debt and equity securities.

In February 2006, the Company filed a registration statement permitting up to 12,191,394 shares to be issued under the Company's Dividend Reinvestment and Stock Purchase Plan. During the six months ended June 30, 2006, the Company received net proceeds totaling \$30,231,000 from the issuance of 1,396,396 shares under the plan.

Business Combination. Between June 2001 and July 2003, a wholly owned subsidiary of the Company, Net Lease Funding, Inc. (NLF), entered into five limited liability company agreements with OAMI to create five limited liability companies (collectively, the LLCs). Kevin B. Habicht, an officer and director of the Company is an officer, director and indirect shareholder of OAMI. Craig Macnab, an officer and director of the Company and Julian E. Whitehurst, an officer of the Company, are each an officer and director of OAMI. Each of the LLCs holds an interest in mortgage loans and is 100 percent equity financed. Prior to the May 2005 acquisition of the 78.9 percent equity interest in OAMI, the Company held a non-voting and non-controlling interest in each of the LLCs ranging between 36.7 and 44.0 percent and accounted for its investment under the equity method of accounting. For the six months ended June 30, 2005, the Company recognized \$1,467,000 of earnings, of which \$342,000 was recognized during the quarter ended June 30, 2005, from the LLCs and is recorded in equity in earnings from unconsolidated affiliates on the condensed consolidated statements of earnings. The Company received \$2,749,000 in distributions from the LLCs during the six months ended June 30, 2005.

In May 2005, the Company acquired a 78.9 percent equity interest in OAMI which resulted in an extraordinary gain of \$11,805,000, net of income tax expense of \$7,223,000 for the quarter and six months ended June 30, 2005. During the quarter ended December 31, 2005, the Company finalized the purchase price allocation based on the fair value of the assets acquired which resulted in a reduction to the extraordinary gain of \$4,242,000. The adjustment to the extraordinary gain was recorded in accordance with SFAS No. 141, Business Combinations. Additionally, in November 2005, Commercial Net Lease Realty Services, Inc. merged into National Retail Properties, Inc. resulting in a tax benefit of \$7,223,000 related to the acquisition of OAMI. The extraordinary gain for the year ended December 31, 2005 related to the OAMI acquisition after all adjustments was \$14,786,000.

Also as a result of the acquisition of a 78.9 percent equity interest in OAMI, the Company's interest in the LLCs is no longer accounted for as an equity investment and is now part of OAMI in the Company's condensed consolidated financial statements. Certain officers and directors own preferred shares of OAMI.

As a result of the independent valuations of the mortgage residual interests (Residuals), the Company reduced the carrying value of the Residuals and recorded an \$2,662,000 impairment during the six months ended June 30, 2006, of which \$842,000 was recorded during the quarter ended June 30, 2006. Mortgage residual interests, classified as available for sale, are reported at their market values with unrealized gains and losses reported as other comprehensive income in shareholders' equity. The Company had unrealized gains of \$300,000 at June 30, 2006.

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In 2005 the Company elected to convert OAMI to a REIT. As a result, effective January 1, 2005, OAMI was taxed as a REIT under Sections 856 through 860 of the Internal Revenue Code of 1986, as amended, and related regulations. Upon making the REIT conversion, a portion of OAMI's tax liability was eliminated and recorded as an adjustment to the net assets acquired at the time of the option exercise. The remaining tax liability will be reduced over the next ten years in proportion to the reduction of the basis of the respective mortgage residual assets. During the six months ended June 30, 2006, an additional \$2,695,000 of OAMI's tax liability was reduced, of which \$1,337,000 was reduced during the quarter ended June 30, 2006 and is included in the income tax benefit on the condensed consolidated statement of earnings.

Notes Receivable. The structured finance investments outstanding at June 30, 2006, bear a weighted average interest rate of 15.4% per annum, of which 10.2% is payable monthly and the remaining 5.2% accrues and is due at maturity. The principal balance of each structured finance investment is due in full at maturity, which ranges between October 2007 and August 2008. The structured finance investments are generally structured as loans secured by the borrowers' pledge of their respective membership interests in the entities which own real estate. As of June 30, 2006 and December 31, 2005, the outstanding principal balance of the structured finance investments was \$8,886,000 and \$27,805,000, respectively.

During the six months ended June 30, 2006, the Company entered into structured finance investments of \$9,117,000. In addition, the Company received the total outstanding principal of \$28,036,000 on its structured finance investments plus accrued interest and prepayment penalties during the six months ended June 30, 2006.

Results of Operations**Property Analysis - Investment Portfolio**

General. As of June 30, 2006, the Company owned 607 Investment Properties that are leased primarily to retail tenants. Approximately 98 percent of the gross leasable area of the Company's Investment Portfolio was leased at June 30, 2006.

The following table summarizes the Company's Investment Portfolio:

	June 30, 2006	December 31, 2005	June 30, 2005
Investment Properties Owned:			
Number	607	524	427
Total gross leasable area (square feet)	8,872,000	9,227,000	8,840,000
Investment Properties Leased:			
Number	595	512	418
Total gross leasable area (square feet)	8,731,000	9,066,000	8,731,000
Percent of total gross leasable area	98%	98%	99%
Weighted average remaining lease term (years)	12	11	11

The Company regularly evaluates its (i) Investment Portfolio, (ii) financial position, (iii) market opportunities and (iv) strategic objectives and, based on certain factors, may decide to acquire or dispose of a given property or portfolio of properties.

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Property Acquisitions. Property acquisitions are typically funded using funds from the Company's revolving credit facility, proceeds for debt or equity offerings and to a lesser extent, proceeds generated from the sale of properties. The following table summarizes the Investment Property acquisitions (dollars in thousands):

	Quarter Ended		Six Months Ended	
	June 30,		June 30,	
	2006	2005	2006	2005
Acquisitions:				
Number of Investment Properties	46	49	86	70
Gross leasable area (square feet)	176,000	439,000	285,000	705,000
Total dollars invested	\$ 99,841	\$ 79,162	\$ 136,133	\$ 126,155

Property Dispositions. The Company typically uses the proceeds from property sales to either pay down the outstanding indebtedness of the Company's credit facility or reinvest in real estate. The following table summarizes the Investment Properties sold by the Company (dollars in thousands):

	Quarter Ended		Six Months Ended	
	June 30,		June 30,	
	2006	2005	2006	2005
Number of properties	3	2	6	6
Gross leasable area (square feet)	555,000	70,000	639,000	405,000
Net sales proceeds	\$ 227,876	\$ 1,330	\$ 244,740	\$ 33,162
Net gain	\$ 59,501	\$ 16	\$ 64,452	\$ 9,801

In May 2006, the Company disposed of two office buildings containing an aggregate of 555,000 rentable square feet and a related parking garage with approximately 1,000 parking spaces (DC Office Properties). The carrying value of the DC Office Properties was \$163,723,000 at December 31, 2005. The sale of the DC Office Properties yielded \$227,876,000 of net proceeds and the Company recognized a gain of \$59,496,000 on the disposition of these Investment Properties.

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the Company has classified all Investment Properties sold subsequent to December 31, 2001, the effective date of SFAS No. 144, as discontinued operations. During the quarter and six months ended June 30, 2006 and 2005, the Company used the proceeds from the sale of Investment Properties to pay down the Company's credit facility and to reinvest in real estate.

Property Analysis Inventory Portfolio

General. The Company's inventory real estate assets are operated through the NNN TRS. The following summarizes the number of properties held for sale in the Company's Inventory Portfolio:

	June 30,		June 30,
	2006	December 31, 2005	2005
Development Portfolio:			
Completed Inventory Properties	2	1	1
Properties under construction	10	12	11
Land parcels	12	4	4
	24	17	16

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Exchange Portfolio:			
Inventory Properties	67	46	3
Total Inventory Properties	91	63	19

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Property Acquisitions. Inventory Property acquisitions are typically funded using funds from the Company's credit facility and proceeds from debt or equity offerings.

The following table summarizes the Inventory Property acquisitions (dollars in thousands):

	Quarter Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Development Portfolio:				
Number of properties acquired		3	10	6
Dollars invested ⁽¹⁾	\$ 19,968	\$ 11,636	\$ 46,259	\$ 30,255
Exchange Portfolio:				
Number of properties acquired	25		45	6
Dollars invested	\$ 41,631	\$	\$ 54,313	\$ 1,966
Total dollars invested in real estate held for sale	\$ 61,599	\$ 11,636	\$ 100,572	\$ 32,221

⁽¹⁾ Includes dollars invested in projects currently under construction.

Property Dispositions. The following table summarizes the number of Inventory Properties sold and the corresponding gain recognized from the disposition of real estate held for sale included in earnings from continuing and discontinued operations (dollars in thousands):

	Quarter Ended June 30,				Six Months Ended June 30,			
	2006		2005		2006		2005	
	# of Properties	Gain	# of Properties	Gain	# of Properties	Gain	# of Properties	Gain
Development	2	\$ 1,573	3	\$ 2,251	4	\$ 8,334	5	\$ 3,622
Exchange	17	1,468	5	633	24	2,275	8	1,739
Intercompany eliminations		88		86		124		139
Minority interest, development		(787)				(4,009)		
	19	\$ 2,342	8	\$ 2,970	28	\$ 6,724	13	\$ 5,500

During the quarter and six months ended June 30, 2006, and 2005, the Company used the proceeds from the sale of the Inventory Properties to pay down the Company's credit facility and to reinvest in real estate.

Table of Contents**Revenue From Operations Analysis**

General. During the six months ended June 30, 2006, the Company's revenues increased primarily due to the acquisition of Investment Properties (See Results of Operations Property Analysis Investment Portfolio Property Acquisitions). The Company anticipates any significant increase in rental income will continue to come primarily from additional property acquisitions.

The following table summarizes the Company's revenues (dollars in thousands):

	Quarter Ended June 30,				Percent Increase (Decrease)	Six Months Ended June 30,				Percent Increase (Decrease)
	2006	2005	2006	2005		2006	2005	2006	2005	
			Percent of Total	Percent of Total				Percent of Total	Percent of Total	
Rental income ⁽¹⁾	\$ 33,041	\$ 25,639	86.6%	83.1%	28.9%	\$ 65,315	\$ 50,345	80.1%	86.3%	29.7%
Real estate expense reimbursement from tenants	914	794	2.4%	2.6%	15.1%	1,910	1,807	2.3%	3.1%	5.7%
Gain on disposition of real estate, Inventory Portfolio	563	378	1.5%	1.2%	48.9%	7,007	846	8.6%	1.4%	728.3%
Interest and other income from real estate transactions	1,668	2,124	4.4%	6.9%	(21.5)%	3,127	3,432	3.8%	5.9%	(8.9)%
Interest income on mortgage residual interests	1,947	1,922	5.1%	6.2%	1.3%	4,244	1,922	5.2%	3.3%	120.8%
Total revenues from continuing operations	\$ 38,133	\$ 30,857	100.0%	100.0%	23.6%	81,603	58,352	100.0%	100.0%	39.8%

⁽¹⁾ Includes rental income from operating leases, earned income from direct financing leases and contingent rental income from continuing operations (Rental Income).

Revenue From Operations Analysis by Source of Income. The Company has identified two primary business segments, and thus, sources of revenue: (i) earnings from the Company's Investment Assets and (ii) earnings from the Company's Inventory Assets. Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision makers in deciding how to allocate resources and in assessing performance. The following table summarizes the revenues from continuing operations for the quarters ended June 30 (dollars in thousands):

	Quarter Ended June 30,				Percent of Total	Six Months Ended June 30,				Percent of Total
	2006	2005	2006	2005		2006	2005	2006	2005	
Investment Assets	\$ 34,689	\$ 29,047	91.0%	94.1%		\$ 69,367	\$ 55,466	85.0%	95.1%	
Inventory Assets	3,444	1,810	9.0%	5.9%		12,236	2,886	15.0%	4.9%	
Total revenues from continuing operations	\$ 38,133	\$ 30,857	100.0%	100.0%		\$ 81,603	58,352	100.0%	100.0%	

The Company evaluates its ability to pay dividends to shareholders by considering the combined effect of income from continuing and discontinued operations.

Rental Income. The increase in Rental Income was relatively consistent for both the quarter and six months ended June 30, 2006 compared to the same periods in 2005 and was relatively consistent as a percentage of total revenues from continuing operations. The increase in Rental Income in 2006, as

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compared to the same periods in 2005 is primarily due to the acquisition of (i) 86 Investment Properties with an aggregate gross leasable area of 285,000 square feet during the six months ended June 30, 2006 (of which 46 Investment Properties with an aggregate gross leasable area of 176,000 square feet were acquired during the quarter ended June 30, 2006) and (ii) the 170 Investment Properties with an aggregate gross leasable area of 1,150,000 square feet during the year ended December 31, 2005, of which 100 Investment Properties with an aggregate gross leasable area of 445,000 square feet were acquired during the six months ended December 31, 2005.

Gain on Disposition of Real Estate Inventory Portfolio. Inventory Properties typically are operating properties and are classified as discontinued operations. The following table summarizes the Inventory Property dispositions included in continuing operations (dollars in thousands):

	Quarter Ended				Six Months Ended			
	June 30,		June 30,		June 30,		June 30,	
	2006	2005	2006	2005	2006	2005	2006	2005
	# of Properties	Gain	# of Properties	Gain	# of Properties	Gain	# of Properties	Gain
Continuing operations	1	\$ 563	1	\$ 378	2	\$ 7,007	2	\$ 846
Minority interest		(282)				(3,504)		
Total continuing operations	1	\$ 281	1	\$ 378	2	\$ 3,503	2	\$ 846

Interest and Other Income from Real Estate Transactions. Interest and other income from real estate transactions decreased for the quarter and six months ended June 30, 2006 compared to the same periods in 2005. For the quarter and six months ended June 30, 2005, the Company recognized \$579,000 and \$709,000, respectively, of income in connection with disposition and development services. However, the decrease in interest and other income is partially offset by an increase in interest earned on the structured finance investments. During the six months ended June 30, 2006, the Company recognized interest and other income of \$499,000 from prepayment penalties resulting from the principal payments received on certain structured finance investments totaling \$28,036,000.

Interest Income from Mortgage Residual Interests. The Company recognizes interest income from mortgage residual interests as a result of its acquisition of 78.9 percent of OAMI in May 2005. As a result, the significant increase in interest income for the six months ended June 30, 2006 is due to the Company's ownership for the full six months of 2006 versus a partial period in 2005 (see Business Combinations).

Table of ContentsExpense Analysis

General. During the quarter and six months ended June 30, 2006, operating expenses increased but remained generally proportionate to the Company's total revenue from continuing operations. The following summarizes the Company's expenses for the quarters ended June 30 (dollars in thousands):

			Percentage of Total		Percent of Revenues from Continuing Operations		Percentage Increase
	2006	2005	2006	2005	2006	2005	(Decrease)
General and administrative	\$ 7,088	\$ 5,739	43.7%	50.6%	18.6%	18.6%	23.5%
Real estate	1,359	996	8.4%	8.8%	3.6%	3.3%	36.4%
Depreciation and amortization	5,358	3,872	33.0%	34.1%	14.1%	12.5%	38.4%
Impairment - real estate		741		6.5%		2.4%	(100.0)%
Impairment - mortgage residual interests	842		5.2%		2.2%		100.0%
Restructuring costs	1,580		9.7%		4.1%		100.0%
Total operating expenses from continuing operations	\$ 16,227	\$ 11,348	100.0%	100.0%	42.6%	36.8%	43.0%

The following summarizes the Company's expenses for the six months ended June 30 (dollars in thousands):

			Percentage of Total		Percent of Revenues from Continuing Operations		Percentage Increase
	2006	2005	2006	2005	2006	2005	(Decrease)
General and administrative	\$ 14,258	\$ 10,518	44.7%	48.7%	17.5%	18.0%	35.6%
Real estate	2,697	2,272	8.5%	10.5%	3.3%	3.9%	18.7%
Depreciation and amortization	10,709	7,497	33.6%	34.7%	13.1%	12.8%	42.8%
Impairment - real estate		1,328		6.1%		2.3%	(100.0)%
Impairment - mortgage residual interests	2,662		8.3%		3.3%		100.0%
Restructuring costs	1,580		4.9%		1.9%		100.0%
Total operating expenses from continuing operations	\$ 31,906	\$ 21,615	100.0%	100.0%	39.1%	37.0%	47.6%

General and Administrative Expenses. For the quarter and six months ended June 30, 2006, general and administrative expenses increased primarily as a result of (i) an increase in expenses related to personnel and (ii) an increase in professional services provided to the Company. In addition, the increase in general and administrative expenses for the six months ended June 30, 2006 is partially attributable to an increase in lost pursuit costs.

Depreciation and Amortization Expenses. For the quarter and six months ended June 30, 2006, the increase in depreciation and amortization expenses is primarily attributable to the depreciation on (i) the 86 Investment Properties with an aggregate gross leasable area of 285,000 square feet acquired during the six months ended June 30, 2006, of which 46 Investment Properties with an aggregate gross leasable area of 176,000 square feet were acquired during the quarter ended June 30, 2006, and (ii) the 170 Investment Properties with an aggregate gross leasable area of 1,150,000 square feet acquired during the year ended December 31, 2005, of which 100 Investment Properties with an aggregate gross leasable area of 445,000 square feet were acquired during the six months ended December 31, 2005.

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Impairments Real Estate. The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Events or circumstances that may occur include changes in real estate market conditions, the ability of the Company to re-lease properties that are currently vacant or become vacant, and the ability to sell properties at an attractive return. Generally, the Company calculates a possible impairment by comparing the future cash flows and the current net book value. Impairments are measured as the amount by which the current book value of the asset exceeds the fair value of the asset.

Impairments Mortgage Residual Interests. The Company reduced the carrying value of the Residuals during the quarter and six months ended June 30, 2006 based upon the fair value as determined by an independent valuation. The reduction in the Residuals value was recorded as an aggregate impairment of \$2,662,000 for the six months ended June 30, 2006 of which \$842,000 was recorded during the quarter ended June 2006 (see Business Combinations). Mortgage residual interests, classified as available for sale, are reported at their market values with unrealized gains and losses reported as other comprehensive income in shareholders equity. The Company had unrealized gains of \$300,000 at June 30, 2006.

Restructuring Costs. During the quarter and six months ended June 30, 2006, the Company recorded restructuring costs of \$1,580,000, which included severance costs and accelerated vesting of restricted stock in connection with a workforce reduction in April 2006.

Analysis of Other Expenses and Revenues

General. During the quarter and six months ended June 30, 2006, the combined interest and other income and interest expense increased but remained generally proportionate to the Company's total revenue and expenses. The following summarizes the Company's other expenses (revenues) from continuing operations for the quarters ended June 30 (dollars in thousands):

			Percentage of Total		Percent of Revenues from Continuing Operations		Percentage Increase
	2006	2005	2006	2005	2006	2005	(Decrease)
Interest and other income	\$ (1,015)	\$ (308)	(9.9)%	(4.2)%	(2.7)%	(1.0)%	229.5%
Interest expense	11,217	7,566	109.9%	104.2%	29.4%	24.5%	48.3%
Total other expenses (revenues) from continuing operations	\$ 10,202	\$ 7,258	100.0%	100.0%	26.7%	23.5%	40.6%

The following summarizes the Company's other expenses (revenues) from continuing operations for the six months ended June 30 (dollars in thousands):

			Percentage of Total		Percent of Revenues from Continuing Operations		Percentage Increase
	2006	2005	2006	2005	2006	2005	(Decrease)
Interest and other income	\$ (1,831)	\$ (764)	(8.6)%	(5.7)%	(2.2)%	(1.3)%	139.7%
Interest expense	23,152	14,261	108.6%	105.7%	28.4%	24.4%	62.3%
Total other expenses (revenues) from continuing operations	\$ 21,321	\$ 13,497	100.0%	100.0%	26.2%	23.1%	58.0%

Interest and Other Income. During the quarter ended June 30, 2006, interest and other income increased due to the increase in interest earned on restricted cash. However, interest and other income remained generally proportionate to the Company's total revenue and expense.

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Interest Expense. The increase in interest expense for the quarter and six months ended June 30, 2006, over the quarter and six months ended June 30, 2005 was primarily due to a \$297,910,000 increase in the weighted average long-term debt outstanding for the six months ended June 30, 2006. The increase in the weighted average long-term debt outstanding included (i) the \$30,000,000 secured notes payable assumed in May 2005 in connection with the 78.9 percent equity interest in OAMI, and (ii) the \$150,000,000 of notes payable issued in November 2005 with an effective interest rate of 6.185% due in December 2015 which was primarily used to acquire properties. However, the increase in weighted average long-term debt outstanding was partially offset by the maturity of a mortgage with a 7.435% interest rate which had an outstanding principal balance of \$18,538,000 at December 31, 2005.

Unconsolidated Affiliates

During the six months ended June 30, 2006 and 2005, the Company recognized equity in earnings of unconsolidated affiliates of \$195,000, and \$1,081,000, respectively, of which \$228,000 and \$100,000, was recognized during the quarters ended June 30, 2006 and 2005, respectively. The decrease in equity in earnings of unconsolidated affiliates for the six months ended June 30, 2006, was primarily attributable to a decrease in the income earned on investments in mortgage residual interests as a result of the acquisition of 78.9 percent equity interest in OAMI in May 2005. The Company's interest in the LLCs is no longer accounted for as an equity investment and is now included as a part of OAMI in the Company's condensed consolidated financial statements.

Earnings from Discontinued Operations

The Company records discontinued operations by the Company's identified segments: (i) Investment Assets and (ii) Inventory Assets. As a result, in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company classified the revenues and expenses related to its Investment Properties that were sold and its leasehold interests that expired subsequent to December 31, 2001, as discontinued operations, as well as, the revenues and expenses related to any Investment Property that was held for sale at June 30, 2006. The Company also classified the revenues and expenses of its Inventory Properties that were sold which generated rental revenues as discontinued operations, as well as, the revenues and expenses related to its Inventory Properties held for sale which generated rental revenues as of June 30, 2006. The following table summarizes the earnings from discontinued operations for each of the quarters ended June 30 (dollars in thousands):

	# of Sold Properties	2006 Gain on Disposition	Earnings	# of Sold Properties	2005 Gain on Disposition	Earnings
Investment Portfolio	3	\$ 59,501	\$ 62,510	2	\$ 16	\$ 2,301
Inventory Portfolio, net of minority interest	18	2,061	2,479	7	2,592	1,891
	21	\$ 61,562	\$ 64,989	9	\$ 2,608	\$ 4,192

The following table summarizes the earnings from discontinued operations for each of the six months ended June 30 (dollars in thousands):

	# of Sold Properties	2006 Gain on Disposition	Earnings	# of Sold Properties	2005 Gain on Disposition	Earnings
Investment Portfolio	6	\$ 64,452	\$ 68,831	6	\$ 9,801	\$ 14,225
Inventory Portfolio, net of minority interest	26	3,221	4,271	11	4,654	3,285
	32	\$ 67,673	\$ 73,102	17	\$ 14,455	\$ 17,510

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The Company occasionally sells investment properties and may reinvest the proceeds of the sales to purchase new properties. The Company evaluates its ability to pay dividends to shareholders by considering the combined effect of income from continuing and discontinued operations.

Table of Contents**Item 3 Quantitative and Qualitative Disclosures about Market Risk**

The Company is exposed to interest rate changes primarily as a result of its variable rate credit facility and its long-term, fixed rate debt used to finance the Company's development and acquisition activities and for general corporate purposes. The Company's interest rate risk management objective is to limit the impact of interest rate changes on earnings and cash flows and to lower its overall borrowing costs. To achieve its objectives, the Company borrows at both fixed and variable rates on its long-term debt.

The Company had no outstanding derivatives as of June 30, 2006 or December 31, 2005.

The information in the table below summarizes the Company's market risks associated with its debt obligations outstanding as of June 30, 2006 and December 31, 2005. The table presents principal cash flows and related interest rates by year for debt obligations outstanding as of June 30, 2006. As the table incorporates only those exposures that exist as of June 30, 2006, it does not consider those exposures or positions which could arise after this date. Moreover, because firm commitments are not presented in the table below, the information presented therein has limited predictive value. As a result, the Company's ultimate realized gain or loss with respect to interest rate fluctuations will depend on the exposures that arise during the period, the Company's hedging strategies at that time and interest rates.

	Variable Rate Debt Credit Facility &		Debt Obligations (dollars in thousands)					
			Fixed Rate Debt			Secured Debt		
	Term Note		Mortgages		Unsecured Debt ^{(2) (3)}		Secured Debt	
	Debt Obligation	Weighted Average Interest Rate ⁽¹⁾	Debt Obligation	Weighted Average Interest Rate	Debt Obligation	Effective Interest Rate	Debt Obligation	Weighted Average Interest Rate
2006			865	7.12%				
2007			8,413	7.12%			12,250	10.00%
2008			1,190	7.04%	99,939	7.16%	14,000	10.00%
2009	170,500	5.67%	1,000	7.02%				
2010			1,022	7.01%	19,934	8.60%		
Thereafter			24,268	7.00%	375,102	6.21%		
Total	\$ 170,500	5.67%	36,758	7.12%	494,975	6.50%	\$ 26,250	10.00%
Fair Value:								
June 30, 2006	\$ 170,500	5.67%	36,758	7.12%	495,249	6.50%	\$ 26,250	10.00%
December 31, 2005	\$ 183,100	4.81%	\$ 151,133	6.18%	\$ 520,144	6.50%	\$ 28,250	10.00%

(1) The credit facility interest rate varies based upon a tiered rate structure ranging from 70 to 135 basis points above LIBOR based upon the debt rating of the Company. The term note interest rate varies based upon a tiered rate structure ranging from 85 to 165 basis points above LIBOR based upon the debt rating of the Company. The weighted average interest rates shown represent the rates at the end of the period.

(2) Includes Company's notes payable, net of unamortized note discounts.

(3) In July 2004, the Company sold five investment properties for \$26,041 and subsequently leased back the properties under a 10-year financing lease obligation. The Company may repurchase one or more of the properties subject to put and call options included in the financing lease.

The Company is also exposed to market risks related to the Company's Residuals. Factors that may impact the market value of the Residuals include delinquencies, loan losses, prepayment speeds and interest rates. The Residuals, which are reported at market value, had a carrying value of \$41,925,000 and \$55,184,000 as of June 30, 2006 and December 31, 2005, respectively. Unrealized gains and losses are reported as other comprehensive income in shareholders' equity. Losses are considered permanent and reported as an impairment if and when there has been a change in the timing or amount of estimated cash flows that leads to a loss in value.

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Item 4 Controls and Procedures

Evaluation of Disclosure Controls and