

REALTY INCOME CORP
Form 10-Q
October 29, 2015
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 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 September 30, 2015, or

o Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File Number 1-13374

REALTY INCOME CORPORATION

(Exact name of registrant as specified in its charter)

Maryland

33-0580106

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(State or Other Jurisdiction of
Incorporation or Organization)

(IRS Employer Identification
Number)

11995 El Camino Real, San Diego, California 92130

(Address of Principal Executive Offices)

Registrant's telephone number, including area code: **(858) 284-5000**

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

There were 249,600,461 shares of common stock outstanding as of October 22, 2015.

Table of Contents

REALTY INCOME CORPORATION

Index to Form 10-Q

September 30, 2015

<u>PART I.</u>	<u>FINANCIAL INFORMATION</u>	Page
<u>Item 1:</u>	<u>Financial Statements</u>	
	<u>Consolidated Balance Sheets</u>	2
	<u>Consolidated Statements of Income</u>	3
	<u>Consolidated Statements of Cash Flows</u>	4
	<u>Notes to Consolidated Financial Statements</u>	5
<u>Item 2:</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	
	<u>Forward-Looking Statements</u>	21
	<u>The Company</u>	22
	<u>Recent Developments</u>	25
	<u>Liquidity and Capital Resources</u>	28
	<u>Results of Operations</u>	33
	<u>Funds from Operations (FFO) Available to Common Stockholders</u>	38
	<u>Adjusted Funds from Operations (AFFO) Available to Common Stockholders</u>	40
	<u>Property Portfolio Information</u>	41
	<u>Impact of Inflation</u>	48
	<u>Impact of Recent Accounting Pronouncements</u>	48
	<u>Other Information</u>	48
<u>Item 3:</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	49
<u>Item 4:</u>	<u>Controls and Procedures</u>	50
<u>PART II. OTHER INFORMATION</u>		
<u>Item 2:</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	51
<u>Item 6:</u>	<u>Exhibits</u>	51
<u>SIGNATURE</u>		54

Table of Contents**PART 1. FINANCIAL INFORMATION****Item 1. Financial Statements**

REALTY INCOME CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

September 30, 2015 and December 31, 2014

(dollars in thousands, except per share data)

	2015 (unaudited)	2014
ASSETS		
Real estate, at cost:		
Land	\$ 3,246,465	\$ 3,046,372
Buildings and improvements	8,859,414	8,107,199
Total real estate, at cost	12,105,879	11,153,571
Less accumulated depreciation and amortization	(1,609,914)	(1,386,871)
Net real estate held for investment	10,495,965	9,766,700
Real estate held for sale, net	13,346	14,840
Net real estate	10,509,311	9,781,540
Cash and cash equivalents	7,074	3,852
Accounts receivable, net	74,977	64,386
Acquired lease intangible assets, net	1,043,554	1,039,724
Goodwill	15,372	15,470
Other assets, net	88,281	107,650
Total assets	\$ 11,738,569	\$ 11,012,622
LIABILITIES AND EQUITY		
Distributions payable	\$ 47,844	\$ 43,675
Accounts payable and accrued expenses	97,219	123,287
Acquired lease intangible liabilities, net	241,128	220,469
Other liabilities	36,993	53,145
Lines of credit payable	439,000	223,000
Term loans	320,000	70,000
Mortgages payable, net	706,141	852,575
Notes payable, net	3,786,408	3,785,372
Total liabilities	5,674,733	5,371,523
Commitments and contingencies		
Stockholders' equity:		
Preferred stock and paid in capital, par value \$0.01 per share, 69,900,000 shares authorized, 16,350,000 shares issued and outstanding as of September 30, 2015 and December 31, 2014	395,378	395,378
Common stock and paid in capital, par value \$0.01 per share, 370,100,000 shares authorized, 238,085,515 shares issued and outstanding as of September 30, 2015 and 224,881,192 shares issued and outstanding as of December 31, 2014	7,107,662	6,464,987
Distributions in excess of net income	(1,463,392)	(1,246,964)

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Total stockholders' equity	6,039,648	5,613,401
Noncontrolling interests	24,188	27,698
Total equity	6,063,836	5,641,099
Total liabilities and equity	\$ 11,738,569	\$ 11,012,622

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

Table of Contents

REALTY INCOME CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

For the three and nine months ended September 30, 2015 and 2014

(dollars in thousands, except per share data) (unaudited)

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2015	2014	2015	2014
REVENUE				
Rental	\$ 247,578	\$ 226,832	\$ 724,131	\$ 662,822
Tenant reimbursements	10,187	8,275	31,757	20,872
Other	1,124	606	3,729	2,238
Total revenue	258,889	235,713	759,617	685,932
EXPENSES				
Depreciation and amortization	104,338	95,260	303,476	278,124
Interest	63,950	52,814	181,098	157,246
General and administrative	10,861	11,025	36,331	35,499
Property (including reimbursable)	13,542	12,770	42,455	33,474
Income taxes	745	697	2,448	2,358
Provisions for impairment	3,864	495	9,182	2,676
Total expenses	197,300	173,061	574,990	509,377
Gain on sales of real estate	6,224	10,975	17,117	14,211
Income from continuing operations	67,813	73,627	201,744	190,766
Income from discontinued operations	-	-	-	3,097
Net income	67,813	73,627	201,744	193,863
Net income attributable to noncontrolling interests	(338)	(344)	(919)	(1,016)
Net income attributable to the Company	67,475	73,283	200,825	192,847
Preferred stock dividends	(6,770)	(9,327)	(20,310)	(30,292)
Excess of redemption value over carrying value of preferred shares redeemed	-	(6,015)	-	(6,015)
Net income available to common stockholders	\$ 60,705	\$ 57,941	\$ 180,515	\$ 156,540
Amounts available to common stockholders per common share, basic and diluted:				
Income from continuing operations	\$ 0.26	\$ 0.26	\$ 0.78	\$ 0.71
Net income	\$ 0.26	\$ 0.26	\$ 0.78	\$ 0.72
Weighted average common shares outstanding:				
Basic	236,211,706	222,061,661	231,434,521	216,804,815

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Diluted

236,739,942

222,236,071

231,862,767

217,147,035

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

-3-

Table of Contents

REALTY INCOME CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the nine months ended September 30, 2015 and 2014

(dollars in thousands) (unaudited)

	2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 201,744	\$ 193,863
Adjustments to net income:		
Depreciation and amortization	303,476	278,124
Income from discontinued operations	-	(3,097)
Amortization of share-based compensation	7,598	7,653
Non-cash rental adjustments	(6,462)	(5,390)
Amortization of net premiums on mortgages payable	(5,608)	(10,843)
Amortization of deferred financing costs	6,806	8,027
Loss on interest rate swaps	7,138	409
Gain on sales of real estate	(17,117)	(14,211)
Provisions for impairment on real estate	9,182	2,676
Cash provided by discontinued operations	-	1,310
Change in assets and liabilities		
Accounts receivable and other assets	2,351	11,976
Accounts payable, accrued expenses and other liabilities	(36,160)	(30,416)
Net cash provided by operating activities	472,948	440,081
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment in real estate	(1,061,871)	(1,076,391)
Improvements to real estate, including leasing costs	(5,861)	(4,538)
Proceeds from sales of real estate:		
Continuing operations	51,958	46,644
Discontinued operations	-	6,918
Collection of loans receivable	-	350
Restricted escrow deposits for Section 1031 tax-deferred exchanges and pending acquisitions	20,517	(27,340)
Net cash used in investing activities	(995,257)	(1,054,357)
CASH FLOWS FROM FINANCING ACTIVITIES		
Cash distributions to common stockholders	(392,767)	(356,735)
Cash dividends to preferred stockholders	(20,310)	(31,447)
Borrowings on line of credit	1,059,000	1,359,121
Payments on line of credit	(843,000)	(1,442,121)
Proceeds from notes and bonds payable issued	-	598,594
Principal payments on mortgages payable	(140,825)	(77,619)
Proceeds from term loans	250,000	-
Proceeds from common stock offerings, net	276,430	528,615
Redemption of preferred units	(6,750)	-
Distributions to noncontrolling interests	(1,267)	(1,390)
Debt issuance costs	(10,358)	(5,609)
Proceeds from dividend reinvestment and stock purchase plan, net	360,941	56,580
Other items, including shares withheld upon vesting	(5,563)	(7,034)
Net cash provided by financing activities	525,531	620,955
Net increase in cash and cash equivalents	3,222	6,679
Cash and cash equivalents, beginning of period	3,852	10,257

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Cash and cash equivalents, end of period	\$	7,074	\$	16,936
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For supplemental disclosures, see note 18.

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

Table of Contents

REALTY INCOME CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2015

(unaudited)

1. Management Statement

The consolidated financial statements of Realty Income Corporation (Realty Income , the Company , we , our or us) were prepared from our books and records without audit and include all adjustments (consisting of only normal recurring accruals) necessary to present a fair statement of results for the interim periods presented. Readers of this quarterly report should refer to our audited consolidated financial statements for the year ended December 31, 2014, which are included in our 2014 Annual Report on Form 10-K, as certain disclosures that would substantially duplicate those contained in the audited financial statements have not been included in this report.

At September 30, 2015, we owned 4,473 properties, located in 49 states and Puerto Rico, containing over 74.8 million leasable square feet.

2. Summary of Significant Accounting Policies and Procedures and Recent Accounting Pronouncements

A. The accompanying consolidated financial statements include the accounts of Realty Income and other entities for which we make operating and financial decisions (i.e., control), after elimination of all material intercompany balances and transactions. We consolidate entities that we control and record a noncontrolling interest for the portion that we do not own. Noncontrolling interest that was created or assumed as part of a business combination was recognized at fair value as of the date of the transaction (see note 11). We have no unconsolidated investments.

B. We have elected to be taxed as a real estate investment trust, or REIT, under the Internal Revenue Code of 1986, as amended. We believe we have qualified and continue to qualify as a REIT. Under the REIT operating structure, we are permitted to deduct dividends paid to our stockholders in determining our taxable income. Assuming our dividends equal or exceed our net income, we generally will not be required to pay federal corporate income taxes on such income. Accordingly, no provision has been made for federal income taxes in the accompanying consolidated financial statements, except for federal income taxes of our taxable REIT subsidiaries. The income taxes recorded on our consolidated statements of income represent amounts paid by Realty Income for city and state income and franchise taxes.

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C. We recognize an allowance for doubtful accounts relating to accounts receivable for amounts deemed uncollectible. We consider tenant specific issues, such as financial stability and ability to pay rent, when determining collectability of accounts receivable and appropriate allowances to record. The allowance for doubtful accounts was \$607,000 at September 30, 2015 and \$765,000 at December 31, 2014.

D. We assign a portion of goodwill to our applicable property sales, which results in a reduction of the carrying amount of our goodwill. In order to allocate goodwill to the carrying amount of properties that we sell, we utilize a relative fair value approach based on the original methodology for assigning goodwill. As we sell properties, our goodwill will likely continue to gradually decrease over time. During our tests for impairment of goodwill during the second quarters of 2015 and 2014, we determined that the estimated fair values of our reporting units exceeded their carrying values. We did not have an impairment on our existing goodwill in 2015 or 2014.

E. In April 2015, the Financial Accounting Standards Board, or FASB, issued ASU 2015-03, which amends Topic 835, *Other Presentation Matters*. The amendments in this ASU require that debt issuance costs be reported on the balance sheet as a direct reduction of the face amount of the debt instrument they relate to, and should not be classified as a deferred charge, as was previously required under the Accounting Standards Codification. ASU 2015-03 is effective, on a retrospective basis, for interim and annual periods beginning after December 15, 2015; early adoption is permitted. We have not yet adopted this ASU and do not expect it to have a material impact on our consolidated financial statements.

In September 2015, FASB, issued ASU 2015-16, which amends Topic 805, *Business Combinations*. The amendments in this ASU require that we recognize purchase price allocation adjustments that are identified during the measurement period in the reporting period in which the adjustment amounts are determined, and

Table of Contents

eliminate the requirement to retrospectively account for these adjustments. ASU 2015-16 is effective, on a prospective basis, for interim and annual periods beginning after December 15, 2015; early adoption is permitted. We have chosen to early adopt ASU 2015-16 for the three- and nine-months ended September 30, 2015 and it did not have a material impact on our consolidated financial statements.

3. Supplemental Detail for Certain Components of Consolidated Balance Sheets

A. Acquired lease intangible assets, net, consist of the following (dollars in thousands) at:	September 30, 2015	December 31, 2014
Acquired in-place leases	\$ 1,046,040	\$ 1,005,244
Accumulated amortization of acquired in-place leases	(242,183)	(177,722)
Acquired above-market leases	296,196	252,581
Accumulated amortization of acquired above-market leases	(56,499)	(40,379)
	\$ 1,043,554	\$ 1,039,724
B. Other assets, net, consist of the following (dollars in thousands) at:	September 30, 2015	December 31, 2014
Deferred financing costs, net	\$ 21,428	\$ 23,274
Notes receivable issued in connection with property sales	18,040	18,342
Restricted escrow deposits	17,437	36,540
Prepaid expenses	13,292	14,137
Credit facility origination costs, net	10,979	4,171
Impounds related to mortgages payable	5,093	5,789
Corporate assets, net	2,188	2,600
Other items	(176)	2,797
	\$ 88,281	\$ 107,650
C. Distributions payable consist of the following declared distributions (dollars in thousands) at:	September 30, 2015	December 31, 2014
Common stock distributions	\$ 45,447	\$ 41,268
Preferred stock dividends	2,257	2,257
Noncontrolling interests distributions	140	150
	\$ 47,844	\$ 43,675
D. Accounts payable and accrued expenses consist of the following (dollars in thousands) at:	September 30, 2015	December 31, 2014
Notes payable - interest payable	\$ 33,987	\$ 63,919
Property taxes payable	19,181	11,634
Accrued costs on properties under development	11,944	18,011
Mortgages, term loans, credit line - interest payable and interest rate swaps	11,337	4,569
Other items	20,770	25,154
	\$ 97,219	\$ 123,287
E. Acquired lease intangible liabilities, net, consist of the following (dollars in thousands) at:	September 30, 2015	December 31, 2014
Acquired below-market leases	\$ 274,739	\$ 243,025
Accumulated amortization of acquired below-market leases	(33,611)	(22,556)
	\$ 241,128	\$ 220,469
F. Other liabilities consist of the following	September 30,	December 31,

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(dollars in thousands) at:	2015	2014
Rent received in advance	\$ 26,313	\$ 36,122
Security deposits	6,051	5,876
Capital lease obligations	4,629	4,397
Preferred units issued upon acquisition of ARCT	-	6,750
	\$ 36,993	\$ 53,145

Table of Contents

4. Investments in Real Estate

We acquire land, buildings and improvements necessary for the successful operations of commercial tenants.

A. Acquisitions during the First Nine Months of 2015 and 2014

During the first nine months of 2015, we invested \$1.1 billion in 195 new properties and properties under development or expansion with an initial weighted average contractual lease rate of 6.5%. The 195 new properties and properties under development or expansion are located in 36 states, will contain approximately 5.1 million leasable square feet, and are 100% leased with a weighted average lease term of 16.7 years. The tenants occupying the new properties operate in 18 industries and the property types consist of 87.0% retail and 13.0% industrial, based on rental revenue. None of our investments during 2015 caused any one tenant to be 10% or more of our total assets at September 30, 2015.

The \$1.1 billion invested during the first nine months of 2015 was allocated as follows: \$214.8 million to land, \$780.8 million to buildings and improvements, \$86.6 million to intangible assets related to leases, and \$27.2 million to intangible liabilities related to leases and other assumed liabilities. There was no contingent consideration associated with these acquisitions.

The properties acquired during the first nine months of 2015 generated total revenues of \$25.3 million and income from continuing operations of \$12.6 million.

Of the \$1.1 billion we invested during the first nine months of 2015, \$117.2 million of the purchase price allocation is based on a preliminary measurement of fair value that is subject to change. The allocation for these properties represents our current best estimate of fair value and we expect to finalize the valuations and complete the purchase price allocations in 2015. During the first nine months of 2015, we finalized the purchase price allocations for \$147.1 million invested in the fourth quarter of 2014. There were no material changes to our consolidated balance sheets or income statements as a result of these purchase price allocations being finalized.

In comparison, during the first nine months of 2014, we invested \$1.24 billion in 439 new properties and properties under development or expansion with an initial weighted average contractual lease rate of 7.1%. The 439 new properties and properties under development or expansion, were located in 42 states, contain over 8.5 million leasable square feet and were 100% leased with a weighted average lease term of 12.6 years. The tenants occupying the new properties operated in 27 industries and the property types consisted of 85.6% retail, 7.2% industrial and 7.2% office, based on rental revenue.

The \$1.24 billion invested during the first nine months of 2014 was allocated as follows: \$240.1 million to land, \$861.9 million to buildings and improvements, \$202.0 million to intangible assets related to leases, \$901,000 to other assets, net, and \$60.5 million to intangible liabilities related to leases and other assumed liabilities. We also recorded net mortgage premiums of \$604,000 associated with the \$166.7 million of mortgages acquired during the first nine months of 2014. There was no contingent consideration associated with these acquisitions.

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The properties acquired during the first nine months of 2014 contributed total revenues of \$47.3 million and income from continuing operations of \$19.2 million for the nine months ended September 30, 2014.

The estimated initial weighted average contractual lease rate for a property is generally computed as estimated contractual net operating income, which, in the case of a net leased property, is equal to the aggregate base rent for the first full year of each lease, divided by the total cost of the property. Since it is possible that a tenant could default on the payment of contractual rent, we cannot provide assurance that the actual return on the funds invested will remain at the percentages listed above.

In the case of a property under development or expansion, the contractual lease rate is generally fixed such that rent varies based on the actual total investment in order to provide a fixed rate of return. When the lease does not provide for a fixed rate of return on a property under development or expansion, the estimated initial weighted average contractual lease rate is computed as follows: estimated net operating income (determined by the lease) for the first full year of each lease, divided by our projected total investment in the property, including land, construction and capitalized interest costs. Of the \$1.1 billion we invested during the first nine months of 2015, \$37.1 million was invested in 30 properties under development or expansion with an estimated initial weighted average contractual lease rate of 9.9%. Of the \$1.24 billion we invested during the first nine months of 2014, \$69.0 million was invested in 32 properties under development or expansion with an estimated initial weighted average contractual lease rate of 8.5%.

Table of Contents**B. Acquisition Transaction Costs**

Acquisition transaction costs of \$368,000 and \$589,000 were recorded to general and administrative expense on our consolidated statements of income during the first nine months of 2015 and 2014, respectively.

C. Investments in Existing Properties

During the first nine months of 2015, we capitalized costs of \$5.9 million on existing properties in our portfolio, consisting of \$555,000 for re-leasing costs, \$3.8 million for recurring capital expenditures and \$1.5 million for non-recurring building improvements. In comparison, during the first nine months of 2014, we capitalized costs of \$4.5 million on existing properties in our portfolio.

D. Properties with Existing Leases

Of the \$1.1 billion we invested during the first nine months of 2015, approximately \$304.2 million was used to acquire 47 properties with existing leases. In comparison, of the \$1.24 billion we invested in the first nine months of 2014, approximately \$949.6 million was used to acquire 180 properties with existing leases. The value of the in-place and above-market leases is recorded to acquired lease intangible assets, net on our consolidated balance sheets, and the value of the below-market leases is recorded to acquired lease intangible liabilities, net on our consolidated balance sheets.

The values of the in-place leases are amortized as depreciation and amortization expense. The amounts amortized to expense for all of our in-place leases, for the first nine months of 2015 and 2014, were \$65.5 million and \$62.1 million, respectively.

The values of the above-market and below-market leases are amortized over the term of the respective leases, including any bargain renewal options, as an adjustment to rental revenue on our consolidated statements of income. The amounts amortized as a net decrease to rental revenue for capitalized above-market and below-market leases for the first nine months of 2015 and 2014 were \$5.8 million and \$6.4 million, respectively. If a lease were to be terminated prior to its stated expiration, all unamortized amounts relating to that lease would be recorded to revenue or expense as appropriate.

The following table presents the estimated impact during the next five years and thereafter related to the amortization of the acquired above-market and below-market lease intangibles and the amortization of the in-place lease intangibles for properties held for investment at September 30, 2015 (in thousands):

	Net increase (decrease) to rental revenue	Increase to amortization expense
2015	\$ (2,090)	\$ 22,242
2016	(8,353)	88,878
2017	(8,296)	87,689
2018	(8,049)	85,194

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2019		(7,059)		75,130
Thereafter		35,278		444,724
Totals	\$	1,431	\$	803,857

5. Credit Facility

In June 2015, we entered into a new \$2 billion unsecured revolving credit facility, or our new credit facility, which replaced our \$1.5 billion credit facility that was scheduled to expire in May 2016. The initial term of our new credit facility expires in June 2019 and includes, at our option, two six-month extensions. Our new credit facility has a \$1.0 billion accordion expansion option. Under our new credit facility, our current investment grade credit ratings provide for financing at the London Interbank Offered Rate, commonly referred to as LIBOR, plus 0.90% with a facility commitment fee of 0.15%, for all-in drawn pricing of 1.05% over LIBOR. The borrowing rate is subject to an interest rate floor. We also have other interest rate options available to us under our new credit facility. Our new credit facility is unsecured and, accordingly, we have not pledged any assets as collateral for this obligation.

Table of Contents

At September 30, 2015, credit facility origination costs of \$11.0 million are included in other assets, net on our consolidated balance sheet. This balance includes \$9.1 million of new credit facility origination costs incurred during the second and third quarters of 2015 as a result of entering into our new credit facility. These costs, as well as the costs incurred as a result of entering into our previous credit facilities, are being amortized over the remaining term of our new credit facility.

At September 30, 2015, we had a borrowing capacity of \$1.56 billion available on our new credit facility (subject to customary conditions to borrowing) and an outstanding balance of \$439.0 million, as compared to an outstanding balance of \$223.0 million at December 31, 2014.

The weighted average interest rate on outstanding borrowings under our credit facilities was 1.2% during the first nine months of 2015 and 2014. At September 30, 2015, the effective interest rate was 1.3%. Our new and previous credit facilities are and were subject to various leverage and interest coverage ratio limitations, and at September 30, 2015, we remain in compliance with the covenants on our new credit facility.

6. Mortgages Payable

During the first nine months of 2015, we made \$140.8 million in principal payments, including the repayment of ten mortgages in full for \$135.3 million. No mortgages were assumed during the first nine months of 2015.

During the first nine months of 2014, we made \$77.6 million in principal payments, including the repayment of five mortgages in full for \$72.0 million, and assumed mortgages totaling \$166.7 million, excluding net premiums. The mortgages are secured by the properties on which the debt was placed. We expect to pay off the mortgages as soon as prepayment penalties make it economically feasible to do so.

During the first nine months of 2014, aggregate net premiums totaling \$604,000 were recorded upon assumption of the mortgages for above-market interest rates. Amortization of our net premiums is recorded as a reduction to interest expense over the remaining term of the respective mortgages, using a method that approximates the effective-interest method.

These mortgages contain customary covenants, such as limiting our ability to further mortgage each applicable property or to discontinue insurance coverage without the prior consent of the lender. At September 30, 2015, we remain in compliance with these covenants.

We did not incur any deferred financing costs on our mortgages assumed in the first nine months of 2014. The balance of our deferred financing costs, which are classified as part of other assets, net, on our consolidated balance sheets, was \$619,000 at September 30, 2015 and \$827,000 at December 31, 2014. These costs are being amortized over the remaining term of each mortgage.

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The following is a summary of all our mortgages payable as of September 30, 2015 and December 31, 2014, respectively (dollars in thousands):

As Of	Number of Properties(1)	Weighted Average Stated Interest Rate(2)	Weighted Average Effective Interest Rate(3)	Weighted Average Remaining Years Until Maturity	Remaining Principal Balance	Unamortized Premium Balance, net	Mortgage Payable Balance
9/30/15	192	4.9%	4.0%	3.6	\$ 695,186	\$ 10,955	\$ 706,141
12/31/14	241	5.0%	4.0%	3.7	\$ 836,011	\$ 16,564	\$ 852,575

(1) At September 30, 2015, there were 47 mortgages on 192 properties, while at December 31, 2014, there were 57 mortgages on 241 properties.

The mortgages require monthly payments, with principal payments due at maturity. The mortgages are at fixed interest rates, except for four mortgages on 13 properties totaling \$51.0 million at September 30, 2015, including net unamortized discounts. At December 31, 2014, five mortgages on 14 properties totaling \$74.5 million, including net unamortized discounts, were at variable interest rates. After factoring in arrangements which limit our exposure to interest rate risk and effectively fix our per annum interest rates, our variable rate mortgage debt includes two mortgages totaling \$15.5 million at September 30, 2015, and three mortgages totaling \$39.1 million at December 31, 2014.

(2) Stated interest rates ranged from 2.0% to 6.9% at September 30, 2015 and December 31, 2014.

(3) Effective interest rates ranged from 2.2% to 8.9% at September 30, 2015, while effective interest rates ranged from 2.2% to 9.0% at December 31, 2014.

Table of Contents

The following table summarizes the maturity of mortgages payable, excluding net premiums of \$11.0 million, as of September 30, 2015 (dollars in millions):

Year of Maturity		
2015	\$	1.9
2016		225.6
2017		142.7
2018		15.3
2019		26.2
Thereafter		283.5
Totals	\$	695.2

7. Term Loans

In June 2015, in conjunction with entering into our new credit facility, we entered into a \$250 million senior unsecured term loan maturing on June 30, 2020. Borrowing under this term loan bears interest at the current one month LIBOR, plus 0.95%. In conjunction with this term loan, we also entered into an interest rate swap which effectively fixes our per annum interest rate on this term loan at 2.67%.

In January 2013, in conjunction with our acquisition of American Realty Capital Trust, Inc., or ARCT, we entered into a \$70 million senior unsecured term loan maturing January 21, 2018. Borrowing under this term loan bears interest at the current one month LIBOR, plus 1.2%. In conjunction with this term loan, we also entered into an interest rate swap which effectively fixes our per annum interest rate on this term loan at 2.15%.

Deferred financing costs of \$1.2 million incurred in conjunction with the \$250 million term loan and \$303,000 incurred in conjunction with the \$70 million term loan are being amortized over the remaining terms of each term loan. The net balance of these deferred financing costs, which was \$1.2 million at September 30, 2015, and \$187,000 at December 31, 2014, is included in other assets, net on our consolidated balance sheets.

8. Notes Payable

A. General

Our senior unsecured notes and bonds consisted of the following, sorted by maturity date (dollars in millions):

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	September 30, 2015		December 31, 2014
5.5% notes, issued in November 2003 and due in November 2015	\$ 150	\$	150
5.95% notes, issued in September 2006 and due in September 2016	275		275
5.375% notes, issued in September 2005 and due in September 2017	175		175
2.0% notes, issued in October 2012 and due in January 2018	350		350
6.75% notes, issued in September 2007 and due in August 2019	550		550
5.75% notes, issued in June 2010 and due in January 2021	250		250
3.25% notes, issued in October 2012 and due in October 2022	450		450
4.65% notes, issued in July 2013 and due in August 2023	750		750
3.875% notes, issued in June 2014 and due in July 2024	350		350
4.125% notes, issued in September 2014 and due in October 2026	250		250
5.875% bonds, \$100 issued in March 2005 and \$150 issued in June 2011, both due in March 2035	250		250
Total principal amount	3,800		3,800
Unamortized original issuance discounts	(14)		(15)
	\$ 3,786	\$	3,785

Table of Contents

The following table summarizes the maturity of our notes and bonds payable as of September 30, 2015, excluding unamortized original issuance discounts (dollars in millions):

Year of Maturity		Notes and Bonds
2015	\$	150
2016		275
2017		175
2018		350
2019		550
Thereafter		2,300
Totals	\$	3,800

As of September 30, 2015, the weighted average interest rate on our notes and bonds payable was 4.8% and the weighted average remaining years until maturity was 6.5 years.

B. Note Issuance

In September 2014, we issued \$250 million of 4.125% senior unsecured notes due October 2026, or the 2026 Notes. The price to the investors for the 2026 Notes was 99.499% of the principal amount for an effective yield of 4.178% per annum. A portion of the total net proceeds of approximately \$246.4 million from this offering were used to repay all outstanding borrowings under our credit facility, and the remaining proceeds were used for other general corporate purposes, including additional property acquisitions. Interest is paid semiannually on the 2026 Notes.

In June 2014, we issued \$350 million of 3.875% senior unsecured notes due July 2024, or the 2024 Notes. The price to the investors for the 2024 Notes was 99.956% of the principal amount for an effective yield of 3.88% per annum. The total net proceeds of approximately \$346.7 million from these offerings were used to repay a portion of the outstanding borrowings under our credit facility. Interest is paid semiannually on the 2024 Notes.

9. Redemption of Preferred Stock

In September 2014, we issued an irrevocable notice of redemption for all 8.8 million shares of our 6.75% Monthly Income Class E Preferred Stock for \$25 per share, plus accrued dividends. The redemption occurred in October 2014. We incurred a charge of \$6.0 million, representing the Class E preferred stock original issuance costs that we paid in 2006.

10. Issuance of Common Stock

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In April 2015, we issued 5,500,000 shares of common stock. After underwriting discounts and other offering costs of \$1.4 million, the net proceeds of \$276.4 million were used to repay borrowings under our credit facility.

In April 2014, we issued 13,800,000 shares of common stock, including 1,800,000 shares purchased by the underwriters upon the exercise of their option to purchase additional shares. After underwriting discounts and other offering costs of \$22.8 million, the net proceeds of \$528.6 million were used to repay borrowings under our credit facility.

11. Noncontrolling Interests

In January 2013, we completed our acquisition of ARCT. Equity issued as consideration for this transaction included common and preferred partnership units issued by Tau Operating Partnership, L.P., or Tau Operating Partnership, the consolidated subsidiary which owns properties acquired through the ARCT acquisition. Realty Income and its subsidiaries hold a 99.4% interest in Tau Operating Partnership, and consolidate the entity.

In June 2013, we completed the acquisition of a portfolio of properties by issuing common partnership units in a newly formed entity, Realty Income, L.P. The units were issued as consideration for the acquisition. At September 30, 2015, the remaining units from this issuance represent a 1.7% ownership in Realty Income, L.P. Realty Income holds the remaining 98.3% interests in this entity and consolidates the entity.

Table of Contents

A. Neither of the common partnership units have voting rights. Both common partnership units are entitled to monthly distributions equal to the amount paid to common stockholders of Realty Income, and are redeemable in cash or Realty Income common stock, at our option, and at a conversion ratio of one to one, subject to certain exceptions. Noncontrolling interests with redemption provisions that permit the issuer to settle in either cash or common stock, at the option of the issuer, were evaluated to determine whether temporary or permanent equity classification on the balance sheet was appropriate. We determined that the units meet the requirements to qualify for presentation as permanent equity.

The following table represents the change in the carrying value of all noncontrolling interests through September 30, 2015 (dollars in thousands):

	Tau Operating Partnership units(1)		Realty Income, L.P. units(2)		Total
Carrying value at December 31, 2014	\$ 13,067	\$	14,631	\$	27,698
Reallocation of equity	836		(1,887)		(1,051)
Redemptions	-		(2,121)		(2,121)
Distributions	(541)		(716)		(1,257)
Allocation of net income	195		724		919
Carrying value at September 30, 2015	\$ 13,557	\$	10,631	\$	24,188
	Tau Operating Partnership units(1)		Realty Income, L.P. units(2)		Total
Carrying value at December 31, 2013	\$ 13,489	\$	22,422	\$	35,911
Reallocation of equity	-		(6,647)		(6,647)
Redemptions	-		(1,032)		(1,032)
Distributions	(695)		(1,144)		(1,839)
Allocation of net income	273		1,032		1,305
Carrying value at December 31, 2014	\$ 13,067	\$	14,631	\$	27,698

(1) 317,022 Tau Operating Partnership units were issued on January 22, 2013 and remained outstanding as of September 30, 2015 and December 31, 2014.

(2) 534,546 Realty Income, L.P. units were issued on June 27, 2013, and 499,546 units were outstanding as of December 31, 2014 and 419,546 remain outstanding as of September 30, 2015.

During the first nine months of 2015, we recorded net equity reclassification adjustments of \$1.1 million between noncontrolling interests and additional paid in capital to adjust the carrying value of noncontrolling interests to be in-line with their equity ownership interests in the entities. During 2014, we recorded an equity reclassification adjustment of \$6.6 million between noncontrolling interests and additional paid in capital to adjust the carrying value of the Realty Income, L.P. noncontrolling interests to be in-line with their equity ownership interest in the entity.

B. The Tau Operating Partnership preferred units were recorded at fair value as of the date of acquisition. Since they were redeemable at a fixed price on a determinable date, we initially classified them in other liabilities on our consolidated balance sheets. Payments on these preferred units were made monthly at a rate of 2% per annum and were included in interest expense. As of December 31, 2014, the preferred units had a carrying value of \$6.75 million. In January 2015, we redeemed all 6,750 Tau

Operating Partnership preferred units for \$1,000 per unit, plus accrued and unpaid distributions.

12. Fair Value of Financial Instruments

Fair value is defined as the price that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The disclosure for assets and liabilities measured at fair value requires allocation to a three-level valuation hierarchy. This valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. Categorization within this hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Table of Contents

We believe that the carrying values reflected in our consolidated balance sheets reasonably approximate the fair values for cash and cash equivalents, accounts receivable, escrow deposits, loans receivable, line of credit payable, term loans and all other liabilities, due to their short-term nature or interest rates and terms that are consistent with market, except for our notes receivable issued in connection with property sales, mortgages payable and our senior notes and bonds payable, which are disclosed below (dollars in millions):

	Carrying value per balance sheet		Estimated fair value
At September 30, 2015			
Notes receivable issued in connection with property sales	\$ 18.0	\$	19.7
Mortgages payable assumed in connection with acquisitions, net	706.1		713.4
Notes and bonds payable, net of unamortized original issuance discounts	3,786.4		4,001.0
	Carrying value per balance sheet		Estimated fair value
At December 31, 2014			
Notes receivable issued in connection with property sales	\$ 18.3	\$	20.1
Mortgages payable assumed in connection with acquisitions, net	852.6		857.9
Notes and bonds payable, net of unamortized original issuance discounts	3,785.4		4,092.8

The estimated fair values of our notes receivable issued in connection with property sales and our mortgages payable have been calculated by discounting the future cash flows using an interest rate based upon the relevant Treasury yield curve, plus an applicable credit-adjusted spread. Because this methodology includes unobservable inputs that reflect our own internal assumptions and calculations, the measurement of estimated fair values related to our notes receivable and mortgages payable is categorized as level three on the three-level valuation hierarchy.

The estimated fair values of our senior notes and bonds payable are based upon indicative market prices and recent trading activity of our senior notes and bonds payable. Because this methodology includes inputs that are less observable by the public and are not necessarily reflected in active markets, the measurement of the estimated fair values, related to our notes and bonds payable, is categorized as level two on the three-level valuation hierarchy.

We record interest rate swaps on the consolidated balance sheet at fair value. The fair value of our interest rate swaps are based on valuation techniques including discounted cash flow analysis on the expected cash flows of each swap, using both observable and unobservable market-based inputs, including interest rate curves. Because this methodology uses observable and unobservable inputs, the measurement of interest rate swaps is categorized as level two on the three-level valuation hierarchy.

13. Gain on Sales of Real Estate

During the third quarter of 2015, we sold eight properties for \$21.5 million, which resulted in a gain of \$6.2 million. During the first nine months of 2015, we sold 22 investment properties for \$52.0 million, which resulted in a gain of \$17.1 million. The results of operations for these properties are presented within continuing operations.

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During the third quarter of 2014, we sold 11 properties for \$33.8 million, which resulted in a gain of \$11.0 million. During the first nine months of 2014, we sold 28 properties for \$53.6 million, which resulted in a gain of \$16.8 million. Only the results of operations specifically related to the properties classified as held for sale at December 31, 2013 and sold during the first nine months of 2014 have been reclassified as discontinued operations, which was \$2.6 million for the nine months ended September 30, 2014.

During the first nine months of 2015, Crest Net Lease, Inc., or Crest, did not sell any properties. During the first nine months of 2014, Crest sold one property for \$820,000, which did not result in a gain. The results of operations for this property were reclassified as discontinued operations.

Table of Contents

14. Discontinued Operations

During the first quarter of 2014, the Financial Accounting Standards Board issued guidance that changed the definition of discontinued operations by limiting discontinued operations reporting to disposals of components of an entity that represent strategic shifts that have, or will have, a major effect on an entity's operations and financial results. We early adopted the requirements of this accounting pronouncement in the first quarter of 2014.

Starting with the first quarter of 2014, the results of operations for all qualifying disposals and properties classified as held for sale that were not previously reported in discontinued operations in our 2013 Annual Report on Form 10-K are presented within income from continuing operations on our consolidated statements of income. Prior to the date of adoption of Accounting Standards Update 2014-08 (ASU 2014-08), which amends Topic 205, *Presentation of Financial Statements*, and Topic 360, *Property, Plant, and Equipment*, we reported, in discontinued operations, the results of operations of properties that had either been disposed of or classified as held for sale in financial statements issued. For the nine months ended September 30, 2014, we recorded income from discontinued operations of \$3.1 million, or \$0.01 per common share, basic and diluted.

15. Impairments

We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. A provision is made for impairment if estimated future operating cash flows (undiscounted and without interest charges) plus estimated disposition proceeds (undiscounted) are less than the current book value of the property. Key factors that we utilize in this analysis include projected rental rates, estimated holding periods, historical sales and releases, capital expenditures and property sales capitalization rates. If a property is classified as held for sale, it is carried at the lower of carrying cost or estimated fair value, less estimated cost to sell, and depreciation of the property ceases.

During the third quarter of 2015, we recorded total provisions for impairment of \$3.9 million on one property classified as held for sale, one property classified as held for investment, and two sold properties in the following industries: one in the pet supplies and services industry and three in the restaurant-casual dining industry. For the first nine months of 2015, we recorded total provisions for impairment of \$9.2 million on four properties classified as held for sale, three properties classified as held for investment, four sold properties, and one property disposed of other than by sale in the following industries: one in the health and fitness industry, one in the pet supplies and services industry, nine in the restaurant-casual dining industry, and one among the industry we classify as other. These properties were not previously classified as held for sale in financial statements issued prior to the date of adoption of ASU 2014-08; accordingly, the provisions for impairment are included in income from continuing operations on our consolidated statement of income for the three and nine months ended September 30, 2015.

In comparison, for the third quarter of 2014, we recorded total provisions for impairment of \$495,000 on four sold properties in the following industries: one in the convenience stores industry, two in the home improvement industry, and one in the restaurant-casual dining industry. For the first nine months of 2014, we recorded total provisions for impairment of \$2.7 million on nine sold properties in the following industries: one in the consumer electronics industry, one in the convenience stores industry, one in the home furnishings industry, two in the home improvement industry, and four in the restaurant-casual dining industry. These properties were not previously classified as held for sale in financial statements issued prior to the date of adoption of ASU 2014-08; accordingly, these provisions for impairment are included in income from continuing operations on our consolidated statements of income for the three and nine months ended September 30, 2014.

Table of Contents**16. Distributions Paid and Payable****A. Common Stock**

We pay monthly distributions to our common stockholders. The following is a summary of monthly distributions paid per common share for the first nine months of 2015 and 2014:

Month		2015		2014
January	\$	0.1834167	\$	0.1821667
February		0.1890000		0.1821667
March		0.1890000		0.1821667
April		0.1895000		0.1824792
May		0.1895000		0.1824792
June		0.1895000		0.1824792
July		0.1900000		0.1827917
August		0.1900000		0.1827917
September		0.1900000		0.1827917
Total	\$	1.6999167	\$	1.6423128

At September 30, 2015, a distribution of \$0.1905 per common share was payable and was paid in October 2015.

B. Class E Preferred Stock

Prior to the redemption of the Class E preferred stock in October 2014, dividends of \$0.140625 per share were paid monthly in arrears on the Class E preferred stock. During the first nine months of 2014, we paid six monthly dividends to holders of our Class E preferred stock totaling \$1.265625 per share, or \$11.1 million.

C. Class F Preferred Stock

The Class F preferred stockholders receive cumulative distributions at a rate of 6.625% per annum on the \$25.00 per share liquidation preference (equivalent to \$1.65625 per annum per share). Dividends of \$0.138021 per share are paid monthly in arrears on the Class F preferred stock. During each of the first nine months of 2015 and 2014, we paid nine monthly dividends to holders of our Class F preferred stock totaling \$1.242189 per share, or \$20.3 million, and at September 30, 2015, a monthly dividend of \$0.138021 per share was payable and was paid in October 2015. We are current in our obligations to pay dividends on our Class F preferred stock.

17. Net Income Per Common Share

Basic net income per common share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during each period. Diluted net income per common share is computed by dividing net income available to common stockholders, plus income attributable to dilutive shares and convertible common units, for the period by the weighted average number of common shares that would have been outstanding assuming the issuance of common shares for all potentially dilutive common shares outstanding during the reporting period.

Table of Contents

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

	Three months ended		Nine months ended	
	September 30, 2015	2014	September 30, 2015	2014
Weighted average shares used for the basic net income per share computation	236,211,706	222,061,661	231,434,521	216,804,815
Incremental shares from share-based compensation	211,214	174,410	111,224	25,198
Weighted average partnership common units convertible to common shares that were dilutive	317,022	-	317,022	317,022
Weighted average shares used for diluted net income per share computation	236,739,942	222,236,071	231,862,767	217,147,035
Unvested shares from share-based compensation that were anti-dilutive	132,948	45,654	107,879	58,654
Weighted average partnership common units convertible to common shares that were anti-dilutive	419,546	841,568	426,469	529,381

18. Supplemental Disclosures of Cash Flow Information

Cash paid for interest was \$201.4 million in the first nine months of 2015 and \$183.1 million in the first nine months of 2014.

Interest capitalized to properties under development was \$463,000 in the first nine months of 2015 and \$383,000 in the first nine months of 2014.

Cash paid for income taxes was \$3.1 million in the first nine months of 2015 and \$3.5 million in the first nine months of 2014.

The following non-cash activities are included in the accompanying consolidated financial statements:

A. See note 15 for a discussion of impairments recorded by Realty Income for the first nine months of 2015 and 2014.

B. See note 9 for a discussion of the \$6.0 million excess of redemption value over carrying value of preferred shares subject to redemption charge recorded by Realty Income during the third quarter and first nine months of 2014.

C. During the first nine months of 2014, we acquired mortgages payable to third-party lenders of \$166.7 million, recorded \$604,000 of net premiums, and recorded \$901,000 of interest rate swap value to other assets, net, related to property acquisitions.

D. During the first nine months of 2014, we applied \$48.9 million of loans receivable to the purchase price of five acquired properties.

E. Accrued costs on properties under development resulted in an increase in buildings and improvements and accounts payable of \$4.8 million at September 30, 2014.

19. Segment Information

We evaluate performance and make resource allocation decisions on an industry by industry basis. For financial reporting purposes, we have grouped our tenants into 48 activity segments. All of the properties are incorporated into one of the applicable segments. Because almost all of our leases require the tenant to pay operating expenses, rental revenue is the only component of segment profit and loss we measure.

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Table of Contents

The following tables set forth certain information regarding the properties owned by us, classified according to the business of the respective tenants (dollars in thousands):

Assets, as of:	September 30, 2015	December 31, 2014
Segment net real estate:		
Apparel	\$ 181,049	\$ 185,237
Automotive service	130,860	120,948
Automotive tire services	249,279	255,447
Beverages	298,793	302,001
Child care	52,697	54,194
Convenience stores	733,545	752,047
Dollar stores	1,139,714	1,165,560
Drug stores	1,344,565	1,036,697
Financial services	255,915	262,095
Grocery stores	334,031	341,773
Health and fitness	836,062	546,583
Health care	221,642	227,084
Home improvement	268,609	226,577
Restaurants-casual dining	426,261	448,484
Restaurants-quick service	405,802	336,753
Theaters	369,280	375,982
Transportation services	690,809	661,053
Wholesale club	455,814	465,569
30 other non-reportable segments	2,114,584	2,017,456
Total segment net real estate	10,509,311	9,781,540
Intangible assets:		
Apparel	49,198	52,445
Automotive service	19,431	2,909
Automotive tire services	13,619	14,871
Beverages	2,603	2,797
Convenience stores	16,414	17,535
Dollar stores	54,675	58,691
Drug stores	191,900	194,905
Financial services	35,860	39,564
Grocery stores	43,861	46,964
Health and fitness	64,469	66,460
Health care	31,217	35,017
Home improvement	43,933	35,726
Restaurants-casual dining	9,706	10,649
Restaurants-quick service	25,105	16,415
Theaters	18,635	21,600
Transportation services	95,854	101,040
Wholesale club	37,088	39,707
Other non-reportable segments	289,986	282,429
Goodwill:		
Automotive service	448	451
Automotive tire services	865	865
Child care	5,053	5,095
Convenience stores	2,020	2,023
Restaurants-casual dining	2,232	2,279
Restaurants-quick service	1,085	1,085

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Other non-reportable segments		3,669		3,672
Other corporate assets		170,332		175,888
Total assets	\$	11,738,569	\$	11,012,622

-17-

Table of Contents

Revenue	Three months ended			Nine months ended		
		September 30, 2015	2014		September 30, 2015	2014
Segment rental revenue:						
Apparel	\$	4,961	\$	4,849	\$	14,825
Automotive service		4,690		4,040		13,806
Automotive tire services		7,132		6,995		21,503
Beverages		6,397		6,321		19,054
Child care		5,019		4,990		14,901
Convenience stores		22,638		22,592		67,770
Dollar stores		22,086		21,875		65,976
Drug stores		27,320		21,269		75,744
Financial services		4,260		4,248		12,787
Grocery stores		7,441		7,236		22,323
Health and fitness		21,238		15,764		54,649
Health care		4,012		4,017		12,045
Home improvement		6,155		4,796		16,839
Restaurants-casual dining		9,426		9,551		28,245
Restaurants-quick service		9,961		7,933		29,940
Theaters		12,288		11,899		36,765
Transportation services		12,573		11,598		37,775
Wholesale club		9,341		9,250		28,024
30 other non-reportable segments		50,640		47,609		151,160
Total rental revenue		247,578		226,832		724,131
Tenant reimbursements		10,187		8,275		31,757
Other revenue		1,124		606		3,729
Total revenue	\$	258,889	\$	235,713	\$	759,617

20. Common Stock Incentive Plan

In 2012, our Board of Directors adopted and stockholders approved the Realty Income Corporation 2012 Incentive Award Plan, or the 2012 Plan, to enable us to motivate, attract and retain the services of directors and employees considered essential to our long-term success. The 2012 Plan offers our directors and employees an opportunity to own stock in Realty Income or rights that will reflect our growth, development and financial success. Under the terms of the 2012 plan, the aggregate number of shares of our common stock subject to options, restricted stock, stock appreciation rights, restricted stock units and other awards, will be no more than 3,985,734 shares. The 2012 Plan has a term of ten years from the date it was adopted by our Board of Directors.

The amount of share-based compensation costs recognized in general and administrative expense on our consolidated statements of income was \$2.2 million during the third quarter of 2015, \$2.2 million during the third quarter of 2014, \$7.6 million during the first nine months of 2015 and \$7.7 million during the first nine months of 2014.

Table of Contents*A. Restricted Stock*

The following table summarizes our common stock grant activity under our 2012 Plan. Our outstanding restricted stock vests over periods ranging from immediately to five years.

	For the nine months ended September 30, 2015		For the year ended December 31, 2014	
	Number of shares	Weighted average price(1)	Number of shares	Weighted average price(1)
Outstanding nonvested shares, beginning of year	527,176	\$ 29.02	722,263	\$ 23.37
Shares granted	154,385	\$ 50.88	262,655	\$ 39.87
Shares vested	(165,199)	\$ 36.71	(440,348)	\$ 36.88
Shares forfeited	(24,738)	\$ 44.86	(17,394)	\$ 39.07
Outstanding nonvested shares, end of each period	491,624	\$ 32.07	527,176	\$ 29.02

(1) Grant date fair value.

During the first nine months of 2015, we issued 154,385 shares of common stock under the 2012 Plan. These shares vest over a five year service period, except for the annual grant of shares to our Board of Directors, totaling 28,000 shares, of which 12,000 shares vested immediately, 8,000 shares vest in one year following the grant (assuming continued service), and 8,000 shares vest over a three year service period. Not included in the table above are 10,269 restricted share units granted during the first nine months of 2015 that vest over a five year service period and have the same economic rights as shares of restricted stock.

As of September 30, 2015, the remaining unamortized share-based compensation expense related to restricted stock totaled \$15.8 million, which is being amortized on a straight-line basis over the service period of each applicable award.

Due to a historically low turnover rate, we do not estimate a forfeiture rate for our nonvested shares. Accordingly, unexpected forfeitures will lower share-based compensation expense during the applicable period. Under the terms of our 2012 Plan, we pay non-refundable dividends to the holders of our nonvested shares. Applicable accounting guidance requires that the dividends paid to holders of these nonvested shares be charged as compensation expense to the extent that they relate to nonvested shares that do not or are not expected to vest. However, since we do not estimate forfeitures given our historical trends, we did not record any compensation expense related to dividends paid in the first nine months of 2015 or 2014.

B. Performance Shares

During the first nine months of 2015, and the year ended December 31, 2014, we granted performance share awards, as well as dividend equivalent rights. The number of performance shares that vest is based on the achievement of the following performance goals:

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2015 Performance Awards

Metrics	Weighting
Total shareholder return (TSR) relative to MSCI US REIT Index	50%
TSR relative to NAREIT Freestanding Index	20%
Dividend per share growth rate	20%
Debt-to-EBITDA ratio	10%

2014 Performance Awards

Metrics	Weighting
TSR relative to MSCI US REIT Index	60%
TSR relative to NAREIT Freestanding Index	20%
Debt-to-EBITDA ratio	20%

The performance shares are earned based on our performance, and vest 50% on the first and second January 1 after the end of the three year performance period, subject to continued service. The performance period for the 2014 performance awards began on January 1, 2014 and will end on December 31, 2016. The performance period for the 2015 performance awards began on January 1, 2015 and will end on December 31, 2017.

Table of Contents

The fair value of the performance shares was estimated on the date of grant using a Monte Carlo Simulation model. The following table summarizes our performance share grant activity:

	September 30, 2015		December 31, 2014		Weighted average price(1)
	Number of performance shares	Weighted average price(1)	Number of performance shares	Weighted average price(1)	
Outstanding nonvested shares, beginning of year	59,405	\$ 41.46	-	\$ -	-
Shares granted	55,716	\$ 52.78	71,705	\$ 41.46	41.46
Shares vested	-	\$ -	(4,067)	\$ 41.46	41.46
Shares forfeited	-	\$ -	(8,233)	\$ 41.46	41.46
Outstanding nonvested shares, end of each period	115,121	\$ 46.94	59,405	\$ 41.46	41.46

(1) Grant date fair value.

As of September 30, 2015, the remaining share-based compensation expense related to the performance shares totaled \$3.8 million. The portion related to the market-based awards is being recognized on a straight-line basis over the service period, and the portion related to the performance-based awards is being recognized on a tranche-by-tranche basis over the service period.

21. Dividend Reinvestment and Stock Purchase Plan

We have a Dividend Reinvestment and Stock Purchase Plan, or the DRSP, to provide our common stockholders, as well as new investors, with a convenient and economical method of purchasing our common stock and reinvesting their distributions. The DRSP also allows our current stockholders to buy additional shares of common stock by reinvesting all or a portion of their distributions. The DRSP authorizes up to 26,000,000 common shares to be issued. During the first nine months of 2015, we issued 7,565,432 shares and raised approximately \$360.9 million under the DRSP. During the first nine months of 2014, we issued 1,290,872 shares and raised approximately \$56.6 million under the DRSP. From the inception of the DRSP through September 30, 2015, we have issued 12,656,940 shares and raised approximately \$579.5 million.

In 2013, we revised our DRSP to pay for a majority of the plan-related fees, which were previously paid by investors, and to institute a waiver approval process, allowing larger investors or institutions, per a formal approval process, to purchase shares at a small discount, if approved by us. During the first nine months of 2015, we issued 7,413,207 shares and raised \$353.7 million under the waiver approval process. During the first nine months 2014, we issued 1,135,897 shares and raised \$50.0 million under the waiver approval process. These shares are included in the total activity for the first nine months of 2015 and 2014 noted in the preceding paragraph.

22. Commitments and Contingencies

In the ordinary course of business, we are party to various legal actions which we believe are routine in nature and incidental to the operation of our business. We believe that the outcome of the proceedings will not have a material adverse effect upon our consolidated financial position or results of operations.

At September 30, 2015, we had commitments of \$2.3 million for re-leasing costs, recurring capital expenditures, and non-recurring building improvements. In addition, as of September 30, 2015, we had committed \$58.4 million under construction contracts, which is expected to be paid in the next twelve months.

23. Subsequent Events

In October 2015, we declared the following dividends, which will be paid in November 2015:

- \$0.1905 per share to our common stockholders and

Table of Contents

- \$0.138021 per share to our Class F preferred stockholders.

In October 2015, we issued 11,500,000 shares of common stock, including 1,500,000 shares purchased by the underwriters upon the exercise of their option to purchase additional shares. After underwriting discounts and other offering costs of \$22.1 million, a portion of the net proceeds of \$517.0 million was used to repay borrowings under our new credit facility and the remaining portion was used for other general corporate purposes, which may include acquisitions.

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

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q, including the documents incorporated by reference, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act of 1934, as amended. When used in this quarterly report, the words estimated, anticipated, expect, believe, intend and similar expressions are intended to identify forward-looking statements. Forward-looking statements include discussions of strategy, plans, or intentions of management. Forward-looking statements are subject to risks, uncertainties, and assumptions about Realty Income Corporation, including, among other things:

- Our anticipated growth strategies;
- Our intention to acquire additional properties and the timing of these acquisitions;
- Our intention to sell properties and the timing of these property sales;
- Our intention to re-lease vacant properties;
- Anticipated trends in our business, including trends in the market for long-term, net leases of freestanding, single-tenant properties; and
- Future expenditures for development projects.

Future events and actual results, financial and otherwise, may differ materially from the results discussed in the forward-looking statements. In particular, some of the factors that could cause actual results to differ materially are:

- Our continued qualification as a real estate investment trust;
- General business and economic conditions;
- Competition;
- Fluctuating interest rates;
- Access to debt and equity capital markets;
- Continued volatility and uncertainty in the credit markets and broader financial markets;
- Other risks inherent in the real estate business including tenant defaults, potential liability relating to environmental matters, illiquidity of real estate investments, and potential damages from natural disasters;
- Impairments in the value of our real estate assets;
- Changes in the tax laws of the United States of America;

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- The outcome of any legal proceedings to which we are a party or which may occur in the future; and
- Acts of terrorism and war.

Additional factors that may cause risks and uncertainties include those discussed in the sections entitled Business , Risk Factors and Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K, for the fiscal year ended December 31, 2014.

Readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date that this quarterly report was filed with the Securities and Exchange Commission, or SEC. While forward-looking statements reflect our good faith beliefs, they are not guarantees of future performance. We undertake no obligation to publicly release the results of any revisions to these forward-looking statements that may be made to reflect events or circumstances after the date of this quarterly report or to reflect the occurrence of unanticipated events. In light of these risks and uncertainties, the forward-looking events discussed in this quarterly report might not occur.

Table of Contents

THE COMPANY

Realty Income, The Monthly Dividend Company®, is an S&P 500 real estate company with the primary business objective of generating dependable monthly cash dividends from a consistent and predictable level of cash flow from operations. Our monthly dividends are supported by the cash flow from our property portfolio. We have in-house acquisition, portfolio management, asset management, credit research, real estate research, legal, finance and accounting, information technology, and capital markets capabilities. Over the past 46 years, Realty Income has been acquiring and managing freestanding commercial properties that generate rental revenue under long-term net lease agreements.

Realty Income (NYSE: O) was founded in 1969, and listed on the New York Stock Exchange, or NYSE, in 1994. We elected to be taxed as a real estate investment trust, or REIT, requiring us to distribute dividends to our stockholders aggregating at least 90% of our taxable income (excluding net capital gains).

We seek to increase earnings and distributions to stockholders through active portfolio management, asset management and the acquisition of additional properties.

Generally, our portfolio and asset management efforts seek to achieve:

- Contractual rent increases on existing leases;
- Rent increases at the termination of existing leases, when market conditions permit;
- Optimum exposure to certain tenants and markets through re-leasing vacant properties and selectively selling properties;
- Maximum asset-level returns on properties re-leased and/or sold;
- Optimum value of existing portfolio by enhancing individual properties, pursuing alternative uses, and deriving ancillary revenue; and
- Investment opportunities in new asset classes for the portfolio.

At September 30, 2015, we owned a diversified portfolio:

- Of 4,473 properties;
- With an occupancy rate of 98.3%, or 4,399 properties leased and 74 properties available for lease;
- Leased to 236 different commercial tenants doing business in 47 separate industries;
- Located in 49 states and Puerto Rico;
- With over 74.8 million square feet of leasable space; and
- With an average leasable space per property of approximately 16,740 square feet, including approximately 11,580 square feet per retail property and 215,460 square feet per industrial property.

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Of the 4,473 properties in the portfolio, 4,454, or 99.6%, are single-tenant properties, and the remaining are multi-tenant properties. At September 30, 2015, of the 4,454 single-tenant properties, 4,380 were leased with a weighted average remaining lease term (excluding rights to extend a lease at the option of the tenant) of approximately 10.1 years.

Investment Philosophy

We believe that owning an actively managed, diversified portfolio of commercial properties under long-term, net leases produces consistent and predictable income. A net lease typically requires the tenant to be responsible for minimum monthly rent and certain property operating expenses including property taxes, insurance, and maintenance. In addition, tenants of our properties typically pay rent increases based on: (1) increases in the consumer price index (typically subject to ceilings), (2) fixed increases, or (3) additional rent calculated as a percentage of the tenants' gross sales above a specified level. We believe that a portfolio of properties under long-term, net leases generally produces a more predictable income stream than many other types of real estate portfolios, while continuing to offer the potential for growth in rental income.

Diversification is also a key component of our investment philosophy. We believe that diversification of the portfolio by tenant, industry, geography, and, to a certain extent, property type leads to more predictable investment results for our shareholders by reducing vulnerability that can come with any single concentration. Our investment efforts have led to a diversified property portfolio that, as of September 30, 2015, consisted of 4,473 properties located in 49 states and Puerto Rico, leased to 236 different commercial tenants doing business in 47 industry segments. Each of the 47 industry segments represented in our property portfolio individually accounted for no more than 11.1% of our rental revenue for the quarter ended September 30, 2015. Since 1970, our occupancy rate at the end of each year has never been below 96%. However, we cannot assure you that our future occupancy levels will continue to equal or exceed 96%.

Table of Contents

Investment Strategy

Our investment strategy is to act as a source of capital to regional and national tenants by acquiring and leasing back their real estate locations. When identifying new properties for investment, we generally focus on acquiring the real estate tenants consider important to the successful operation of their business. We generally seek to acquire real estate that has the following characteristics:

- Properties that are freestanding, commercially-zoned with a single tenant;
- Properties that are in significant markets or strategic locations critical to generating revenue for regional and national tenants (i.e. they need the property in which they operate in order to conduct their business);
- Properties that we deem to be profitable for the tenants and/or can generally be characterized as important to the successful operations of the company's business;
- Properties that are located within attractive demographic areas relative to the business of our tenants, and have good visibility and easy access to major thoroughfares;
- Properties with real estate valuations that approximate replacement costs;
- Properties with rental or lease payments that approximate market rents; and
- Properties that can be purchased with the simultaneous execution or assumption of long-term, net lease agreements, offering both current income and the potential for future rent increases.

We seek to invest in industries in which several, well-organized, regional and national tenants are capturing market share through service, quality control, economies of scale, strong consumer brands, advertising, and the selection of prime locations. In addition, we frequently acquire large portfolios of single-tenant properties net leased to different tenants operating in a variety of industries. We have an internal team dedicated to sourcing such opportunities, often using our relationships with various tenants, owners/developers, and advisers to uncover and secure transactions. We also undertake thorough research and analysis to identify what we consider to be appropriate industries, tenants, and property locations for investment. This research expertise is instrumental to uncovering net lease opportunities in markets where we believe we can add value.

In selecting potential investments, we look for tenants with the following attributes:

- Tenants with reliable and sustainable cash flow;
- Tenants with revenue and cash flow from multiple sources;
- Tenants that are willing to sign a long-term lease (10 or more years); and
- Tenants that are large owners and users of real estate.

From a retail perspective, our investment strategy is to target tenants that have a service, non-discretionary, and/or low-price-point component to their business. We believe these characteristics better position tenants to operate in a variety of economic conditions and to compete more effectively with internet retailers. As a result of the execution of this strategy, over 90% of our retail rental revenue for the third quarter of 2015 is derived from tenants with a service, non-discretionary, and/or low price point component to their business. From a non-retail perspective, we target industrial properties leased to Fortune 1000, primarily investment grade rated companies. We believe rental revenue generated from businesses with these characteristics is generally more durable and stable.

After applying this investment strategy, we pursue those transactions where we can achieve an attractive investment spread over our cost of capital and favorable risk-adjusted returns.

Underwriting Strategy

We believe the principal financial obligations for most of our tenants typically include their bank and other debt, payment obligations to suppliers, and real estate lease obligations. Because we typically own the land and building in which a tenant conducts its business or which are critical to the tenant's ability to generate revenue, we believe the risk of default on a tenant's lease obligation is less than the tenant's unsecured general obligations. It has been our experience that tenants must retain their profitable and critical locations in order to survive. Therefore, in the event of reorganization, they are less likely to reject a lease of a profitable or critical location because this would terminate their right to use the property. Thus, as the property owner, we believe that we will fare better than unsecured creditors of the same tenant in the event of reorganization. If a property is rejected by the tenant during reorganization, we own the property and can either lease it to a new tenant or sell the property. In addition, we believe that the risk of default on real estate leases can be further mitigated by monitoring the performance of the tenants' individual locations and considering whether to sell locations that are weaker performers.

Table of Contents

In order to be considered for acquisition, properties must meet stringent investment and credit requirements. The properties must generate attractive current yields and the tenant must meet our credit criteria. We have established a four-part analysis that examines each potential investment based on:

- Industry, company, market conditions, and credit profile;
- Store profitability for retail locations, if profitability data is available;
- Overall real estate characteristics, including property value and comparative rental rates; and
- The importance of the real estate location to the operations of the tenants' business.

Prior to entering into any transaction, our research department conducts a review of a tenant's credit quality. The information reviewed may include reports and filings, including any public credit ratings, financial statements, debt and equity analyst reports, and reviews of corporate credit spreads, stock prices, market capitalization, and other financial metrics. We conduct additional due diligence, including additional financial reviews of the tenant and a more comprehensive review of the business segment and industry in which the tenant operates. We continue to monitor our tenants' credit quality on an ongoing basis by reviewing the available information previously discussed, and providing summaries of these findings to management. We estimate that approximately 44% of our annualized rental revenue comes from properties leased to investment grade rated companies or their subsidiaries. At September 30, 2015, our top 20 tenants represent approximately 55% of our annualized revenue and eight of these tenants have investment grade credit ratings.

Asset Management Strategy

The active management of the property portfolio is an essential component of our long-term strategy. We continually monitor our portfolio for any changes that could affect the performance of the tenant's industries and locations in which we have invested. We also regularly analyze our portfolio with a view towards optimizing its returns and enhancing the overall credit quality.

We regularly review and analyze:

- The performance of the various industries of our tenants;
- The operation, management, business planning, and financial condition of our tenants; and
- The quality of the underlying real estate locations.

We have an active asset management program that incorporates the sale of assets when we believe the reinvestment of the sale proceeds will:

- Generate higher returns;
- Enhance the credit quality of our real estate portfolio;
- Extend our average remaining lease term; or
- Decrease tenant or industry concentration.

At September 30, 2015, we classified 17 properties with a carrying amount of \$13.3 million as held for sale on our balance sheet. For the remainder of 2015, we intend to continue our active disposition efforts to further enhance our real estate portfolio and anticipate approximately \$65 million in property sales for all of 2015. We intend to invest these proceeds into new property acquisitions, if there are attractive opportunities available. However, we cannot guarantee that we will sell properties during 2015 at our estimated values or be able to invest the property sale proceeds in new properties.

Impact of Real Estate and Credit Markets

In the commercial real estate market, property prices generally continue to fluctuate. Likewise, during certain periods, the U.S. credit markets have experienced significant price volatility, dislocations, and liquidity disruptions, which may impact our access to and cost of capital. We continually monitor the commercial real estate and U.S. credit markets carefully and, if required, will make decisions to adjust our business strategy accordingly.

Table of Contents**RECENT DEVELOPMENTS****Increases in Monthly Dividends to Common Stockholders**

We have continued our 46-year policy of paying monthly dividends. In addition, we increased the dividend five times during 2015. As of October 2015, we have paid 72 consecutive quarterly dividend increases and increased the dividend 82 times since our listing on the NYSE in 1994.

2015 Dividend increases	Month Declared	Month Paid	Dividend per share	Increase per share
1st increase	Dec 2014	Jan 2015	\$ 0.1834167	\$ 0.0003125
2nd increase	Jan 2015	Feb 2015	0.1890000	0.0055833
3rd increase	Mar 2015	Apr 2015	0.1895000	0.0005000
4th increase	Jun 2015	Jul 2015	0.1900000	0.0005000
5th increase	Sep 2015	Oct 2015	0.1905000	0.0005000

The dividends paid per share during the first nine months of 2015 totaled approximately \$1.6999167, as compared to approximately \$1.6423128 during the first nine months of 2014, an increase of \$0.0576, or 3.5%.

The monthly dividend of \$0.1905 per share represents a current annualized dividend of \$2.286 per share, and an annualized dividend yield of approximately 4.8% based on the last reported sale price of our common stock on the NYSE of \$47.39 on September 30, 2015. Although we expect to continue our policy of paying monthly dividends, we cannot guarantee that we will maintain our current level of dividends, that we will continue our pattern of increasing dividends per share, or what our actual dividend yield will be in any future period.

Acquisitions during the Third Quarter of 2015

During the third quarter of 2015, we invested \$123.9 million in 47 new properties and properties under development or expansion, with an estimated initial weighted average contractual lease rate of 7.0%. The 47 new properties and properties under development or expansion are located in 22 states, will contain approximately 960,000 leasable square feet and are 100% leased, with a weighted average lease term of 10.9 years. The tenants occupying the new properties operate in 13 industries and the property types consist of 51.7% retail and 48.3% industrial, based on rental revenue.

Acquisitions during the First Nine Months of 2015

During the first nine months of 2015, we invested \$1.1 billion in 195 new properties and properties under development or expansion, with an initial weighted average contractual lease rate of 6.5%. The 195 new properties and properties under development or expansion are located in 36 states, will contain approximately 5.1 million leasable square feet, and are 100% leased with a weighted average lease term of 16.7 years. The tenants occupying the new properties operate in 18 industries and the property types consist of 87.0% retail and 13.0% industrial, based on rental revenue. During the first nine months of 2015,

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none of our real estate investments caused any one tenant to be 10% or more of our total assets at September 30, 2015.

The estimated initial weighted average contractual lease rate for a property is generally computed as estimated contractual net operating income, which, in the case of a net leased property, is equal to the aggregate base rent for the first full year of each lease, divided by the total cost of the property. Since it is possible that a tenant could default on the payment of contractual rent, we cannot provide assurance that the actual return on the funds invested will remain at the percentage listed above.

In the case of a property under development or expansion, the contractual lease rate is generally fixed such that rent varies based on the actual total investment in order to provide a fixed rate of return. When the lease does not provide for a fixed rate of return on a property under development or expansion, the estimated initial weighted average contractual lease rate is computed as follows: estimated net operating income (determined by the lease) for the first full year of each lease, divided by our projected total investment in the property, including land, construction and capitalized interest costs. Of the \$1.1 billion we invested during the first nine months of 2015, \$37.1 million was invested in 30 properties under development or expansion with an estimated initial weighted average contractual lease rate of 9.9%. We may continue to pursue development or expansion opportunities under similar arrangements in the future.

Table of Contents

Portfolio Discussion

Leasing Results

At September 30, 2015, we had 74 properties available for lease out of 4,473 properties in our portfolio, which represents a 98.3% occupancy rate based on the number of properties. Since December 31, 2014, when we reported 70 properties available for lease out of 4,327 and a 98.4% occupancy rate, we:

- Had 239 lease expirations;
- Re-leased 221 properties; and
- Sold 14 vacant properties.

Of the 221 properties re-leased during the first nine months of 2015, 189 properties were re-leased to existing tenants, six were re-leased to new tenants without vacancy, and 26 were re-leased to new tenants after a period of vacancy. The annual rent on these 221 leases was \$32.8 million, as compared to the previous rent on these same properties of \$32.3 million, which represents a rent recapture rate of 101.5%.

At September 30, 2015, our average annualized rental revenue was approximately \$13.32 per square foot on the 4,399 leased properties in our portfolio. At September 30, 2015, we classified 17 properties with a carrying amount of \$13.3 million as held for sale on our balance sheet. The disposal of these properties does not represent a strategic shift that will have a major effect on our operations and financial results.

Investments in Existing Properties

In the third quarter of 2015, we capitalized costs of \$3.4 million on existing properties in our portfolio, consisting of \$93,000 for re-leasing costs, \$1.8 million for recurring capital expenditures and \$1.5 million for non-recurring building improvements. In the third quarter of 2014, we capitalized costs of \$1.8 million on existing properties in our portfolio.

In the first nine months of 2015, we capitalized costs of \$5.9 million on existing properties in our portfolio, consisting of \$555,000 for re-leasing costs, \$3.8 million for recurring capital expenditures and \$1.5 million for non-recurring building improvements. In the first nine months of 2014, we capitalized costs of \$4.5 million on existing properties in our portfolio.

As part of our re-leasing costs, we typically pay leasing commissions and sometimes provide tenant rent concessions. Leasing commissions are paid based on the commercial real estate industry standard and any rent concessions provided are minimal. We

do not consider the collective impact of the leasing commissions or tenant rent concessions to be material to our financial position or results of operations.

The majority of our building improvements relate to roof repairs, HVAC improvements, and parking lot resurfacing and replacements. It is not customary for us to offer significant tenant improvements on our properties as tenant incentives. The amounts of our capital expenditures can vary significantly, depending on the rental market, tenant credit worthiness, the lease term and the willingness of tenants to pay higher rents over the terms of the leases.

At-the-Market (ATM) Program

In September 2015, we established an at the market equity distribution program, or our ATM program, pursuant to which we can offer and sell up to 12,000,000 shares of common stock to, or through a consortium of banks acting as our sales agents by means of ordinary brokers transactions on the NYSE or otherwise at market prices prevailing at the time of sale, at prices related to prevailing market prices or at negotiated prices. As of September 30, 2015, no shares have been sold under our ATM program.

New Credit Facility

In June 2015, we closed on a \$2.25 billion unsecured credit facility. Our new credit facility is comprised of a \$2.0 billion revolving credit facility and a \$250 million five-year unsecured term loan. As of September 30, 2015, \$1.56 billion was available on our new credit facility to fund additional acquisitions and for other general corporate purposes.

Inclusion in S&P Indices

In January 2015, we were added to the S&P High Yield Dividend Aristocrats® index. In April 2015, we were added to the S&P 500 index and are one of 24 REITs, and the only net lease REIT included in this index.

Table of Contents

Issuance of Common Stock

In April 2015, we issued 5,500,000 shares of common stock. After underwriting discounts and other offering costs of \$1.4 million, the net proceeds of \$276.4 million were used to repay borrowings under our credit facility.

In October 2015, we issued 11,500,000 shares of common stock, including 1,500,000 shares purchased by the underwriters upon the exercise of their option to purchase additional shares. After underwriting discounts and other offering costs of \$22.1 million, a portion of the net proceeds of \$517.0 million was used to repay borrowings under our credit facility and the remaining portion will be used for other general corporate purposes, which may include acquisitions.

Dividend Reinvestment and Stock Purchase Plan

We have a Dividend Reinvestment and Stock Purchase Plan, or the DRSP, to provide our common stockholders, as well as new investors, with a convenient and economical method of purchasing our common stock and reinvesting their distributions. The DRSP also allows our current stockholders to buy additional shares of common stock by reinvesting all or a portion of their distributions. The DRSP authorizes up to 26,000,000 common shares to be issued. In 2013, we revised our DRSP to pay for a majority of the plan-related fees, which were previously paid by investors, and to institute a waiver approval process, allowing larger investors or institutions, per a formal approval process, to purchase shares at a small discount, if approved by us. During the first nine months of 2015, we issued 7,565,432 shares and raised approximately \$360.9 million under the DRSP, of which 7,413,207 shares and \$353.7 million was raised under the waiver approval process.

Net Income Available to Common Stockholders

Net income available to common stockholders was \$60.7 million in the third quarter of 2015, compared to \$57.9 million in the third quarter of 2014, an increase of \$2.8 million. On a diluted per common share basis, net income was \$0.26 in the third quarter of 2015 and 2014.

Net income available to common stockholders was \$180.5 million in the first nine months of 2015, compared to \$156.5 million in the first nine months of 2014, an increase of \$24.0 million. On a diluted per common share basis, net income was \$0.78 in the first nine months of 2015, as compared to \$0.72 in the first nine months of 2014, an increase of \$0.06, or 8.3%.

The calculation to determine net income available to common stockholders includes impairments and/or gains from the sale of properties. The amount of impairments and/or gains varies from period to period based on the timing of property sales and can significantly impact net income available to common stockholders.

Gains from the sale of properties during the third quarter of 2015 were \$6.2 million, as compared to gains from the sale of properties of \$11.0 million during the third quarter of 2014. Gains from the sale of properties during the first nine months of 2015 were \$17.1 million, as compared to gains from the sale of properties of \$16.8 million during the first nine months of 2014.

Funds from Operations (FFO) Available to Common Stockholders

In the third quarter of 2015, our FFO increased by \$19.9 million, or 14.0%, to \$162.2 million, compared to \$142.3 million in the third quarter of 2014. On a diluted per common share basis, FFO was \$0.69 in the third quarter of 2015 and \$0.64 in the third quarter of 2014, an increase of \$0.05, or 7.8%.

In the first nine months of 2015, our FFO increased by \$55.3 million, or 13.2%, to \$474.5 million versus \$419.2 million in the first nine months of 2014. On a diluted per common share basis, FFO was \$2.05 in the first nine months of 2015, compared to \$1.93 in the first nine months of 2014, an increase of \$0.12, or 6.2%.

Adjusted Funds from Operations (AFFO) Available to Common Stockholders

In the third quarter of 2015, our AFFO increased by \$23.4 million, or 16.4%, to \$165.8 million, compared to \$142.4 million in the third quarter of 2014. On a diluted per common share basis, AFFO was \$0.70 in the third quarter of 2015 and \$0.64 in the third quarter of 2014, an increase of \$0.06, or 9.4%.

In the first nine months of 2015, our AFFO increased by \$60.7 million, or 14.6%, to \$477.0 million versus \$416.3 million in the first nine months of 2014. On a diluted per common share basis, AFFO was \$2.06 in the first nine months of 2015, compared to \$1.92 in the first nine months of 2014, an increase of \$0.14, or 7.3%. See our discussion of FFO and AFFO (which are not financial measures under generally accepted accounting principles, or GAAP), later in this Management's Discussion and Analysis of Financial Condition and Results of Operations, which includes a reconciliation of net income available to common stockholders to FFO and AFFO.

Table of Contents

LIQUIDITY AND CAPITAL RESOURCES

Capital Philosophy

Historically, we have met our long-term capital needs by issuing common stock, preferred stock and long-term unsecured notes and bonds. Over the long-term, we believe that common stock should be the majority of our capital structure, however; we may issue additional preferred stock or debt securities. We may issue common stock when we believe that our share price is at a level that allows for the proceeds of any offering to be accretively invested into additional properties. In addition, we may issue common stock to permanently finance properties that were financed by our credit facility or debt securities. However, we cannot assure you that we will have access to the capital markets at times and at terms that are acceptable to us.

Our primary cash obligations, for the current year and subsequent years, are included in the Table of Obligations, which is presented later in this section. We expect to fund our operating expenses and other short-term liquidity requirements, including property acquisitions and development costs, payment of principal and interest on our outstanding indebtedness, property improvements, re-leasing costs and cash distributions to common and preferred stockholders, primarily through cash provided by operating activities, borrowing on our new \$2.0 billion credit facility and periodically through public securities offerings.

Conservative Capital Structure

We believe that our stockholders are best served by a conservative capital structure. Therefore, we seek to maintain a conservative debt level on our balance sheet and solid interest and fixed charge coverage ratios. At September 30, 2015, our total outstanding borrowings of senior unsecured notes and bonds, term loans, mortgages payable and credit facility borrowings were \$5.25 billion, or approximately 30.9% of our total market capitalization of \$16.98 billion.

We define our total market capitalization at September 30, 2015 as the sum of:

- Shares of our common stock outstanding of 238,085,515, plus total common units outstanding of 736,568, multiplied by the last reported sales price of our common stock on the NYSE of \$47.39 per share on September 30, 2015, or \$11.32 billion;
- Aggregate liquidation value (par value of \$25.00 per share) of the Class F preferred stock of \$408.8 million;
- Outstanding borrowings of \$439.0 million on our new credit facility;
- Outstanding mortgages payable of \$695.2 million, excluding net mortgage premiums of \$11.0 million;
- Outstanding borrowings of \$320.0 million on our term loans; and
- Outstanding senior unsecured notes and bonds of \$3.8 billion, excluding unamortized original issuance discounts of \$13.6 million.

Universal Shelf Registration

In February 2013, we filed a shelf registration statement with the SEC, which is effective for a term of three years and will expire in February 2016. This replaced our prior shelf registration statement. In accordance with SEC rules, the amount of securities to be issued pursuant to this shelf registration statement was not specified when it was filed and there is no specific dollar limit. The securities covered by this registration statement include (1) common stock, (2) preferred stock, (3) debt securities, (4) depository shares representing fractional interests in shares of preferred stock, (5) warrants to purchase debt securities, common stock, preferred stock, or depository shares, and (6) any combination of these securities. We may periodically offer one or more of these

securities in amounts, prices and on terms to be announced when and if these securities are offered. The specifics of any future offerings, along with the use of proceeds of any securities offered, will be described in detail in a prospectus supplement, or other offering materials, at the time of any offering.

Mortgage Debt

As of September 30, 2015, we had \$695.2 million of mortgages payable, all of which were assumed in connection with our property acquisitions. Additionally, at September 30, 2015, we had net premiums totaling \$11.0 million on these mortgages. We expect to pay off the mortgages payable as soon as prepayment penalties have declined to a level that will make it economically feasible to do so. During the first nine months of 2015, we made \$140.8 million of principal payments, including the repayment of ten mortgages in full for \$135.3 million.

Table of Contents

Term Loans

In June 2015, in conjunction with entering into our new credit facility, we entered into a \$250 million senior unsecured term loan maturing June 30, 2020. Borrowing under this term loan bears interest at the current one month London Interbank Offered Rate, commonly referred to as LIBOR, plus 0.95%. In conjunction with this term loan, we also entered into an interest rate swap which effectively fixes our per annum interest rate on this term loan at 2.67%.

In January 2013, in conjunction with our acquisition of ARCT, we entered into a \$70 million senior unsecured term loan maturing in January 2018. Borrowing under the term loan bears interest at LIBOR, plus 1.20%. In conjunction with this term loan, we also acquired an interest rate swap which effectively fixes our per annum interest rate on this term loan at 2.15%.

\$2.0 Billion Revolving Credit Facility

In June 2015, we entered into a new \$2 billion unsecured revolving credit facility, which replaced our \$1.5 billion credit facility that was scheduled to expire in May 2016. The initial term of our new credit facility expires in June 2019 and includes, at our option, two six-month extensions. Our new credit facility has a \$1.0 billion accordion expansion option. Under our new credit facility, our current investment grade credit ratings provide for financing at LIBOR, plus 0.9% with a facility commitment fee of 0.15%, for all-in drawn pricing of 1.05% over LIBOR. The borrowing rate is subject to an interest rate floor. We also have other interest rate options available to us under our new credit facility. Our new credit facility is unsecured and, accordingly, we have not pledged any assets as collateral for this obligation.

As of October 7, 2015, we had a borrowing capacity of \$2.0 billion available on our new credit facility (subject to customary conditions to borrowing) after using common stock offering proceeds to pay off outstanding borrowings on our new credit facility. At September 30, 2015, we had a borrowing capacity of \$1.56 billion available on our new credit facility and an outstanding balance of \$439.0 million. The interest rate on borrowings outstanding under our new credit facility, at September 30, 2015, was 1.3% per annum. We must comply with various financial and other covenants in our credit facility. At September 30, 2015, we remain in compliance with these covenants. We expect to use our new credit facility to acquire additional properties and for other general corporate purposes. Any additional borrowings will increase our exposure to interest rate risk.

We generally use our credit facility for the short-term financing of new property acquisitions. Thereafter, when capital is available on acceptable terms, we generally seek to refinance those borrowings with the net proceeds of long-term or permanent financing, which may include the issuance of common stock, preferred stock or debt securities. We cannot assure you, however, that we will be able to obtain any such refinancing, or that market conditions prevailing at the time of the refinancing will enable us to issue equity or debt securities at acceptable terms.

Notes Outstanding

Our senior unsecured note and bond obligations consist of the following as of September 30, 2015, sorted by maturity date (dollars in millions):

5.5% notes, issued in November 2003 and due in November 2015	\$	150
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5.95% notes, issued in September 2006 and due in September 2016		275
5.375% notes, issued in September 2005 and due in September 2017		175
2.0% notes, issued in October 2012 and due in January 2018		350
6.75% notes, issued in September 2007 and due in August 2019		550
5.75% notes, issued in June 2010 and due in January 2021		250
3.25% notes, issued in October 2012 and due in October 2022		450
4.65% notes, issued in July 2013 and due in August 2023		750
3.875% notes, issued in June 2014 and due in July 2024		350
4.125% notes, issued in September 2014 and due in October 2026		250
5.875% bonds, \$100 issued in March 2005 and \$150 issued in June 2011, both due in March 2035		250
Total principal amount	\$	3,800
Unamortized original issuance discounts		(14)
	\$	3,786

In November 2015, we expect to repay our \$150 million 5.5% notes by borrowing on our new credit facility.

All of our outstanding notes and bonds have fixed interest rates and contain various covenants, which we remain in compliance with at September 30, 2015. Additionally, interest on all of our senior note and bond obligations is paid semiannually.

Table of Contents

The following is a summary of the key financial covenants for our senior unsecured notes, as defined and calculated per the terms of our senior notes and bonds. These calculations, which are not based on U.S. GAAP, measurements, are presented to investors to show our ability to incur additional debt under the terms of our senior notes and bonds as well as to disclose our current compliance with such covenants, and are not measures of our liquidity or performance. The actual amounts as of September 30, 2015 are:

Note Covenants	Required	Actual
Limitation on incurrence of total debt	≤ 60% of adjusted assets	43.0%
Limitation on incurrence of secured debt	≤ 40% of adjusted assets	5.8%
Debt service coverage (trailing 12 months)(1)	≥ 1.5 x	4.1x
Maintenance of total unencumbered assets	≥ 150% of unsecured debt	239.4%

(1) This covenant is calculated on a pro forma basis for the preceding four-quarter period on the assumption that: (i) the incurrence of any Debt (as defined in the covenants) incurred by us since the first day of such four-quarter period and the application of the proceeds therefrom (including to refinance other Debt since the first day of such four-quarter period), (ii) the repayment or retirement of any of our Debt since the first day of such four-quarter period, and (iii) any acquisition or disposition by us of any asset or group since the first day of such four-quarters had in each case occurred on October 1, 2014, and subject to certain additional adjustments. Such pro forma ratio has been prepared on the basis required by that debt service covenant, reflects various estimates and assumptions and is subject to other uncertainties, and therefore does not purport to reflect what our actual debt service coverage ratio would have been had transactions referred to in clauses (i), (ii) and (iii) of the preceding sentence occurred as of October 1, 2014, nor does it purport to reflect our debt service coverage ratio for any future period. The following is our calculation of debt service coverage at September 30, 2015 (in thousands, for trailing twelve months):

Net income attributable to the Company	\$	278,614
Plus: interest expense		231,461
Plus: provision for taxes		3,552
Plus: depreciation and amortization		400,013
Plus: provisions for impairment		11,141
Plus: pro forma adjustments		42,618
Less: gain on sales of real estate		(42,387)
Income available for debt service, as defined	\$	925,012
Total pro forma debt service charge	\$	223,686
Debt service coverage ratio		4.1

Fixed Charge Coverage Ratio

Fixed charge coverage ratio is calculated in exactly the same manner as the debt service coverage ratio, except that preferred stock dividends are also added to the denominator. Similar to debt service coverage ratio, we consider fixed charge coverage ratio to be an appropriate supplemental measure of a company's ability to make its interest and preferred stock dividend payments. Our calculations of both debt service and fixed charge coverage ratios may be different from the calculations used by other companies and, therefore, comparability may be limited. The presentation of debt service and fixed charge coverage ratios should not be considered as alternatives to any U.S. GAAP operating performance measures. Below is our calculation of fixed charges at September 30, 2015 (in thousands, for the trailing twelve months):

Income available for debt service, as defined	\$	925,012
Pro forma debt service charge plus preferred stock dividends	\$	250,766
Fixed charge coverage ratio		3.7

Cash Reserves

We are organized to operate as an equity REIT that acquires and leases properties and distributes to stockholders, in the form of monthly cash distributions, a substantial portion of our net cash flow generated from leases on our properties. We intend to retain an appropriate amount of cash as working capital. At September 30, 2015, we had cash and cash equivalents totaling \$7.1 million.

We believe that our cash and cash equivalents on hand, cash provided from operating activities, and borrowing capacity is sufficient to meet our liquidity needs for the next twelve months. We intend, however, to use permanent or long-term capital to fund property acquisitions and to repay future borrowings under our new credit facility.

Table of Contents**Credit Agency Ratings**

The borrowing interest rates under our new credit facility are based upon our ratings assigned by credit rating agencies. We are currently assigned the following investment grade corporate credit ratings on our senior unsecured notes and bonds: Moody's Investors Service has assigned a rating of Baa1 with a stable outlook, Standard & Poor's Ratings Group has assigned a rating of BBB+ with a stable outlook to our senior notes, and Fitch Ratings has assigned a rating of BBB+ with a stable outlook.

Based on our current ratings, the current facility interest rate is LIBOR plus 0.9% with a facility commitment fee of 0.15%, for all-in drawn pricing of 1.05% over LIBOR. Our new credit facility provides that the interest rate can range between: (i) LIBOR plus 1.55% if our credit rating is lower than BBB-/Baa3 or unrated and (ii) LIBOR plus 0.85% if our credit rating is A-/A3 or higher. In addition, our credit facility provides for a facility commitment fee based on our credit ratings, which range from: (i) 0.3% for a rating lower than BBB-/Baa3 or unrated, and (ii) 0.125% for a credit rating of A-/A3 or higher.

We also issue senior debt securities from time to time and our credit ratings can impact the interest rates charged in those transactions. If our credit ratings or ratings outlook change, our cost to obtain debt financing could increase or decrease. The credit ratings assigned to us could change based upon, among other things, our results of operations and financial condition. These ratings are subject to ongoing evaluation by credit rating agencies and we cannot assure you that our ratings will not be changed or withdrawn by a rating agency in the future if, in its judgment, circumstances warrant. Moreover, a rating is not a recommendation to buy, sell or hold our debt securities, preferred stock or common stock.

Table of Obligations

The following table summarizes the maturity of each of our obligations as of September 30, 2015 (dollars in millions):

Year of Maturity	Credit Facility(1)	Notes and Bonds(2)	Term Loan	Mortgages Payable(3)	Interest(4)	Ground Leases Paid by Realty Income(5)	Ground Leases Paid by Our Tenants(6)	Other(7)	Totals
2015	\$ -	\$ 150.0	\$ -	\$ 1.9	\$ 55.9	\$ 0.4	\$ 3.1	\$ 30.4	\$ 241.7
2016	-	275.0	-	225.6	203.4	1.5	12.3	30.3	748.1
2017	-	175.0	-	142.7	181.4	1.5	12.4	-	513.0
2018	-	350.0	70.0	15.3	163.0	1.6	12.4	-	612.3
2019	439.0	550.0	-	26.2	145.4	1.4	12.2	-	1,174.2
Thereafter	-	2,300.0	250.0	283.5	569.3	24.6	115.8	-	3,543.2
Totals	\$ 439.0	\$ 3,800.0	\$ 320.0	\$ 695.2	\$ 1,318.4	\$ 31.0	\$ 168.2	\$ 60.7	\$ 6,832.5

(1) The initial term of the credit facility expires in June 2019 and includes, at our option, two six-month extensions.

(2) Excludes non-cash original issuance discounts recorded on the notes payable. The unamortized balance of the original issuance discounts at September 30, 2015, is \$13.6 million.

(3) Excludes non-cash net premiums recorded on the mortgages payable. The unamortized balance of these net premiums at September 30, 2015, is \$11.0 million.

(4) Interest on the term loans, notes, bonds, mortgages payable, and credit facility has been calculated based on outstanding balances as of September 30, 2015 through their respective maturity dates.

(5) Realty Income currently pays the ground lessors directly for the rent under the ground leases.

(6)

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Our tenants, who are generally sub-tenants under ground leases, are responsible for paying the rent under these ground leases. In the event a tenant fails to pay the ground lease rent, we are primarily responsible.

- (7) Other consists of \$58.4 million of commitments under construction contracts and \$2.3 million of commitments for tenant improvements and leasing costs. Amounts represent estimated annual payments.

Our new credit facility, term loans, and notes payable obligations are unsecured. Accordingly, we have not pledged any assets as collateral for these obligations.

Preferred Stock and Preferred Units Outstanding

In 2006, we issued 8,800,000 shares of Class E preferred stock at a price of \$25.00 per share. In October 2014, we redeemed all of the 8,800,000 shares of our Class E preferred stock for \$25.00 per share, plus accrued dividends. In the third quarter of 2014, we incurred a charge of \$6.0 million, representing the Class E preferred stock original issuance costs that we paid in 2006.

Table of Contents

In February 2012, we issued 14,950,000 shares of our Class F preferred stock at \$25.00 per share. In April 2012, we issued an additional 1,400,000 shares of Class F preferred stock at \$25.2863 per share. Beginning February 15, 2017, shares of our Class F preferred stock are redeemable at our option for \$25.00 per share, plus any accrued and unpaid dividends. Dividends on the shares of our Class F preferred stock are paid monthly in arrears. We are current on our obligations to pay dividends on our Class F preferred stock.

As part of our acquisition of ARCT in January 2013, we issued 6,750 partnership units, with a carrying value of \$6.75 million. Payments on these preferred units were made monthly in arrears at rate of 2% per annum, or \$135,000, and are included in interest expense. In January 2015, we redeemed all 6,750 Tau Operating Partnership preferred units for \$1,000 per unit, plus accrued and unpaid distributions.

No Unconsolidated Investments

We have no unconsolidated investments, nor do we engage in trading activities involving energy or commodity contracts.

Dividend Policy

Distributions are paid monthly to holders of shares of our common stock and Class F preferred stock if, and when, declared by our Board of Directors.

Distributions are paid monthly to the limited partners holding common units of Tau Operating Partnership, L.P. and Realty Income, L.P., each on a per unit basis that is generally equal to the amount paid per share to our common stockholders.

In order to maintain our status as a REIT for federal income tax purposes, we generally are required to distribute dividends to our stockholders aggregating annually at least 90% of our taxable income (excluding net capital gains), and we are subject to income tax to the extent we distribute less than 100% of our taxable income (including net capital gains). In 2014, our cash distributions to preferred and common stockholders totaled \$519.1 million, or approximately 155.0% of our taxable income of \$334.9 million. Our taxable income reflects non-cash deductions for depreciation and amortization. Our taxable income is presented to show our compliance with REIT dividend requirements and is not a measure of our liquidity or operating performance. We intend to continue to make distributions to our stockholders that are sufficient to meet this dividend requirement and that will reduce or eliminate our exposure to income taxes. Furthermore, we believe our funds from operations are more than sufficient to support our current level of cash distributions to our stockholders. Our cash distributions to common stockholders, for the first nine months of 2015, totaled \$392.8 million, representing 82.3% of our adjusted funds from operations available to common stockholders of \$477.0 million. In comparison, our 2014 cash distributions to common stockholders totaled \$479.3 million, representing 85.3% of our adjusted funds from operations available to common stockholders of \$561.7 million.

The Class F preferred stockholders receive cumulative distributions at a rate of 6.625% per annum on the \$25.00 per share liquidation preference (equivalent to \$1.65625 per annum per share). Dividends on our Class F preferred stock are current.

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Future distributions will be at the discretion of our Board of Directors and will depend on, among other things, our results of operations, FFO, AFFO, cash flow from operations, financial condition, capital requirements, the annual distribution requirements under the REIT provisions of the Internal Revenue Code of 1986, as amended, our debt service requirements, and any other factors the Board of Directors may deem relevant. In addition, our new credit facility contains financial covenants that could limit the amount of distributions payable by us in the event of a default, and which prohibit the payment of distributions on the common or preferred stock in the event that we fail to pay when due (subject to any applicable grace period) any principal or interest on borrowings under our new credit facility.

Distributions of our current and accumulated earnings and profits for federal income tax purposes generally will be taxable to stockholders as ordinary income, except to the extent that we recognize capital gains and declare a capital gains dividend, or that such amounts constitute qualified dividend income subject to a reduced rate of tax. The maximum tax rate of non-corporate taxpayers for qualified dividend income is generally 20%. In general, dividends payable by REITs are not eligible for the reduced tax rate on qualified dividend income,

Table of Contents

except to the extent that certain holding requirements have been met with respect to the REIT's stock and the REIT's dividends are attributable to dividends received from certain taxable corporations (such as our taxable REIT subsidiaries) or to income that was subject to tax at the corporate or REIT level (for example, if we distribute taxable income that we retained and paid tax on in the prior taxable year).

Distributions in excess of earnings and profits generally will first be treated as a non-taxable reduction in the stockholders' basis in their stock, but not below zero. Distributions in excess of that basis generally will be taxable as a capital gain to stockholders who hold their shares as a capital asset. Approximately 24.8% of the distributions to our common stockholders, made or deemed to have been made in 2014, were classified as a return of capital for federal income tax purposes. We estimate that in 2015, between 20% and 35% of the distributions may be classified as a return of capital.

RESULTS OF OPERATIONS

Critical Accounting Policies

Our consolidated financial statements have been prepared in accordance with GAAP, and are the basis for our discussion and analysis of financial condition and results of operations. Preparing our consolidated financial statements requires us to make a number of estimates and assumptions that affect the reported amounts and disclosures in the consolidated financial statements. We believe that we have made these estimates and assumptions in an appropriate manner and in a way that accurately reflects our financial condition. We continually test and evaluate these estimates and assumptions using our historical knowledge of the business, as well as other factors, to ensure that they are reasonable for reporting purposes. However, actual results may differ from these estimates and assumptions. This summary should be read in conjunction with the more complete discussion of our accounting policies and procedures included in note 2 to our consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2014.

In order to prepare our consolidated financial statements according to the rules and guidelines set forth by GAAP, many subjective judgments must be made with regard to critical accounting policies. One of these judgments is our estimate for useful lives in determining depreciation expense for our properties. Depreciation on a majority of our buildings and improvements is computed using the straight-line method over an estimated useful life of 25 to 35 years for buildings and 4 to 20 years for improvements, which we believe are appropriate estimates of useful life. If we use a shorter or longer estimated useful life, it could have a material impact on our results of operations.

Management must make significant assumptions in determining the fair value of assets acquired and liabilities assumed. When acquiring a property for investment purposes, we typically allocate the fair value of real estate acquired to: (1) land, (2) building and improvements, and (3) identified intangible assets and liabilities, based in each case on their estimated fair values. Intangible assets and liabilities consist of above-market or below-market lease value of in-place leases, the value of in-place leases, and tenant relationships, as applicable. In an acquisition of multiple properties, we must also allocate the purchase price among the properties. The allocation of the purchase price is based on our assessment of estimated fair value and is often based upon the expected future cash flows of the property and various characteristics of the market where the property is located. In addition, any assumed mortgages receivable or payable and any assumed or issued noncontrolling interests are recorded at their estimated fair values. The estimated fair values of our mortgages payable have been calculated by discounting the future cash flows using applicable interest rates that have been adjusted for factors, such as industry type, tenant investment grade, maturity date, and comparable borrowings for similar assets. The initial allocation of the purchase price is based on management's preliminary assessment, which may differ when final information becomes available. Subsequent adjustments made to the initial purchase

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price allocation are made within the allocation period, which does not exceed one year. The use of different assumptions in the allocation of the purchase price of the acquired properties and liabilities assumed could affect the timing of recognition of the related revenue and expenses.

Another significant judgment must be made as to if, and when, impairment losses should be taken on our properties when events or a change in circumstances indicate that the carrying amount of the asset may not be recoverable. A provision is made for impairment if estimated future operating cash flows (undiscounted and without interest charges) plus estimated disposition proceeds (undiscounted) are less than the current book value of the property. Key inputs that we utilize in this analysis include projected rental rates, estimated holding periods, historical sales and releases, capital expenditures, and property sales capitalization rates. If a property

8,443

Total securities available-for-sale

\$

6,267,691

\$

56,067

\$

(82,641

)

\$

6,241,117

Securities held-to-maturity (1):

Federal agency - Debt

\$

178,413

\$

133

\$

(5,122

)

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\$

173,424

Federal agency - MBS

445,360

1,005

(11,930

)

434,435

CMOs - Federal agency

1,781,219

1,839

(40,621

)

1,742,437

State and municipal

454,155

421

68

	(19,014
)	
	435,562
Other debt securities	
	98,696
	(619
)	
	98,077
Total securities held-to-maturity	
\$	
	2,957,843
\$	
	3,398
\$	
	(77,306
)	
\$	
	2,883,935

(1) Securities held-to-maturity are presented in the consolidated balance sheets at amortized cost.

Table of Contents**Note 3. Securities (Continued)**

Proceeds from sales of securities available-for-sale were \$15.0 million and \$626.1 million for the three and six months ended June 30, 2014, respectively, compared with \$0.2 million and \$1.25 billion for the three and six months ended June 30, 2013. There were no sales of securities held-to-maturity during the three and six months ended June 30, 2014 and 2013. The following table provides the gross realized gains and losses on the sales and calls of securities (including trading securities):

(in thousands)	For the three months ended June 30,		For the six months ended June 30,		2013
	2014	2013	2014	2013	
Gross realized gains	\$ 5,368	\$ 5,790	\$ 7,970	\$ 6,836	
Gross realized losses	(1)		(481)		
Net realized gains	\$ 5,367	\$ 5,790	\$ 7,489	\$ 6,836	

Interest income on securities for the three months ended June 30, 2014 and 2013 is comprised of: (i) taxable interest income of \$37.5 million and \$36.7 million, respectively (ii) nontaxable interest income of \$6.0 million and \$4.4 million, respectively, and (iii) dividend income of \$16 thousand and \$0.1 million, respectively. Interest income on securities for the six months ended June 30, 2014 and 2013 is comprised of: (i) taxable interest income of \$73.5 million and \$76.6 million, respectively (ii) nontaxable interest income of \$11.5 million and \$8.8 million, respectively, and (iii) dividend income of \$25 thousand and \$0.1 million, respectively.

The following table provides the expected remaining maturities of debt securities included in the securities portfolio at June 30, 2014, except for maturities of mortgage-backed securities which are allocated according to the average life of expected cash flows. Average expected maturities will differ from contractual maturities because of the amortizing nature of the loan collateral and prepayment behavior of borrowers.

(in thousands)	One year or less	Over 1 year through 5 years	Over 5 years through 10 years	Over 10 years	Total
Securities available-for-sale:					
U.S. Treasury	\$ 23,194	\$ 13,064	\$	\$	\$ 36,258
Federal agency - Debt	639,733	347,513	39,270		1,026,516
Federal agency - MBS		105,432	17,797		123,229
CMOs - Federal agency	98,070	3,236,456	204,793		3,539,319
CMOs - Non-agency	2,237	24,666			26,903
State and municipal	100,959	288,314		3,320	392,593
Other	58,751	119,236			177,987
Total debt securities available-for-sale	\$ 922,944	\$ 4,134,681	\$ 261,860	\$ 3,320	\$ 5,322,805
Amortized cost	\$ 919,336	\$ 4,135,324	\$ 265,930	\$ 3,400	\$ 5,323,990
Securities held-to-maturity:					
Federal agency - Debt	\$	\$ 26,000	\$ 86,170	\$ 190,748	\$ 302,918
Federal agency - MBS		75,854	467,171	11,396	554,421
CMOs - Federal agency		805,601	1,077,860		1,883,461
State and municipal		80,107	399,352	100,014	579,473
Other		98,080			98,080

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Total debt securities held-to-maturity at amortized cost	\$	\$	1,085,642	\$	2,030,553	\$	302,158	\$	3,418,353
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Table of Contents**Note 3. Securities (Continued)***Impairment Assessment*

The Company performs a quarterly assessment of debt and equity securities in its investment portfolio to determine whether a decline in fair value below amortized cost is other-than-temporary. The Company's impairment assessment of debt securities takes the following factors into consideration: the length of time and the extent to which the market value has been less than cost; the financial condition and near-term prospects of the issuer, including events specific to the issuer or industry; defaults or deferrals of scheduled interest and principal payments; external credit ratings; and whether the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis. For equity securities, the evaluation of whether an impairment is other than temporary is based on whether and when an equity security will recover in value and whether the Company has the intent and ability to hold the equity security until the anticipated recovery in value occurs. If a decline in fair value is determined to be other-than-temporary, the cost basis of the individual security is written down to fair value which then becomes the security's new cost basis. The new cost basis is not adjusted for subsequent recoveries in fair value.

Other-than-temporary impairment losses on equity securities are recognized in earnings. For debt securities, if the Company intends to sell an impaired security or it is more likely than not it will be required to sell a security prior to recovery of its amortized cost, an impairment loss is recognized in earnings for the entire difference between the amortized cost and fair value of the security on the measurement date. If the Company does not intend to sell the security or it is not more likely than not it will be required to sell the security prior to recovery of its amortized cost, the credit loss component of impairment is recognized in earnings. Impairment associated with factors other than credit, such as market liquidity, is recognized in other comprehensive income, net of tax.

Securities Deemed to be Other-Than-Temporarily Impaired

The Company recorded impairment losses in earnings on securities available-for-sale of \$0.2 million for the three and six months ended June 30, 2014 and 2013, respectively. The Company recognized \$0.3 million and \$0.2 million of non-credit-related other-than-temporary impairment in accumulated other comprehensive income or loss (AOCI) on non-agency CMO securities classified as available-for-sale at June 30, 2014 and 2013, respectively. No impairment losses were recognized in earnings or AOCI for securities held-to-maturity during the three and six months ended June 30, 2014 and 2013.

The following table summarizes the changes in cumulative credit-related other-than-temporary impairment recognized in earnings for debt securities for the three and six months ended June 30, 2014 and 2013. Credit-related other-than-temporary impairment that was recognized in earnings is reflected as an Initial credit-related impairment if the period reported is the first time the security had a credit impairment. A credit-related other-than-temporary impairment is reflected as a Subsequent credit-related impairment if the period reported is not the first time the security had a credit impairment. Cumulative impairment is reduced for securities with previously recognized credit-related impairment that were sold or redeemed during the period. Cumulative impairment is further adjusted for other changes in expected cash flows.

**For the three months ended
June 30,**

**For the six months ended
June 30,**

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(in thousands)	2014		2013	
Balance, beginning of period	\$	4,549	\$	3,676
Subsequent credit-related impairment		248		182
Reduction for securities sold or redeemed		(2,402)		(2,402)
Reduction for increase in expected cash flows on securities for which OTTI was previously recognized				(204)
Balance, end of period	\$	2,395	\$	3,654

Table of Contents**Note 3. Securities (Continued)**

The following table provides a summary of the gross unrealized losses and fair value of investment securities that are not deemed to be other-than-temporarily impaired aggregated by investment category and length of time that the securities have been in a continuous unrealized loss position as of June 30, 2014 and December 31, 2013. The table also includes investment securities that had both a credit-related impairment recognized in earnings and a non-credit-related impairment recognized in AOCI.

(in thousands)	Less than 12 months		12 months or greater		Total	
	Fair Value	Estimated Unrealized Loss	Fair Value	Estimated Unrealized Loss	Fair Value	Estimated Unrealized Loss
June 30, 2014						
Securities available-for-sale:						
Federal agency - Debt	\$ 104,163	\$ 31	\$ 312,696	\$ 1,460	\$ 416,859	\$ 1,491
Federal agency - MBS	17,834	70	42,442	1,507	60,276	1,577
CMOs - Federal agency	615,321	1,909	1,299,169	39,695	1,914,490	41,604
CMOs - Non-agency			13,610	400	13,610	400
State and municipal	1,720	4	5,194	97	6,914	101
Total securities available-for-sale	\$ 739,038	\$ 2,014	\$ 1,673,111	\$ 43,159	\$ 2,412,149	\$ 45,173
Securities held-to-maturity:						
Federal agency - Debt	\$	\$	\$ 76,094	\$ 856	\$ 76,094	\$ 856
Federal agency - MBS	27,802	154	123,966	3,904	151,768	4,058
CMOs - Federal agency	619,017	8,334	362,367	8,200	981,384	16,534
State and municipal	46,463	283	140,436	4,666	186,899	4,949
Other debt securities	24,437	4			24,437	4
Total securities held-to-maturity	\$ 717,719	\$ 8,775	\$ 702,863	\$ 17,626	\$ 1,420,582	\$ 26,401
December 31, 2013						
Securities available-for-sale:						
Federal agency - Debt	\$ 1,026,142	\$ 7,911			\$ 1,026,142	\$ 7,911
Federal agency - MBS	17,962	85	43,492	2,703	61,454	2,788
CMOs - Federal agency	1,637,994	35,922	728,101	34,849	2,366,095	70,771
CMOs - Non-agency	10,056	319	8,483	729	18,539	1,048
State and municipal	16,521	39	4,266	84	20,787	123
Total securities available-for-sale	\$ 2,708,675	\$ 44,276	\$ 784,342	\$ 38,365	\$ 3,493,017	\$ 82,641
Securities held-to-maturity:						
Federal agency - Debt	\$ 156,290	\$ 5,122			\$ 156,290	\$ 5,122
Federal agency - MBS	321,090	10,513	15,338	1,417	336,428	11,930
CMOs - Federal agency	1,539,464	36,435	63,276	4,186	1,602,740	40,621
State and municipal	347,305	14,190	41,102	4,824	388,407	19,014
Other debt securities	98,077	619			98,077	619
Total securities held-to-maturity	\$ 2,462,226	\$ 66,879	\$ 119,716	\$ 10,427	\$ 2,581,942	\$ 77,306

At June 30, 2014, the Company had \$2.41 billion of securities available-for-sale and \$1.42 billion of securities held-to-maturity in an unrealized loss position. The debt securities in an unrealized loss position totaled 520 and included 22 federal agency debt securities, 29 federal agency

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MBS securities, 140 federal agency CMOs, 2 non-agency CMOs, 325 state and municipal securities and 2 other debt securities.

At December 31, 2013, the Company had \$3.49 billion of securities available-for-sale and \$2.58 billion of securities held-to-maturity in an unrealized loss position. The debt securities in an unrealized loss position totaled 809 and included 47 federal agency debt securities, 44 federal agency MBS, 182 federal agency CMOs, 4 non-agency CMOs, 520 state and municipal securities and 12 other debt securities.

Table of Contents**Note 4. Other Investments***FHLB and FRB Stock*

The Company's investment in stock issued by the FHLB and FRB totaled \$58.4 million and \$64.4 million at June 30, 2014 and December 31, 2013, respectively. Ownership of government agency securities is restricted to member banks, and the securities do not have readily determinable market values. The Company records investments in FHLB and FRB stock at cost in Other assets of the consolidated balance sheets and evaluates these investments for impairment. The Company expects to recover the full amount invested in FHLB and FRB stock.

Private Equity and Alternative Investments

The Company has ownership interests in a limited number of private equity, venture capital, real estate and hedge funds that are not publicly traded and do not have readily determinable fair values. These investments are carried at cost in the Other assets section of the consolidated balance sheets and are net of impairment write-downs, if applicable. The Company's investments in these funds totaled \$29.7 million at June 30, 2014 and \$34.0 million at December 31, 2013. A summary of investments by fund type is provided below:

(in thousands) Fund Type	June 30, 2014	December 31, 2013
Private equity and venture capital	\$ 18,411	\$ 20,298
Real estate	7,623	7,646
Hedge	1,733	2,733
Other	1,981	3,275
Total	\$ 29,748	\$ 33,952

Management reviews these investments quarterly for impairment. The impairment assessment includes a review of the most recent financial statements and investment reports for each fund and discussions with fund management. An impairment loss is recognized if it is deemed probable that the Company will not recover the cost of an investment. The impairment loss is recognized in Other noninterest income in the consolidated statements of income. The new cost basis of the investment is not adjusted for subsequent recoveries in value. The Company recognized no impairment losses on other investments during the three and six months ended June 30, 2014. The Company recognized no impairment losses on other investments during the three months ended June 30, 2013, and recognized impairment losses of \$0.4 million during the six months ended June 30, 2013.

Table of Contents**Note 5. Loans, Allowance for Loan and Lease Losses, and Reserve for Off-Balance Sheet Credit Commitments**

The following is a summary of the major categories of loans:

Loans and Leases

(in thousands) (1)	June 30, 2014	December 31, 2013
Commercial	\$ 8,230,112	\$ 7,562,300
Commercial real estate mortgages	3,464,918	3,223,001
Residential mortgages	4,814,435	4,554,311
Real estate construction	457,557	367,004
Home equity loans and lines of credit	716,816	709,344
Installment	183,518	151,955
Lease financing	607,432	602,523
Loans and leases, excluding covered loans	18,474,788	17,170,438
Less: Allowance for loan and lease losses	(311,276)	(302,584)
Loans and leases, excluding covered loans, net	18,163,512	16,867,854
Covered loans	605,770	716,911
Less: Allowance for loan losses	(9,103)	(15,922)
Covered loans, net	596,667	700,989
Total loans and leases	\$ 19,080,558	\$ 17,887,349
Total loans and leases, net	\$ 18,760,179	\$ 17,568,843

(1) Commercial loans as of December 31, 2013 have been corrected to include \$158.2 million of loans that were previously reported as lease financing.

The loan amounts above include unamortized fees, net of deferred costs, of \$1.1 million and \$2.3 million as of June 30, 2014 and December 31, 2013, respectively.

Concentrations of credit risk arise when a number of clients are engaged in similar business activities, or activities in the same geographic region, or have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic conditions. Although the Company's lending activities are predominantly in California, and to a lesser extent, New York and Nevada, the Company has various specialty lending businesses that lend to businesses located throughout the United States of America. Excluding covered loans, at June 30, 2014, California represented 73 percent of total loans outstanding and New York and Nevada represented 9 percent and 2 percent, respectively. The remaining 16 percent of total loans outstanding represented other states. Although the Company has a diversified loan portfolio, a substantial portion of the loan portfolio and credit performance depends on the economic stability of Southern California. Credit performance also depends, to a lesser extent, on economic conditions in the San Francisco Bay area, New York and Nevada.

Within the Company's covered loan portfolio at June 30, 2014, the five states with the largest concentration were California (35 percent), Texas (12 percent), Nevada (7 percent), Arizona (6 percent) and Ohio (5 percent). The remaining 35 percent of total covered loans outstanding

represented other states.

Table of Contents**Note 5. Loans, Allowance for Loan and Lease Losses, and Reserve for Off-Balance Sheet Credit Commitments (Continued)***Covered Loans*

Covered loans represent loans acquired from the FDIC that are subject to loss-sharing agreements. Covered loans were \$605.8 million as of June 30, 2014 and \$716.9 million as of December 31, 2013. Covered loans, net of allowance for loan losses, were \$596.7 million at June 30, 2014 and \$701.0 million at December 31, 2013.

The following is a summary of the major categories of covered loans:

(in thousands)	June 30, 2014	December 31, 2013
Commercial	\$ 6,992	\$ 10,009
Commercial real estate mortgages	568,902	666,628
Residential mortgages	5,525	4,976
Real estate construction	20,742	31,184
Home equity loans and lines of credit	3,342	3,695
Installment	267	419
Covered loans	605,770	716,911
Less: Allowance for loan losses	(9,103)	(15,922)
Covered loans, net	\$ 596,667	\$ 700,989

The following table provides information on covered loans and loss-sharing terms by acquired entity:

(in thousands)	Imperial Capital Bank	1st Pacific Bank	Sun West Bank	Nevada Commerce Bank	Total
Covered loans as of:					
June 30, 2014	\$ 536,292	\$ 32,320	\$ 13,651	\$ 23,507	\$ 605,770
December 31, 2013	630,754	40,110	18,761	27,286	716,911
As of June 30, 2014:					
FDIC indemnification asset	\$ 57,624	\$ 2,368	\$ 4,137	\$ 3,909	\$ 68,038
FDIC clawback liability		12,122	1,925	32	14,079
Expiration date of FDIC loss sharing:					
Commercial (1)	12/31/2016	6/30/2015	6/30/2015	6/30/2016	
Residential	12/31/2019	5/31/2020	5/31/2020	4/30/2021	
Termination date of FDIC loss-sharing agreements:					
Commercial (1)	12/19/2017	5/8/2018	5/29/2018	6/30/2019	
Residential	12/31/2019	5/31/2020	5/31/2020	4/30/2021	

(1) The Company is subject to sharing 80 percent of its recoveries with the FDIC up to the last day of the quarter in which the termination dates of the commercial loss-sharing agreements occur.

The Company evaluated the acquired loans from its FDIC-assisted acquisitions and concluded that all loans, with the exception of a small population of acquired loans, would be accounted for under Accounting Standards Codification Topic 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality* (ASC 310-30). Loans are accounted for under ASC 310-30 when there is evidence of credit deterioration since origination and for which it is probable, at acquisition, that the Company would be unable to collect all contractually required payments. Interest income is recognized on all acquired impaired loans through accretion of the difference between the carrying amount of the loans and their expected cash flows.

Table of Contents**Note 5. Loans, Allowance for Loan and Lease Losses, and Reserve for Off-Balance Sheet Credit Commitments (Continued)**

The excess of cash flows expected to be collected over the carrying value of the underlying acquired impaired loans is referred to as the accretable yield. This amount is not reported in the consolidated balance sheets but is accreted into interest income over the remaining estimated lives of the underlying pools of loans. Changes in the accretable yield for acquired impaired loans were as follows for the six months ended June 30, 2014 and 2013:

(in thousands)	For the six months ended	
	June 30,	
	2014	2013
Balance, beginning of period	\$ 219,018	\$ 295,813
Accretion	(24,907)	(33,221)
Reclassifications from nonaccretable difference	18,965	15,978
Disposals and other	(16,198)	(24,605)
Balance, end of period	\$ 196,878	\$ 253,965

The factors that most significantly affect estimates of cash flows expected to be collected, and accordingly the accretable yield balance, include: (i) changes in credit assumptions, including both credit loss amounts and timing; (ii) changes in prepayment assumptions; and (iii) changes in interest rates for variable-rate loans. Reclassifications between accretable yield and nonaccretable difference may vary from period to period as the Company periodically updates its cash flow projections. The reclassification of nonaccretable difference to accretable yield during 2014 was principally driven by positive changes in cash flows, resulting mainly from changes in credit assumptions.

The Company recorded an indemnification asset related to its FDIC-assisted acquisitions, which represents the present value of the expected reimbursement from the FDIC for expected losses on acquired loans, OREO and unfunded commitments. The difference between the carrying value of the FDIC indemnification asset and the undiscounted cash flow that the Company expects to collect from the FDIC is accreted or amortized into noninterest income up until the expiration date of the FDIC loss sharing. Refer to the preceding table for a list of expiration dates of FDIC loss sharing by acquired entity. The FDIC indemnification asset is reviewed on a quarterly basis and adjusted based on changes in cash flow projections. The FDIC indemnification asset from all FDIC-assisted acquisitions was \$68.0 million at June 30, 2014 and \$89.2 million at December 31, 2013.

Credit Quality on Loans and Leases, Excluding Covered Loans***Allowance for Loan and Lease Losses and Reserve for Off-Balance Sheet Credit Commitments***

The Company accounts for the credit risk associated with lending activities through its allowance for loan and lease losses, reserve for off-balance sheet credit commitments and provision for credit losses. The provision is the expense recognized in the consolidated statements of income to adjust the allowance and reserve to the levels deemed appropriate by management, as determined through application of the Company's allowance methodology procedures. The provision for credit losses reflects management's judgment of the adequacy of the allowance for loan and lease losses and the reserve for off-balance sheet credit commitments. It is determined through quarterly analytical reviews of the loan and commitment portfolios and consideration of such other factors as the Company's loan and lease loss experience, trends in problem loans, concentrations of credit risk, underlying collateral values, and current economic conditions, as well as the results of the Company's

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ongoing credit review process. As conditions change, the Company's level of provisioning and the allowance for loan and lease losses and reserve for off-balance sheet credit commitments may change.

The relative significance of risk considerations used in measuring the allowance for loan and lease losses will vary by portfolio segment. For commercial loans, the primary risk consideration is a borrower's ability to generate sufficient cash flows to repay their loan. Secondary considerations include the creditworthiness of guarantors and the valuation of collateral. In addition to the creditworthiness of a borrower, the type and location of real estate collateral is an important risk factor for commercial real estate and real estate construction loans. The primary risk considerations for consumer loans are a borrower's personal cash flow and liquidity, as well as collateral value.

Table of Contents

Note 5. Loans, Allowance for Loan and Lease Losses, and Reserve for Off-Balance Sheet Credit Commitments (Continued)

For commercial, non-homogenous loans that are not impaired, the Bank derives loss factors for each risk grade and loan type via a process that begins with estimates of probable losses inherent in the portfolio based upon various statistical analyses. The factors considered in the analysis include loan type, migration analysis, in which historical delinquency and credit loss experience is applied to the portfolio, as well as analyses that reflect current trends and conditions. Each portfolio of smaller balance homogeneous loans, including residential first mortgages, installment, revolving credit and most other consumer loans, is collectively evaluated for loss potential. The quantitative portion of the allowance for loan and lease losses is adjusted for qualitative factors to account for model imprecision and to incorporate the range of probable outcomes inherent in the estimates used for the allowance. The qualitative portion of the allowance attempts to incorporate the risks inherent in the portfolio, economic uncertainties, competition, and regulatory requirements and other subjective factors such as changes in underwriting standards. It also considers overall portfolio indicators, including current and historical credit losses; delinquent, nonperforming and criticized loans; portfolio concentrations; trends in volumes and terms of loans; and economic trends in the broad market and in specific industries.

A portion of the allowance for loan and lease losses is attributed to impaired loans that are individually measured for impairment. This measurement is based on the present value of expected future cash flows discounted using the loan's contractual effective rate, the fair value of collateral or the secondary market value of the loan.

The allowance for loan and lease losses is decreased by the amount of charge-offs and increased by the amount of recoveries. Generally, commercial, commercial real estate and real estate construction loans are charged off immediately when it is determined that advances to the borrower are in excess of the calculated current fair value of the collateral and if a borrower is deemed incapable of repayment of unsecured debt, there is little or no prospect for near term improvement and no realistic strengthening action of significance pending. Consumer loans are charged-off based on delinquency, ranging from 60 days for overdrafts to 180 days for secured consumer loans, or earlier when it is determined that the loan is uncollectible due to a triggering event, such as bankruptcy, fraud or death.

Table of Contents**Note 5. Loans, Allowance for Loan and Lease Losses, and Reserve for Off-Balance Sheet Credit Commitments (Continued)**

The following is a summary of activity in the allowance for loan and lease losses and period-end recorded investment balances of loans evaluated for impairment, excluding covered loans, for the three and six months ended June 30, 2014 and 2013. Activity is provided by loan portfolio segment which is consistent with the Company's methodology for determining the allowance for loan and lease losses.

(in thousands)	Commercial (1)	Commercial Real Estate Mortgages	Residential Mortgages	Real Estate Construction	Home Equity Loans and Lines of Credit	Installment	Qualitative	Total
Three months ended June 30, 2014								
Allowance for loan and lease losses:								
Beginning balance	\$ 121,574	\$ 51,361	\$ 11,595	\$ 6,468	\$ 6,419	\$ 1,824	\$ 106,549	\$ 305,790
Charge-offs	(12,862)				(149)	(142)		(13,153)
Recoveries	7,503	27	190	687	43	1,068		9,518
Net (charge-offs) recoveries	(5,359)	27	190	687	(106)	926		(3,635)
(Reversal of) provision for credit losses	711	(737)	(1,489)	36	262	(466)	683	(1,000)
Transfers from reserve for off-balance sheet credit commitments	9,353						768	10,121
Ending balance	\$ 126,279	\$ 50,651	\$ 10,296	\$ 7,191	\$ 6,575	\$ 2,284	\$ 108,000	\$ 311,276
Six months ended June 30, 2014								
Allowance for loan and lease losses:								
Beginning balance	\$ 117,103	\$ 50,678	\$ 11,540	\$ 6,351	\$ 6,677	\$ 1,842	\$ 108,393	\$ 302,584
Charge-offs	(14,821)	(5)	(482)		(165)	(188)		(15,661)
Recoveries	9,235	127	225	5,075	202	1,332		16,196
Net (charge-offs) recoveries	(5,586)	122	(257)	5,075	37	1,144		535
(Reversal of) provision for credit losses	5,409	(149)	(987)	(4,235)	(139)	(702)	(197)	(1,000)
Transfers from (to) reserve for off-balance sheet credit commitments	9,353						(196)	9,157
Ending balance	\$ 126,279	\$ 50,651	\$ 10,296	\$ 7,191	\$ 6,575	\$ 2,284	\$ 108,000	\$ 311,276
Ending balance of allowance:								
Individually evaluated for impairment	\$ 8,477	\$ 301	\$ 5	\$	\$	\$ 50	\$	\$ 8,833
Collectively evaluated for impairment	117,802	50,350	10,291	7,191	6,575	2,234	108,000	302,443
Loans and leases, excluding covered loans								

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Ending balance of loans and leases:							
Loans and leases, excluding covered loans	\$ 8,837,544	\$ 3,464,918	\$ 4,814,435	\$ 457,557	\$ 716,816	\$ 183,518	\$ 18,474,788
Individually evaluated for impairment	29,231	33,456	10,596	12,846	3,436	50	89,615
Collectively evaluated for impairment	8,808,313	3,431,462	4,803,839	444,711	713,380	183,468	18,385,173

(1) Includes lease financing loans.

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Table of Contents

Note 5. Loans, Allowance for Loan and Lease Losses, and Reserve for Off-Balance Sheet Credit Commitments (Continued)

(in thousands) (2)	Commercial (1)	Commercial Real Estate Mortgages	Residential Mortgages	Real Estate Construction	Home Equity Loans and Lines of Credit	Installment	Qualitative	Total
Three months ended June 30, 2013								
Allowance for loan and lease losses:								
Beginning balance	\$ 112,748	\$ 52,016	\$ 7,253	\$ 9,962	\$ 4,843	\$ 1,225	\$ 94,281	\$ 282,328
Charge-offs	(2,869)		(1)	(100)	(35)	(81)		(3,086)
Recoveries	5,724	1,034	38	2,782	410	603		10,591
Net recoveries (charge-offs)	2,855	1,034	37	2,682	375	522		7,505
(Reversal of) provision for credit losses	1,016	289	714	(4,309)	182	(392)	2,500	
Transfers from reserve for off-balance sheet credit commitments							81	81
Ending balance	\$ 116,619	\$ 53,339	\$ 8,004	\$ 8,335	\$ 5,400	\$ 1,355	\$ 96,862	\$ 289,914
Six months ended June 30, 2013								
Allowance for loan and lease losses:								
Beginning balance	\$ 104,731	\$ 48,901	\$ 10,558	\$ 11,784	\$ 7,283	\$ 1,858	\$ 92,773	\$ 277,888
Charge-offs	(4,231)	(45)	(106)	(100)	(275)	(352)		(5,109)
Recoveries	9,259	1,082	75	5,448	538	1,020		17,422
Net recoveries (charge-offs)	5,028	1,037	(31)	5,348	263	668		12,313
(Reversal of) provision for credit losses	6,860	3,401	(2,523)	(8,797)	(2,146)	(1,171)	4,376	
Transfers to reserve for off-balance sheet credit commitments							(287)	(287)
Ending balance	\$ 116,619	\$ 53,339	\$ 8,004	\$ 8,335	\$ 5,400	\$ 1,355	\$ 96,862	\$ 289,914
Ending balance of allowance:								
Individually evaluated for impairment	\$ 478	\$ 2,252	\$ 230	\$	\$	\$	\$	\$ 2,960
Collectively evaluated for impairment	116,141	51,087	7,774	8,335	5,400	1,355	96,862	286,954
Loans and leases, excluding covered loans								
Ending balance of loans and leases:								
Loans and leases, excluding covered loans	\$ 7,497,105	\$ 2,978,975	\$ 4,153,051	\$ 340,002	\$ 700,681	\$ 149,438	\$	\$ 15,819,252
Individually evaluated for impairment	34,915	41,932	7,979	30,446	3,257			118,529
Collectively evaluated for impairment	7,462,190	2,937,043	4,145,072	309,556	697,424	149,438		15,700,723

(1) Includes lease financing loans.

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(2) Certain balances for the three and six months ended June 30, 2013 have been revised as a result of correcting the real estate construction loan balance to include loans that were previously reported as commercial real estate mortgages.

Off-balance sheet credit exposures include loan commitments and letters of credit. The following table provides a summary of activity in the reserve for off-balance sheet credit commitments for the three and six months ended June 30, 2014 and 2013:

(in thousands)	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Balance, beginning of period	\$ 34,908	\$ 25,205	\$ 33,944	\$ 24,837
Transfers (to) from allowance for loan and lease losses	(10,121)	(81)	(9,157)	287
Balance, end of period	\$ 24,787	\$ 25,124	\$ 24,787	\$ 25,124

The reserve for off-balance sheet credit commitments decreased \$10.1 million and \$9.2 million during the three and six months ended June 30, 2014, respectively. The decrease for both periods was primarily due to the conversion of an undrawn letter of credit that had a specific reserve to an on-balance sheet loan, and normal fluctuations in the amount of reserves required due to changes in the composition, amount, and quality of risk ratings of borrowers associated with the off-balance sheet commitments. Increases and decreases in the reserve for off-balance sheet credit commitments are reflected as an allocation of provision expense from or to the allowance for loan and lease losses.

Table of Contents**Note 5. Loans, Allowance for Loan and Lease Losses, and Reserve for Off-Balance Sheet Credit Commitments (Continued)***Impaired Loans and Leases*

The Company considers a loan to be impaired when it is probable that it will be unable to collect all amounts due according to the contractual terms of the loan agreement. Once a loan is determined to be impaired, the impairment is measured based on the present value of the expected future cash flows discounted at the loan's effective interest rate, except that if the loan is collateral dependent, the impairment is measured by using the fair value of the loan's collateral. As a final alternative, the observable market price of the debt may be used to assess impairment. Nonperforming loans greater than \$1 million are individually evaluated for impairment based upon the borrower's overall financial condition, resources, and payment record, and the prospects for support from any financially responsible guarantors. Loans under \$1 million will be measured for impairment using historical loss factors. When the measurement of the impaired loan is less than the recorded amount of the loan, an impairment is recognized by creating a valuation allowance with a corresponding charge to the allowance for loan and lease losses or by adjusting an existing valuation allowance for the impaired loan.

Information on impaired loans, excluding covered loans, at June 30, 2014, December 31, 2013 and June 30, 2013 is provided in the following tables:

(in thousands)	Recorded Investment	Unpaid Contractual Principal Balance	Related Allowance	For the three months ended June 30, 2014		For the six months ended June 30, 2014	
				Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
June 30, 2014							
With no related allowance recorded:							
Commercial	\$ 6,980	\$ 7,713	\$	\$ 9,118	\$ 30	\$ 11,986	\$ 167
Commercial real estate mortgages	28,233	30,829		32,398	246	32,522	684
Residential mortgages:							
Fixed	4,796	5,012		4,842	10	3,940	20
Variable	1,799	1,922		2,408	14	3,406	28
Total residential mortgages	6,595	6,934		7,250	24	7,346	48
Real estate construction:							
Construction				2,742	21	3,656	76
Land	12,846	26,520		13,075	35	13,254	69
Total real estate construction	12,846	26,520		15,817	56	16,910	145
Home equity loans and lines of credit	3,436	4,505		3,442		3,071	
Installment:							
Consumer						5	
Total installment						5	
Total with no related allowance	\$ 58,090	\$ 76,501	\$	\$ 68,025	\$ 356	\$ 71,840	\$ 1,044
With an allowance recorded:							
Commercial	\$ 22,251	\$ 28,454	\$ 8,477	\$ 19,839	\$	\$ 17,938	\$
Commercial real estate mortgages	5,223	5,586	301	5,293	74	5,323	118
Residential mortgages:							
Variable	4,001	3,993	5	2,001	11	1,892	11

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Total residential mortgages	4,001	3,993	5	2,001	11	1,892	11
Installment:							
Consumer	50	50	50	25	1	17	1
Total installment	50	50	50	25	1	17	1
Total with an allowance	\$ 31,525	\$ 38,083	\$ 8,833	\$ 27,158	\$ 86	\$ 25,170	\$ 130
Total impaired loans by type:							
Commercial	\$ 29,231	\$ 36,167	\$ 8,477	\$ 28,957	\$ 30	\$ 29,924	\$ 167
Commercial real estate mortgages	33,456	36,415	301	37,691	320	37,845	802
Residential mortgages	10,596	10,927	5	9,251	35	9,238	59
Real estate construction	12,846	26,520		15,817	56	16,910	145
Home equity loans and lines of credit	3,436	4,505		3,442		3,071	
Installment	50	50	50	25	1	22	1
Total impaired loans	\$ 89,615	\$ 114,584	\$ 8,833	\$ 95,183	\$ 442	\$ 97,010	\$ 1,174

Table of Contents**Note 5. Loans, Allowance for Loan and Lease Losses, and Reserve for Off-Balance Sheet Credit Commitments (Continued)**

(in thousands)	Recorded Investment	Unpaid Contractual Principal Balance	Related Allowance
Year ended December 31, 2013			
With no related allowance recorded:			
Commercial	\$ 17,721	\$ 18,041	\$
Commercial real estate mortgages	32,770	37,555	
Residential mortgages:			
Fixed	2,135	2,295	
Variable	5,402	5,783	
Total residential mortgages	7,537	8,078	
Real estate construction:			
Construction	5,485	6,766	
Land	13,612	26,928	
Total real estate construction	19,097	33,694	
Home equity loans and lines of credit	2,329	3,375	
Installment:			
Consumer	16	24	
Total installment	16	24	
Total with no related allowance	\$ 79,470	\$ 100,767	\$
With an allowance recorded:			
Commercial	\$ 14,136	\$ 18,156	\$ 1,961
Commercial real estate mortgages	5,384	5,764	586
Residential mortgages:			
Variable	1,674	1,687	478
Total residential mortgages	1,674	1,687	478
Total with an allowance	\$ 21,194	\$ 25,607	\$ 3,025
Total impaired loans by type:			
Commercial	\$ 31,857	\$ 36,197	\$ 1,961
Commercial real estate mortgages	38,154	43,319	586
Residential mortgages	9,211	9,765	478
Real estate construction	19,097	33,694	
Home equity loans and lines of credit	2,329	3,375	
Installment	16	24	
Total impaired loans	\$ 100,664	\$ 126,374	\$ 3,025

Table of Contents**Note 5. Loans, Allowance for Loan and Lease Losses, and Reserve for Off-Balance Sheet Credit Commitments (Continued)**

(in thousands)	Recorded Investment	Unpaid Contractual Principal Balance	Related Allowance	For the three months ended June 30, 2013		For the six months ended June 30, 2013	
				Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
June 30, 2013							
With no related allowance recorded:							
Commercial	\$ 27,276	\$ 28,029	\$	\$ 23,171	\$ 428	\$ 21,701	\$ 847
Commercial real estate mortgages	26,821	31,116		28,112	427	33,035	662
Residential mortgages:							
Fixed	2,008	2,356		2,963	24	3,136	42
Variable	4,277	4,619		4,161	55	4,396	69
Total residential mortgages	6,285	6,975		7,124	79	7,532	111
Real estate construction:							
Construction	16,265	21,064		17,799	228	18,453	558
Land	14,181	27,156		13,172	253	17,364	287
Total real estate construction	30,446	48,220		30,971	481	35,817	845
Home equity loans and lines of credit	3,257	4,310		2,698	34	2,986	34
Installment:							
Consumer						150	
Total installment						150	
Total with no related allowance	\$ 94,085	\$ 118,650	\$	\$ 92,076	\$ 1,449	\$ 101,221	\$ 2,499
With an allowance recorded:							
Commercial	\$ 7,639	\$ 9,170	\$ 478	\$ 7,606	\$ 311	\$ 7,576	\$ 357
Commercial real estate mortgages	15,111	15,963	2,252	14,228	148	12,886	316
Residential mortgages:							
Fixed						154	
Variable	1,694	1,688	230	847	41	565	41
Total residential mortgages	1,694	1,688	230	847	41	719	41
Real estate construction:							
Land				6,425		4,283	213
Total real estate construction				6,425		4,283	213
Home equity loans and lines of credit						300	
Total with an allowance	\$ 24,444	\$ 26,821	\$ 2,960	\$ 29,106	\$ 500	\$ 25,764	\$ 927
Total impaired loans by type:							
Commercial	\$ 34,915	\$ 37,199	\$ 478	\$ 30,777	\$ 739	\$ 29,277	\$ 1,204
Commercial real estate mortgages	41,932	47,079	2,252	42,340	575	45,921	978
Residential mortgages	7,979	8,663	230	7,971	120	8,251	152
Real estate construction	30,446	48,220		37,396	481	40,100	1,058
Home equity loans and lines of credit	3,257	4,310		2,698	34	3,286	34
Installment						150	
Total impaired loans	\$ 118,529	\$ 145,471	\$ 2,960	\$ 121,182	\$ 1,949	\$ 126,985	\$ 3,426

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Impaired loans at June 30, 2014 and December 31, 2013 included \$34.7 million and \$42.1 million, respectively, of loans that are on accrual status. With the exception of restructured loans on accrual status and a limited number of loans on cash basis nonaccrual for which the full collection of principal and interest is expected, interest income is not recognized on impaired loans until the principal balance of these loans is paid off.

Table of Contents**Note 5. Loans, Allowance for Loan and Lease Losses, and Reserve for Off-Balance Sheet Credit Commitments (Continued)***Troubled Debt Restructured Loans*

The following table provides a summary of loans modified in a troubled debt restructuring during the three months ended June 30, 2014 and 2013:

(in thousands)	Number of Contracts	Pre-Modification Outstanding Principal	Period-End Outstanding Principal	Financial Effects (1)
Three months ended June 30, 2014				
Residential mortgages:				
Variable	1	\$ 4,000	\$ 3,993	\$ 5
Installment:				
Consumer	1	50	50	50
Total troubled debt restructured loans	2	\$ 4,050	\$ 4,043	\$ 55
Three months ended June 30, 2013				
Commercial	6	\$ 6,956	\$ 6,926	\$
Commercial real estate mortgages	1	547	547	\$
Total troubled debt restructured loans	7	\$ 7,503	\$ 7,473	\$

(1) Financial effects are comprised of charge-offs and specific reserves recognized on TDR loans at modification date.

The following table provides a summary of loans modified in a troubled debt restructuring during the six months ended June 30, 2014 and 2013:

(in thousands)	Number of Contracts	Pre-Modification Outstanding Principal	Period-End Outstanding Principal	Financial Effects (1)
Six months ended June 30, 2014				
Commercial	2	\$ 4,098	\$ 3,967	\$
Residential mortgages:				
Variable	2	4,676	4,669	5
Installment:				
Consumer	1	50	50	50
Total troubled debt restructured loans	5	\$ 8,824	\$ 8,686	\$ 55
Six months ended June 30, 2013				
Commercial	10	\$ 8,683	\$ 8,336	\$
Commercial real estate mortgages	1	547	547	\$
Home equity loans and lines of credit	1	345	\$	\$
Total troubled debt restructured loans	12	\$ 9,575	\$ 8,883	\$

(1) Financial effects are comprised of charge-offs and specific reserves recognized on TDR loans at modification date.

A restructuring constitutes a troubled debt restructuring when a lender, for reasons related to a borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. Loans with pre-modification outstanding balances totaling \$4.1 million and \$8.8 million were modified in troubled debt restructurings during the three and six months ended June 30, 2014, respectively. Loans with pre-modification outstanding balances totaling \$7.5 million and \$9.6 million were modified in troubled debt restructurings during the three and six months ended June 30, 2013, respectively. The concessions granted in the restructurings completed in 2014 consisted of maturity extensions and rate modifications.

Table of Contents

Note 5. Loans, Allowance for Loan and Lease Losses, and Reserve for Off-Balance Sheet Credit Commitments (Continued)

The unpaid principal balance of troubled debt restructured (TDR) loans was \$45.4 million, before specific reserves of \$1.6 million, at June 30, 2014 and \$52.2 million, before specific reserves of \$0.8 million, at December 31, 2013. The net decrease in TDR loans from the prior year-end was primarily attributable to payoffs and payments received on existing TDR loans totaling \$16.2 million and to the removal of \$0.5 million of loans that were restructured in an A/B note structure in prior year that are no longer reported as TDRs. These decreases were partially offset by additions totaling \$8.8 million and advances on existing TDR loans totaling \$1.5 million. Loans modified in troubled debt restructurings are impaired loans at the time of restructuring and subject to the same measurement criteria as all other impaired loans.

The Company had no TDR loans that subsequently defaulted during the three and six months ended June 30, 2014. The following table provides a summary of TDR loans that subsequently defaulted during the three and six months ended June 30, 2013, that had been modified as a troubled debt restructuring during the 12 months prior to their default. A TDR loan is considered to be in default when payments are 90 days or more past due.

(in thousands)	For three months ended June 30, 2013			For six months ended June 30, 2013		
	Number of Contracts	Period-End Outstanding Principal	Period-End Specific Reserve	Number of Contracts	Period-End Outstanding Principal	Period-End Specific Reserve
Commercial	2	\$ 427	\$	4	\$ 1,487	\$
Real estate construction:						
Land	1	7,491		1	7,491	
Home equity loans and lines of credit				1	141	
Total loans that subsequently defaulted	3	\$ 7,918	\$	6	\$ 9,119	\$

All TDR loans were performing in accordance with their restructured terms at June 30, 2014. As of June 30, 2014, commitments to lend additional funds on restructured loans totaled \$0.2 million.

Past Due and Nonaccrual Loans and Leases

Loans are considered past due following the date when either interest or principal is contractually due and unpaid. The following tables provide a summary of past due and nonaccrual loans, excluding covered loans, at June 30, 2014 and December 31, 2013 based upon the length of time the loans have been past due:

(in thousands)	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days and Accruing	Nonaccrual	Total Past Due and Nonaccrual Loans	Current	Total Loans and Leases
June 30, 2014							
Commercial	\$ 6,924	\$ 2,702		\$ 27,314	\$ 36,940	\$ 8,193,172	\$ 8,230,112

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Commercial real estate mortgages	1,101	1,418	9,216	11,735	3,453,183	3,464,918
Residential mortgages:						
Fixed	819	379	6,748	7,946	1,419,517	1,427,463
Variable	1,176		2,283	3,459	3,383,513	3,386,972
Total residential mortgages	1,995	379	9,031	11,405	4,803,030	4,814,435
Real estate construction:						
Construction					432,934	432,934
Land			12,834	12,834	11,789	24,623
Total real estate construction			12,834	12,834	444,723	457,557
Home equity loans and lines of credit	388		6,090	6,478	710,338	716,816
Installment:						
Commercial	1	4		5	310	315
Consumer	533		125	658	182,545	183,203
Total installment	534	4	125	663	182,855	183,518
Lease financing			172	172	607,260	607,432
Total	\$ 8,947	\$ 4,697	\$ 1,801	\$ 64,782	\$ 80,227	\$ 18,394,561
						\$ 18,474,788

Table of Contents

Note 5. Loans, Allowance for Loan and Lease Losses, and Reserve for Off-Balance Sheet Credit Commitments (Continued)

(in thousands) (1)	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days and Accruing	Nonaccrual	Total Past Due and Nonaccrual Loans	Current	Total Loans and Leases
December 31, 2013							
Commercial	\$ 6,582	\$ 362	\$	\$ 14,248	\$ 21,192	\$ 7,541,108	\$ 7,562,300
Commercial real estate mortgages	1,197	1,633		18,449	21,279	3,201,722	3,223,001
Residential mortgages:							
Fixed			379	3,789	4,168	1,436,283	1,440,451
Variable				7,872	7,872	3,105,988	3,113,860
Total residential mortgages			379	11,661	12,040	4,542,271	4,554,311
Real estate construction:							
Construction				5,467	5,467	332,131	337,598
Land		797		13,600	14,397	15,009	29,406
Total real estate construction		797		19,067	19,864	347,140	367,004
Home equity loans and lines of credit			74	5,144	5,218	704,126	709,344
Installment:							
Commercial	1				1	361	362
Consumer	10	7		32	49	151,544	151,593
Total installment	11	7		32	50	151,905	151,955
Lease financing	401	126		50	577	601,946	602,523
Total	\$ 8,191	\$ 2,925	\$ 453	\$ 68,651	\$ 80,220	\$ 17,090,218	\$ 17,170,438

(1) Commercial loans as of December 31, 2013 have been corrected to include \$158.2 million of loans that were previously reported as lease financing.

Credit Quality Monitoring

The Company closely monitors and assesses credit quality and credit risk in the loan and lease portfolio on an ongoing basis. Loan risk classifications are continuously reviewed and updated. The following tables provide a summary of the loan and lease portfolio, excluding covered loans, by loan type and credit quality classification as of June 30, 2014 and December 31, 2013. Nonclassified loans generally include those loans that are expected to be repaid in accordance with contractual loan terms. Classified loans are those loans that are classified as substandard or doubtful consistent with regulatory guidelines.

(in thousands) (1)	June 30, 2014			December 31, 2013		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total
Commercial	\$ 8,148,482	\$ 81,630	\$ 8,230,112	\$ 7,416,487	\$ 145,813	\$ 7,562,300
Commercial real estate mortgages	3,416,709	48,209	3,464,918	3,139,707	83,294	3,223,001
Residential mortgages:						

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Fixed	1,407,809	19,654	1,427,463	1,425,087	15,364	1,440,451
Variable	3,357,979	28,993	3,386,972	3,087,636	26,224	3,113,860
Total residential mortgages	4,765,788	48,647	4,814,435	4,512,723	41,588	4,554,311
Real estate construction:						
Construction	432,934		432,934	332,131	5,467	337,598
Land	11,788	12,835	24,623	15,522	13,884	29,406
Total real estate construction	444,722	12,835	457,557	347,653	19,351	367,004
Home equity loans and lines of credit	687,909	28,907	716,816	687,732	21,612	709,344
Installment:						
Commercial	315		315	362		362
Consumer	182,090	1,113	183,203	151,468	125	151,593
Total installment	182,405	1,113	183,518	151,830	125	151,955
Lease financing	602,693	4,739	607,432	598,821	3,702	602,523
Total	\$ 18,248,708	\$ 226,080	\$ 18,474,788	\$ 16,854,953	\$ 315,485	\$ 17,170,438

(1) Commercial loans as of December 31, 2013 have been corrected to include \$158.2 million of loans that were previously reported as lease financing.

Table of Contents**Note 5. Loans, Allowance for Loan and Lease Losses, and Reserve for Off-Balance Sheet Credit Commitments (Continued)***Credit Quality on Covered Loans*

The following is a summary of activity in the allowance for losses on covered loans:

(in thousands)	For the three months ended June 30,			For the six months ended June 30,		
	2014	2013	2013	2014	2013	2013
Balance, beginning of period	\$ 18,439	\$ 42,354	\$ 42,354	\$ 15,922	\$ 44,781	\$ 44,781
(Reversal of) provision for losses	(1,461)	(11,927)	(11,927)	3,194	(2,035)	(2,035)
Reduction in allowance due to loan removals	(7,875)	(6,013)	(6,013)	(10,013)	(18,332)	(18,332)
Balance, end of period	\$ 9,103	\$ 24,414	\$ 24,414	\$ 9,103	\$ 24,414	\$ 24,414

The allowance for losses on covered loans was \$9.1 million, \$15.9 million and \$24.4 million as of June 30, 2014, December 31, 2013 and June 30, 2013, respectively. As a result of improvements in the portfolio's credit quality and general market conditions, the Company recorded a \$1.5 million reversal of provision for losses on covered loans during the three months ended June 30, 2014. Provision expense was \$3.2 million for the six months ended June 30, 2014. The Company recorded an \$11.9 million and \$2.0 million reversal of provision during the three and six months ended June 30, 2013, respectively. The Company updates its cash flow projections for covered loans accounted for under ASC 310-30 on a quarterly basis, and may recognize provision expense or reversal of provision for loan losses as a result of that analysis. The provision expense or reversal of provision for losses on covered loans is the result of changes in expected cash flows, both amount and timing, due to actual loan performance and the Company's revised loan loss and prepayment forecasts. The revisions of these forecasts were based on the results of management's review of market conditions, the credit quality of outstanding covered loans and the analysis of loan performance data since the acquisition of covered loans. The allowance for losses on covered loans is reversed for any loan removals, which occur when a loan has been fully paid off, fully charged off, sold or transferred to OREO.

Covered loans accounted for under ASC 310-30 are generally considered accruing and performing loans as the loans accrete interest income over the estimated life of the loan when cash flows are reasonably estimable. Accordingly, acquired impaired loans that are contractually past due are still considered to be accruing and performing loans. If the timing and amount of future cash flows is not reasonably estimable, the loans may be classified as nonaccrual loans and interest income is not recognized until the timing and amount of future cash flows can be reasonably estimated. There were no covered loans that were on nonaccrual status as of June 30, 2014 and December 31, 2013.

At June 30, 2014, covered loans that were 30 to 89 days delinquent totaled \$11.6 million and covered loans that were 90 days or more past due on accrual status totaled \$31.0 million. At December 31, 2013, covered loans that were 30 to 89 days delinquent totaled \$15.5 million and covered loans that were 90 days or more past due on accrual status totaled \$45.7 million.

Note 6. Other Real Estate Owned

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The following table provides a summary of OREO activity for the three months ended June 30, 2014 and 2013:

(in thousands)	For the three months ended June 30, 2014			For the three months ended June 30, 2013		
	Non-Covered OREO	Covered OREO	Total	Non-Covered OREO	Covered OREO	Total
Balance, beginning of period	\$ 9,412	\$ 24,855	\$ 34,267	\$ 19,786	\$ 43,751	\$ 63,537
Additions	110	1,987	2,097	341	4,612	4,953
Sales	(5,253)	(7,964)	(13,217)	(390)	(4,378)	(4,768)
Valuation adjustments		(934)	(934)	(61)	(2,184)	(2,245)
Balance, end of period	\$ 4,269	\$ 17,944	\$ 22,213	\$ 19,676	\$ 41,801	\$ 61,477

Table of Contents**Note 6. Other Real Estate Owned (continued)**

The following table provides a summary of OREO activity for the six months ended June 30, 2014 and 2013:

(in thousands)	For the six months ended June 30, 2014			For the six months ended June 30, 2013		
	Non-Covered OREO	Covered OREO	Total	Non-Covered OREO	Covered OREO	Total
Balance, beginning of period	\$ 12,611	\$ 25,481	\$ 38,092	\$ 21,027	\$ 58,276	\$ 79,303
Additions	111	4,020	4,131	723	13,906	14,629
Sales	(8,439)	(10,468)	(18,907)	(1,781)	(25,162)	(26,943)
Valuation adjustments	(14)	(1,089)	(1,103)	(293)	(5,219)	(5,512)
Balance, end of period	\$ 4,269	\$ 17,944	\$ 22,213	\$ 19,676	\$ 41,801	\$ 61,477

At June 30, 2014, OREO was \$22.2 million and included \$17.9 million of covered OREO. At December 31, 2013, OREO was \$38.1 million and included \$25.5 million of covered OREO. The balance of OREO at June 30, 2014 and December 31, 2013 is net of valuation allowances of \$11.1 million and \$17.4 million, respectively.

Covered OREO expenses and valuation write-downs are recorded in the noninterest expense section of the consolidated statements of income and gains or losses on sale of covered OREO are recognized in the noninterest income section. Under the loss sharing agreements, 80 percent of eligible covered OREO expenses, valuation write-downs, and losses on sales are reimbursable to the Company from the FDIC and 80 percent of covered gains on sales are payable to the FDIC. The portion of these expenses and income shared with the FDIC is recorded in FDIC loss sharing income (expense), net in the noninterest income section of the consolidated statements of income.

Table of Contents**Note 7. Borrowed Funds**

Short-term borrowings consist of funds with remaining maturities of one year or less and long-term debt consists of borrowings with remaining maturities greater than one year. The components of short-term borrowings and long-term debt as of June 30, 2014 and December 31, 2013 are provided below:

(in thousands) (1)	June 30, 2014	December 31, 2013
Short-term borrowings		
Current portion of subordinated debt:		
City National Bank - 9.00% Subordinated Notes Due July 2019 (2)	\$ 50,000	\$
City National Bank - Fixed and Floating Subordinated Notes due August 2019 (3)	55,000	
Federal funds purchased	50,000	
Current portion of nonrecourse debt (4)	5,337	3,889
Total short-term borrowings	\$ 160,337	\$ 3,889
Long-term debt		
Senior notes:		
City National Corporation - 5.25% Senior Notes Due September 2020	\$ 299,502	\$ 299,463
Subordinated debt:		
City National Bank - 9.00% Subordinated Notes Due July 2019 (2)		50,000
City National Bank - 9.00% Subordinated Notes Due August 2019	75,000	75,000
City National Bank - Fixed and Floating Subordinated Notes due August 2019 (3)		55,000
City National Bank - 5.375% Subordinated Notes Due July 2022	149,994	149,994
Junior subordinated debt:		
Floating Rate Business Bancorp Capital Trust I Securities due November 2034 (5)	5,155	5,155
Nonrecourse debt (4)	88,246	91,388
Other long-term debt (6)	9,871	9,968
Total long-term debt	\$ 627,768	\$ 735,968

(1) The carrying value of certain borrowed funds is net of discount which is being amortized into interest expense, as well as the impact of fair value hedge accounting, if applicable.

(2) These notes bear a fixed interest rate of 9 percent for the initial five years from the date of issuance (July 15, 2009) and thereafter the rate is reset at the Bank's option to either LIBOR plus 6 percent or to prime plus 5 percent. The Bank elected to redeem the notes in accordance with their terms and procedures on July 15, 2014.

(3) These notes bear a fixed interest rate of 9 percent for the initial five years from the date of issuance (August 12, 2009) and thereafter bear an interest rate equal to the three-month LIBOR rate plus 6 percent. The rate is reset quarterly and is subject to an interest rate cap of 10 percent throughout the term of the notes. The Bank has notified investors of its election to redeem the notes in accordance with their terms and procedures on August 12, 2014.

(4) Nonrecourse debt bears interest at an average rate of 3.83 percent as of June 30, 2014 and has maturity dates ranging from August 2014 to February 2023.

(5) These floating rate securities pay interest of three-month LIBOR plus 1.965 percent which is reset quarterly. As of June 30, 2014, the interest rate was approximately 2.19 percent.

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- (6) Other long-term debt includes a note payable that bears a fixed interest rate of 5.64 percent and is scheduled to mature on June 2017.

The Company holds debt affiliated with First American Equipment Finance (FAEF), its wholly-owned equipment finance subsidiary. FAEF assigns the future rentals of certain lease financing loans to financial institutions on a nonrecourse basis at fixed interest rates. In return for future minimum lease rentals assigned, FAEF receives a discounted cash payment. Proceeds from discounting are reflected in the table above as nonrecourse debt.

Table of Contents**Note 8. Shareholders Equity**

On November 7, 2013, the Corporation issued 4 million depository shares, each representing a 1/40th interest in a share of 6.75 percent Series D fixed-to-floating rate non-cumulative perpetual preferred stock with a liquidation preference of \$1,000 per share (equivalent to \$25.00 per depository share). Net proceeds, after issuance cost, were approximately \$97.7 million. Dividends on the preferred stock are payable quarterly, in arrears, if declared by the Corporation's Board of Directors at an annual rate of 6.75 percent. Effective for the February 7, 2024 dividend payment, the annual rate will adjust to three-month LIBOR plus 4.052 percent. The preferred stock has no maturity date and may be redeemed in whole or in part at the option of the Corporation on any dividend payment date after 10 years from the date of issuance, or in whole but not in part within 90 days following a determination by the Corporation that the Corporation will not be entitled to treat the full liquidation preference amount then outstanding as tier 1 capital for purposes of the capital adequacy guidelines of the Federal Reserve (or its equivalent).

At June 30, 2014 and December 31, 2013, AOCI was comprised of net unrealized gains on securities available-for-sale of \$2.1 million and net unrealized losses on securities available-for-sale of \$15.6 million, respectively.

The following table presents the tax effects allocated to each component of other comprehensive income (loss) for the three and six month periods ended June 30, 2014 and 2013:

(in thousands)	For the three months ended June 30, 2014			For the three months ended June 30, 2013		
	Pre-tax	Tax expense (benefit)	Net-of-tax	Pre-tax	Tax expense (benefit)	Net-of-tax
Securities available-for-sale:						
Net unrealized gains (losses) arising during the period	\$ 16,820	\$ 7,056	\$ 9,764	\$ (111,213)	\$ (46,520)	\$ (64,693)
Reclassification adjustment for net gains included in net income (1)	(5,359)	(2,242)	(3,117)	(4,785)	(2,002)	(2,783)
Non-credit related impairment loss	(317)	(133)	(184)	(240)	(100)	(140)
Total securities available-for-sale	11,144	4,681	6,463	(116,238)	(48,622)	(67,616)
Net change on cash flow hedges				(21)		(21)
Total other comprehensive income (loss)	\$ 11,144	\$ 4,681	\$ 6,463	\$ (116,259)	\$ (48,622)	\$ (67,637)

(in thousands)	For the six months ended June 30, 2014			For the six months ended June 30, 2013		
	Pre-tax	Tax expense (benefit)	Net-of-tax	Pre-tax	Tax expense (benefit)	Net-of-tax
Securities available-for-sale:						
Net unrealized gains (losses) arising during the period	\$ 38,348	\$ 16,031	\$ 22,317	\$ (131,515)	\$ (55,013)	\$ (76,502)
Reclassification adjustment for net gains included in net income (1)	(7,551)	(3,159)	(4,392)	(5,672)	(2,373)	(3,299)

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Non-credit related impairment loss	(317)	(133)	(184)	(240)	(100)	(140)
Total securities available-for-sale	30,480	12,739	17,741	(137,427)	(57,486)	(79,941)
Net change on cash flow hedges				(56)		(56)
Total other comprehensive income (loss)	\$ 30,480	\$ 12,739	\$ 17,741	\$ (137,483)	\$ (57,486)	\$ (79,997)

(1) Recognized in Gain on sale of securities in the consolidated statements of income.

Table of Contents**Note 8. Shareholders Equity (Continued)**

The following table summarizes the Company's share repurchases for the three months ended June 30, 2014. All repurchases relate to shares withheld or previously owned shares used to pay taxes due upon vesting of restricted stock. There were no issuer repurchases of the Corporation's common stock as part of its repurchase plan for the three months ended June 30, 2014.

Period	Total Number of Shares (or Units) Purchased	Average Price Paid per Share (or Unit)
April 1, 2014 to April 30, 2014	127	\$ 75.45
May 1, 2014 to May 31, 2014		
June 1, 2014 to June 30, 2014	970	76.33
Total share repurchases	1,097	76.23

Note 9. Earnings per Common Share

The Company applies the two-class method of computing basic and diluted EPS. Under the two-class method, EPS is determined for each class of common stock and participating security according to dividends declared and participation rights in undistributed earnings. The Company grants restricted stock and restricted stock units under a share-based compensation plan that qualify as participating securities.

The computation of basic and diluted EPS is presented in the following table:

(in thousands, except per share amounts)	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Basic EPS:				
Net income attributable to City National Corporation	\$ 66,701	\$ 59,741	\$ 121,212	\$ 111,264
Less: Dividends on preferred stock	4,094	2,406	8,188	4,812
Net income available to common shareholders	\$ 62,607	\$ 57,335	\$ 113,024	\$ 106,452
Less: Earnings allocated to participating securities	626	656	1,173	1,287
Earnings allocated to common shareholders	\$ 61,981	\$ 56,679	\$ 111,851	\$ 105,165
Weighted average common shares outstanding	54,957	54,105	54,824	53,919
Basic earnings per common share	\$ 1.13	\$ 1.05	\$ 2.04	\$ 1.95
Diluted EPS:				
Earnings allocated to common shareholders (1)	\$ 61,986	\$ 56,682	\$ 111,861	\$ 105,173
Weighted average common shares outstanding	54,957	54,105	54,824	53,919
Dilutive effect of equity awards	675	372	717	361
Weighted average diluted common shares outstanding	55,632	54,477	55,541	54,280

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Diluted earnings per common share	\$	1.11	\$	1.04	\$	2.01	\$	1.94
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(1) Earnings allocated to common shareholders for basic and diluted EPS may differ under the two-class method as a result of adding common stock equivalents for options to dilutive shares outstanding, which alters the ratio used to allocate earnings to common shareholders and participating securities for the purposes of calculating diluted EPS.

The average price of the Company's common stock for the period is used to determine the dilutive effect of outstanding stock options. Antidilutive stock options are not included in the calculation of diluted EPS. There were 1.1 million and 2.4 million average outstanding stock options that were antidilutive for the three months ended June 30, 2014 and 2013, respectively. There were 0.7 million and 2.3 million average outstanding stock options that were antidilutive for the six months ended June 30, 2014 and 2013, respectively.

Table of Contents**Note 10. Share-Based Compensation**

On June 30, 2014, the Company had one share-based compensation plan, the Amended and Restated City National Corporation 2008 Omnibus Plan (the Plan), which was originally approved by the Company's shareholders on April 23, 2008. No new awards have been or will be granted under predecessor plans since the adoption of the Plan. The Plan permits the grant of stock options, restricted stock, restricted stock units, cash-settled restricted stock units, performance shares, performance share units, performance units and stock appreciation rights, or any combination thereof, to the Company's eligible employees and non-employee directors. No grants of performance shares, performance share units or stock appreciation rights had been made as of June 30, 2014. At June 30, 2014, there were approximately 2.8 million shares available for future grants. Refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2013 for further discussion of the Company's share-based compensation plan.

The compensation cost recognized for all share-based awards was \$5.2 million and \$10.6 million for the three and six months ended June 30, 2014, respectively, compared with \$5.4 million and \$10.5 million for the three and six months ended June 30, 2013, respectively. The total income tax benefit recognized in the consolidated statements of income for share-based compensation arrangements was \$2.2 million and \$4.5 million for the three and six months ended June 30, 2014, respectively, compared with \$2.3 million and \$4.4 million for the three and six months ended June 30, 2013, respectively. The Company received \$16.4 million and \$17.8 million in cash for the exercise of stock options during the six months ended June 30, 2014 and 2013, respectively. The actual tax benefit realized for the tax deductions from stock option exercises was \$2.2 million and \$3.5 million for the six months ended June 30, 2014 and 2013, respectively.

To estimate the fair value of stock option awards, the Company uses the Black-Scholes methodology, which incorporates the assumptions summarized in the table below:

	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Weighted-average volatility	27.15%		27.35%	28.12%
Dividend yield	1.78%		1.79%	2.15%
Expected term (in years)	5.46		6.06	6.15
Risk-free interest rate	1.92%		1.99%	1.24%

Using the Black-Scholes methodology, the weighted-average grant-date fair values of options granted during the six months ended June 30, 2014 and 2013 were \$17.93 and \$12.57, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2014 and 2013 was \$5.2 million and \$8.5 million, respectively.

A summary of option activity and related information for the six months ended June 30, 2014 is presented below:

Options	Number of Shares (in thousands)	Weighted Average Exercise Price (per share)	Aggregate Intrinsic Value (in thousands) (1)	Weighted Average Remaining Contractual Term

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Outstanding at January 1, 2014	4,075	\$	55.50		
Granted	452		73.64		
Exercised	(289)		56.61		
Forfeited or expired	(30)		58.36		
Outstanding at June 30, 2014	4,208	\$	57.35	\$	77,718
Exercisable at June 30, 2014	2,870	\$	56.05	\$	56,782
					4.43

(1) Includes in-the-money options only.

Table of Contents**Note 10. Share-Based Compensation (Continued)**

A summary of changes in unvested options and related information for the six months ended June 30, 2014 is presented below:

Unvested Options	Number of Shares (in thousands)	Weighted Average Grant Date Fair Value (per share)
Unvested at January 1, 2014	1,425	\$ 13.64
Granted	452	17.93
Vested	(519)	14.57
Forfeited	(19)	12.78
Unvested at June 30, 2014	1,339	\$ 14.75

The number of options vested during the six months ended June 30, 2014 and 2013 was 518,620 and 646,736, respectively. The total fair value of options vested during the six months ended June 30, 2014 and 2013 was \$7.6 million and \$7.8 million, respectively. As of June 30, 2014, there was \$15.2 million of unrecognized compensation cost related to unvested stock options granted under the Company's plans. That cost is expected to be recognized over a weighted-average period of 2.7 years.

A summary of changes in restricted stock and related information for the six months ended June 30, 2014 is presented below:

Restricted Stock (1)	Number of Shares (in thousands)	Weighted Average Grant Date Fair Value (per share)
Unvested at January 1, 2014	608	\$ 53.03
Granted	119	73.63
Vested	(169)	44.00
Forfeited	(6)	54.12
Unvested at June 30, 2014	552	\$ 60.22

(1) Includes restricted stock units.

Restricted stock is valued at the closing price of the Company's stock on the date of award. The weighted-average grant-date fair value of restricted stock granted during the six months ended June 30, 2014 and 2013 was \$73.63 and \$55.73, respectively. The number of restricted shares vested during the six months ended June 30, 2014 and 2013 was 169,028 and 186,109, respectively. The total fair value of restricted stock vested during the six months ended June 30, 2014 and 2013 was \$7.4 million and \$8.5 million, respectively. As of June 30, 2014, the unrecognized compensation cost related to restricted stock granted under the Company's plans was \$19.2 million. That cost is expected to be recognized over a weighted-average period of 3.0 years.

Table of Contents**Note 10. Share-Based Compensation (Continued)**

Cash-settled restricted stock units are initially valued at the closing price of the Company's stock on the date of award. They are subsequently remeasured to the closing price of the Company's stock at each reporting date until settlement. A summary of changes in cash-settled restricted stock units for the six months ended June 30, 2014 is presented below:

Cash-Settled Restricted Stock Units	Number of Shares (in thousands)
Unvested at January 1, 2014	190
Granted	15
Vested	(23)
Forfeited	(3)
Unvested at June 30, 2014	179

Note 11. Derivative Instruments

The Company uses interest-rate swaps to mitigate interest-rate risk associated with changes to (1) the fair value of certain fixed-rate deposits and borrowings (fair value hedges) and (2) certain cash flows related to future interest payments on variable rate loans (cash flow hedges). Interest-rate swap agreements involve the exchange of fixed and variable rate interest payments between counterparties based upon a notional principal amount and maturity date. The Company recognizes derivatives as assets or liabilities on the consolidated balance sheets at their fair value. The treatment of changes in the fair value of derivatives depends on the character of the transaction. The Company also offers various derivative products to clients and enters into derivative transactions in due course. These transactions are not linked to specific Company assets or liabilities in the consolidated balance sheets or to forecasted transactions in a hedge relationship and, therefore, do not qualify for hedge accounting.

The following table summarizes the fair value and balance sheet classification of derivative instruments as of June 30, 2014 and December 31, 2013. The notional amount of the contract is not recorded on the consolidated balance sheets, but is used as the basis for determining the amount of interest payments to be exchanged between the counterparties. If a counterparty fails to perform, the Company's counterparty credit risk is equal to the amount reported as a derivative asset.

Notional Amounts and Fair Values of Derivative Instruments

(in millions) (1)	Notional Amount	June 30, 2014 Derivative Assets	Derivative Liabilities	Notional Amount	December 31, 2013 Derivative Assets	Derivative Liabilities
Derivatives not designated as hedging instruments						
Interest rate contracts:						
Swaps	\$ 2,907.3	\$ 42.5	\$ 42.4	\$ 2,769.4	\$ 42.7	\$ 41.7

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Interest-rate caps, floors and collars	396.4	0.8	0.8	251.6	0.5	0.5
Options purchased	0.2	0.2	0.2	1.5	0.6	0.6
Options written	0.2			1.5		
Total interest-rate contracts	\$ 3,304.1	\$ 43.5	\$ 43.4	\$ 3,024.0	\$ 43.8	\$ 42.8
Option contracts	\$ 2.0	\$ 0.2	\$	\$ 1.9	\$ 0.4	\$
Foreign exchange contracts:						
Spot and forward contracts	\$ 473.1	\$ 3.3	\$ 2.6	\$ 461.4	\$ 3.5	\$ 3.3
Options purchased	5.3			6.3		
Options written	5.3	0.2	0.2	6.3	0.2	0.2
Total foreign exchange contracts	\$ 483.7	\$ 3.5	\$ 2.8	\$ 474.0	\$ 3.7	\$ 3.5
Equity warrants	\$	\$ 0.6	\$	\$	\$	\$
Total derivatives not designated as hedging instruments	\$ 3,789.8	\$ 47.8	\$ 46.2	\$ 3,499.9	\$ 47.9	\$ 46.3

(1) The Company offsets mark-to-market adjustments, interest receivable, interest payable and cash collateral received on interest-rate swaps that are executed with the same counterparty under a master netting agreement, and reports the net balance in other assets or other liabilities in the consolidated balance sheets. For purposes of this disclosure, mark-to-market adjustments, interest receivable and interest payable are presented on a gross basis and cash collateral is excluded from fair value amounts.

Table of Contents**Note 11. Derivative Instruments (Continued)***Derivatives Designated as Hedging Instruments*

The Company had no hedging instruments as of June 30, 2014 and December 31, 2013.

The periodic net settlement of interest-rate swaps is recorded as an adjustment to interest income or interest expense. There was no net interest income recognized on interest rate swaps for the three and six months ended June 30, 2014. Interest rate swaps increased net interest income by \$1.1 million for the six months ended June 30, 2013.

Changes in fair value of the effective portion of cash flow hedges are reported in AOCI. When the cash flows associated with the hedged item are realized, the gain or loss included in AOCI is recognized in Interest income on loans and leases, the same location in the consolidated statements of income as the income on the hedged item. There were no cash flow hedges outstanding during the six-month periods ended June 30, 2014 and 2013. The \$0.1 million of gains on cash flow hedges reclassified from AOCI to interest income for the six months ended June 30, 2013 represents the amortization of deferred gains on cash flow hedges that were terminated in 2010 prior to their respective maturity dates for which the hedge transactions had yet to occur. The balance of deferred gain on terminated swaps was fully amortized in 2013.

Derivatives Not Designated as Hedging Instruments

Derivative contracts not designated as hedges are composed primarily of interest-rate contracts with certain commercial clients that are offset by paired trades with unrelated bank counterparties. The Company also enters into foreign-exchange contracts with its clients and counterparty banks primarily for the purpose of offsetting or economically hedging the clients' transaction and economic exposures arising out of commercial transactions. The Company also obtains equity warrants in association with certain lending transactions. Derivative contracts not designated as hedges are carried at fair value each reporting period with changes in fair value recorded as a part of Noninterest income in the consolidated statements of income. The table below provides the amount of gains and losses on these derivative contracts for the three and six months ended June 30, 2014 and 2013:

(in millions) Derivatives Not Designated as Hedging Instruments	Location in Consolidated Statements of Income	For the three months ended June 30,		For the six months ended June 30,	
		2014	2013	2014	2013
Interest-rate contracts	Other noninterest income	\$ (0.5)	\$ 1.5	\$ (1.0)	\$ 1.2
Option contracts	Other noninterest income	(0.1)	0.1		0.4
Foreign exchange contracts	International services income	8.2	7.3	15.4	13.2
Equity warrants	Other noninterest income	0.1		0.1	
Total income		\$ 7.7	\$ 8.9	\$ 14.5	\$ 14.8

In the course of negotiating credit facilities, the Company may obtain rights to acquire stock in the form of equity warrants in primarily private, venture-backed technology companies. The warrants grant the Company an option to purchase a specific number of shares of stock in the

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underlying company at a specific price within a specific time period. The warrant agreements typically contain a net share settlement provision (cashless exercise) which gives the Company the option to receive at exercise a number of shares equal to the intrinsic value of the warrant divided by the share price. Equity warrants are accounted for as derivatives under ASC Topic 815, *Derivatives and Hedging*, and are recorded as derivative assets at their estimated fair value on the grant date. The warrant portfolio is reviewed quarterly for changes in fair value. Subsequent changes in the fair value of warrants are recognized in Other noninterest income. If a warrant is exercised or paid out for cash, the gain is recorded in Other noninterest income.

Table of Contents**Note 11. Derivative Instruments (Continued)***Credit Risk Exposure and Collateral*

The Company's swap agreements require the deposit of cash or marketable debt securities as collateral based on certain risk thresholds. These requirements apply individually to the Corporation and to the Bank. Additionally, certain of the Company's swap contracts contain security agreements that include credit-risk-related contingent features. Under these agreements, the collateral requirements are based on the Company's credit rating from the major credit rating agencies. The amount of collateral required may vary by counterparty based on a range of credit ratings that correspond with exposure thresholds established in the derivative agreements. If the credit ratings on the Company's debt were to fall below the level associated with a particular exposure threshold and the derivatives with a counterparty are in a net liability position that exceeds that threshold, the counterparty could request immediate payment or delivery of collateral for the difference between the net liability amount and the exposure threshold. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that were in a net liability position on June 30, 2014 was \$14.2 million. The Company delivered collateral in the form of securities valued at \$4.1 million and cash totaling \$17.7 million on swap agreements that had credit-risk contingent features that were in a net liability position at June 30, 2014.

The Company's interest-rate swaps had \$0.2 million and \$2.4 million of credit risk exposure at June 30, 2014 and December 31, 2013, respectively. The credit exposure represents the cost to replace, on a present value basis and at current market rates, all contracts by trading counterparty having an aggregate positive market value, net of margin collateral received. The Company enters into master netting agreements with swap counterparties to mitigate credit risk. Under these agreements, the net amount due from or payable to each counterparty is settled on the contract payment date. No collateral had been received from swap counterparties at June 30, 2014 and December 31, 2013. The Company delivered collateral valued at \$7.6 million on swap agreements that did not have credit-risk contingent features at June 30, 2014.

See Note 12, *Balance Sheet Offsetting*, of the Notes to the Unaudited Consolidated Financial Statements for additional information about the Company's derivative instruments subject to master netting agreements.

Note 12. Balance Sheet Offsetting

Assets and liabilities relating to certain financial instruments, including derivatives, securities purchased under resale agreements (reverse repurchase agreements) and securities sold under repurchase agreements (repurchase agreements), may be eligible for offset in the consolidated balance sheet as permitted under accounting guidance. The Company is party to transactions involving derivative instruments that are subject to enforceable master netting arrangements or similar agreements. Under these agreements, the Company may have the right to net settle multiple contracts with the same counterparty. Certain derivative transactions may require the Company to receive or pledge marketable debt securities as collateral based on certain risk thresholds. The Company also enters into reverse repurchase agreements to invest available liquidity and collateral swap agreements. Under reverse repurchase agreements the Company has the right to claim securities collateral if the counterparty fails to perform. Collateral swap agreements involve the exchange of securities collateral under simultaneous repurchase and reverse repurchase agreements with the same bank counterparty. These agreements have the same principal amounts, inception dates and maturity dates and have been offset against each other in the balance sheet as permitted under the netting provisions of ASC Topic 210-20-45. Securities swaps totaled \$500.0 million at June 30, 2014. At June 30, 2014, the Company had delivered collateral of approximately \$536.5 million on the repurchase agreement and accepted collateral of approximately \$525.9 million on the reverse repurchase agreement. The collateral consisted of agency mortgage-backed securities. Securities that have been pledged by counterparties as collateral are not recorded in the Company's consolidated balance sheet unless the counterparty defaults. Securities that have been pledged by the Company to counterparties continue to be reported in the Company's consolidated balance sheet unless the Company defaults.

The Company also offers various derivative products to clients and enters into derivative transactions in due course. These derivative contracts are offset by paired trades with unrelated bank counterparties. Certain derivative transactions with clients are not subject to master netting arrangements and have been excluded from the balance sheet offsetting table below.

Table of Contents**Note 12. Balance Sheet Offsetting (Continued)**

The following table provides information about financial instruments that are eligible for offset at June 30, 2014 and December 31, 2013:

(in thousands)	Gross Amount Recognized	Gross Amount Offset	Net Amount Presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet Securities Collateral	Cash Collateral	Net Amount
June 30, 2014						
Financial assets:						
Reverse repurchase agreements	\$ 700,149	\$ (500,041)	\$ 200,108	\$ (200,000)	\$	\$ 108
Derivatives not designated as hedging instruments	8,080	(4,500)	3,580			3,580
Total financial assets	\$ 708,229	\$ (504,541)	\$ 203,688	\$ (200,000)	\$	\$ 3,688
Financial liabilities:						
Repurchase agreements	\$ 500,041	\$ (500,041)	\$	\$	\$	\$
Derivatives not designated as hedging instruments	41,791	(4,500)	37,291	(11,721)	(17,729)	7,841
Total financial liabilities	\$ 541,832	\$ (504,541)	\$ 37,291	\$ (11,721)	\$ (17,729)	\$ 7,841
December 31, 2013						
Financial assets:						
Reverse repurchase agreements	\$ 200,000	\$	\$ 200,000	\$ (200,000)	\$	\$
Derivatives not designated as hedging instruments	18,749	(13,323)	5,426			5,426
Total financial assets	\$ 218,749	\$ (13,323)	\$ 205,426	\$ (200,000)	\$	\$ 5,426
Financial liabilities:						
Derivatives not designated as hedging instruments	\$ 32,193	\$ (13,323)	\$ 18,870	\$ (12,376)	\$ (7,761)	\$ (1,267)
Total financial liabilities	\$ 32,193	\$ (13,323)	\$ 18,870	\$ (12,376)	\$ (7,761)	\$ (1,267)

Note 13. Income Taxes

The Company recognized income tax expense of \$29.8 million and \$56.1 million for the three and six months ended June 30, 2014, respectively. The Company recognized income tax expense of \$25.4 million and \$46.7 million for the same periods in 2013.

The Company recognizes accrued interest and penalties relating to uncertain tax positions as an income tax provision expense. The Company recognized a benefit on interest and penalties of \$0.3 million and \$0.5 million for the six months ended June 30, 2014 and 2013, respectively. The Company had approximately \$2.7 million and \$3.0 million of accrued interest and penalties as of June 30, 2014 and December 31, 2013, respectively.

The Company and its subsidiaries file federal and various state income tax returns. The Company is currently being audited by the Internal Revenue Service for the tax year 2013 and 2014. The Company is also under audit with the California Franchise Tax Board for the tax years 2005 to 2007. The financial statement impact resulting from completion of these audits is not expected to be material.

From time to time, there may be differences in opinion with respect to the tax treatment of certain transactions. If a tax position which was previously recognized on the consolidated financial statements is no longer more likely than not to be sustained upon a challenge from the taxing authorities, the tax benefit from the tax position will be derecognized. The Company did not have any material tax positions for which previously recognized benefits were derecognized during the six month period ended June 30, 2014.

Table of Contents

Note 14. Employee Benefit Plans

Defined Contribution Plan

The Company has a profit-sharing retirement plan with an Internal Revenue Code Section 401(k) feature covering eligible employees. Employer contributions are made annually into a trust fund and are allocated to participants based on their salaries. The profit sharing contribution requirement is based on a percentage of annual operating income subject to a percentage of salary cap. Eligible employees may contribute up to 50 percent of their salary to the 401(k) plan, but not more than the maximum allowed under Internal Revenue Service (IRS) regulations. The Company matches 50 percent of the first 6 percent of covered compensation. The Company recorded total profit sharing and matching contribution expense of \$5.4 million and \$10.7 million for the three and six months ended June 30, 2014, respectively. Profit sharing and matching contribution expense was \$5.2 million and \$10.0 million for the same periods in 2013, respectively.

Deferred Compensation Plan

The Company offers a deferred compensation plan for eligible employees and non-employee directors. Participants under the employee plan may make an annual irrevocable election to defer a portion of base salary and up to 100 percent of commission and incentive compensation while employed with the Company. Participants under the non-employee director plan also may make an annual irrevocable election to defer all or part of annual retainers, annual awards, committee chair retainers and meeting fees (collectively, directors fees) until board service with the Company ceases. The deferred compensation plans are nonqualified plans under IRS regulations. Deferrals are made on a pretax basis and are allocated among the investment crediting options available under the plans as directed by the plan participants. The Company informally funds plan benefits through the purchase of life insurance policies which are recorded in Other assets on the consolidated balance sheets. Participant deferrals are recorded in Other liabilities on the consolidated balance sheets. Employee salaries and non-employee directors fees deferred under the plan are charged to Salaries and employee benefits and Other operating expense, respectively, on the consolidated statements of income. Earnings on plan assets, net of benefits payable to plan participants, are reported in Salaries and employee benefits on the consolidated statements of income, and were \$0.4 million and \$0.5 million for the three and six months ended June 30, 2014, respectively. Earnings on plan assets, net of benefits payable to plan participants, were \$0.3 million and \$0.5 million for the same periods in 2013, respectively.

Note 15. Contingencies

In the normal course of business, the Company issues financial guarantees in the form of letters of credit. Standby letters of credit are commitments issued by the Company to guarantee the obligations of its customer to beneficiaries. Commercial letters of credit are issued on behalf of customers to ensure payment in connection with trade transactions. Exposure to credit loss in the event of nonperformance by the other party to the letters of credit is represented by the contractual notional amount. At June 30, 2014, the Company had \$679.0 million in letters of credit, of which \$574.3 million relate to standby letters of credit and \$104.7 million relate to commercial letters of credit. The Company had \$733.5 million outstanding in letters of credit at December 31, 2013, of which \$617.3 million relate to standby letters of credit and \$116.2 million relate to commercial letters of credit.

In connection with the liquidation of an investment acquired in a previous bank merger, the Company has an outstanding long-term indemnity. The maximum liability under the indemnity is \$23.0 million, but the Company does not expect to make any payments of more than nominal

amounts under the terms of this indemnity.

Note 16. Variable Interest Entities

The Company holds ownership interests in certain special-purpose entities formed to provide affordable housing. The Company evaluates its interest in these entities to determine whether they meet the definition of a VIE and whether the Company is required to consolidate these entities. The Company is not the primary beneficiary of the affordable housing VIEs in which it holds interests and is therefore not required to consolidate these entities. The investment in these entities is initially recorded at cost, which approximates the maximum exposure to loss as a result of the Company's involvement with these unconsolidated entities. Subsequently, the carrying value is amortized over the stream of available tax credits and benefits. The Company expects to recover its investments over time, primarily through realization of federal low-income housing tax credits. The balance of the investments in these entities was \$200.6 million and \$188.2 million at June 30, 2014 and December 31, 2013, respectively, and is included in Affordable housing investments in the consolidated balance sheets. Unfunded commitments for affordable housing investments were \$77.1 million at June 30, 2014. These unfunded commitments are recorded in Other liabilities in the consolidated balance sheets.

Table of Contents

Note 16. Variable Interest Entities (Continued)

Of the affordable housing investments held as of June 30, 2014, the Company had a significant variable interest in four affordable housing partnerships. These interests were acquired at various times from 1998 to 2001. The Company's maximum exposure to loss as a result of its involvement with these entities is limited to the \$1.0 million aggregate carrying value of these investments at June 30, 2014. There were no unfunded commitments for these affordable housing investments at June 30, 2014.

The Company also has ownership interests in several private equity and alternative investment funds that are VIEs. The Company is not a primary beneficiary and, therefore, is not required to consolidate these VIEs. The investment in these entities is carried at cost and net of impairments, which approximates the maximum exposure to loss as a result of the Company's involvement with these entities. The Company expects to recover its investments over time, primarily through the allocation of fund income, gains or losses on the sale of fund assets, dividends or interest income. The balance in these entities was \$29.7 million and \$34.0 million at June 30, 2014 and December 31, 2013, respectively, and is included in Other assets in the consolidated balance sheets. Income associated with these investments is reported in Other noninterest income in the consolidated statements of income.

Note 17. Noncontrolling Interest

In accordance with ASC Topic 810, *Consolidation*, and EITF Topic D-98, *Classification and Measurement of Redeemable Securities* (Topic D-98), the Company reports noncontrolling interest in its majority-owned affiliates as Redeemable noncontrolling interest in the mezzanine section between liabilities and equity in the consolidated financial statements. Topic D-98 specifies that securities that are redeemable at the option of the holder or outside the control of the issuer are not considered permanent equity and should be classified in the mezzanine section.

The Corporation holds a majority ownership interest in four investment management and wealth advisory affiliates that it consolidates. In general, the management of each majority-owned affiliate has a significant noncontrolling ownership position in its firm and supervises the day-to-day operations of the affiliate. The Corporation is in regular contact with each affiliate regarding its operations and is an active participant in the management of the affiliates through its position on each firm's board.

The Corporation's investment in each affiliate is governed by operating agreements and other arrangements which provide the Corporation certain rights, benefits and obligations. The Corporation determines the appropriate method of accounting based upon these agreements and the factors contained therein. All majority-owned affiliates that have met the criteria for consolidation are included in the consolidated financial statements. All material intercompany balances and transactions are eliminated. The Company applies the equity method of accounting for certain investments where it holds a noncontrolling interest. For equity method investments, the Company's portion of income before taxes is included in Trust and investment fees in the consolidated statements of income.

As of June 30, 2014, affiliate noncontrolling owners held equity interests with an estimated fair value of \$46.5 million. This estimate reflects the maximum obligation to purchase equity interests in the affiliates. The events which would require the Company to purchase the equity interests may occur in the near term or over a longer period of time. The terms of the put provisions vary by agreement, but the value of the put is at the approximate fair value of the interests. The parent company carries key man life insurance policies to fund a portion of these conditional purchase obligations in the event of the death of certain key holders.

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The following is a summary of activity for redeemable noncontrolling interest for the six months ended June 30, 2014 and 2013:

(in thousands)	For the six months ended			
		June 30,		
		2014		2013
Balance, beginning of period	\$	39,768	\$	41,112
Net income		1,209		1,048
Distributions to redeemable noncontrolling interest		(1,854)		(940)
Additions and redemptions, net		(75)		(1,693)
Adjustments to fair value		7,501		416
Balance, end of period	\$	46,549	\$	39,943

Table of Contents

Note 18. Segment Results

The Company has three reportable segments: Commercial and Private Banking, Wealth Management and Other. The factors considered in determining whether individual operating segments could be aggregated include that the operating segments: (i) offer the same products and services, (ii) offer services to the same types of clients, (iii) provide services in the same manner and (iv) operate in the same regulatory environment. The management accounting process measures the performance of the operating segments based on the Company's management structure and is not necessarily comparable with similar information for other financial services companies. If the management structures and/or the allocation process changes, allocations, transfers and assignments may change.

The Commercial and Private Banking reportable segment is the aggregation of the Commercial and Private Banking, Real Estate, Entertainment, Corporate Banking, Core Branch Banking and FAEF operating segments. The Commercial and Private Banking segment provides banking products and services, including commercial and mortgage lending, lines of credit, equipment lease financing, deposits, cash management services, international trade finance and letters of credit to small and medium-sized businesses, entrepreneurs and affluent individuals. This segment primarily serves clients in California, New York, Nevada, Tennessee and Georgia. FAEF serves clients nationwide.

The Wealth Management segment includes the Corporation's investment advisory affiliates and the Bank's Wealth Management Services. The asset management affiliates and the Wealth Management division of the Bank make the following investment advisory and wealth management resources and expertise available to individual and institutional clients: investment management, wealth advisory services, brokerage, retirement, estate and financial planning and personal, business, custodial and employee trust services. The Wealth Management segment also advises and makes available mutual funds under the name of City National Rochdale Funds. Both the asset management affiliates and the Bank's Wealth Management division provide proprietary and nonproprietary products and offer a full spectrum of investment solutions in multiple asset classes and investment styles, including fixed-income instruments, mutual funds, domestic and international equities, and alternative investments such as hedge funds. This segment serves clients nationwide.

The Other segment includes all other subsidiaries of the Company, the corporate administration departments, including the Treasury Department and the Asset Liability Funding Center, that have not been allocated to the other segments, and inter-segment eliminations for revenue recognized in multiple segments for management reporting purposes. The Company uses traditional matched-maturity funds transfer pricing methodology. However, both positive and negative variances occur over time when transfer pricing non-maturing balance sheet items such as demand deposits. These variances, offset in the Funding Center, are evaluated at least annually by management and allocated back to the business segments as deemed necessary.

Business segment earnings are the primary measure of the segment's performance as evaluated by management. Business segment earnings include direct revenue and expenses of the segment as well as corporate and inter-company cost allocations. Allocations of corporate expenses, such as data processing and human resources, are calculated based on estimated activity or usage levels for the fiscal year. Costs associated with intercompany support and services groups, such as Operational Services, are allocated to each business segment based on actual services used. Capital is allocated based on the estimated risk within each business segment. The methodology of allocating capital is based on each business segment's credit, market, and operational risk profile. If applicable, any provision for credit losses is allocated based on various credit factors, including but not limited to, credit risk ratings, credit rating fluctuation, charge-offs and recoveries and loan growth.

Effective with second quarter 2013 reporting, the methodology for allocating the provision for income taxes to the segments was revised to base the allocation on the Company's effective tax rate. The allocation was previously based on the statutory tax rate. Prior period segment results have been revised to reflect this change in methodology.

Exposure to market risk is managed in the Company's Treasury department. Interest rate risk is mostly removed from the Commercial and Private Banking segment and transferred to the Funding Center through a fund transfer pricing (FTP) methodology and allocation model. The FTP model records a cost of funds or credit for funds using a combination of matched maturity funding for fixed term assets and liabilities and a blended rate for the remaining assets and liabilities with varying maturities.

Table of Contents**Note 18. Segment Results (Continued)**

The Bank's investment portfolio and unallocated equity are included in the Other segment. Amortization expense associated with customer-relationship intangibles is charged to the affected operating segments.

Selected financial information for each segment is presented in the following tables. Commercial and Private Banking includes all revenue and costs from products and services utilized by clients of Commercial and Private Banking, including both revenue and costs for Wealth Management products and services. The revenues and costs associated with Wealth Management products and services that are allocated to Commercial and Private Banking for management reporting purposes are eliminated in the Other segment. The current period reflects any changes made in the process or methodology for allocations to the reportable segments. Prior period segment results have been revised to conform to current period presentation.

(in thousands)	For the three months ended June 30, 2014			Consolidated Company
	Commercial and Private Banking	Wealth Management	Other	
Earnings Summary:				
Net interest income	\$ 208,413	\$ 474	\$ 10,215	\$ 219,102
(Reversal of) provision for credit losses on loans and leases, excluding covered loans	(1,000)			(1,000)
(Reversal of) provision for losses on covered loans	(1,461)			(1,461)
Noninterest income	40,926	69,471	(9,298)	101,099
Depreciation and amortization	2,774	1,766	4,799	9,339
Noninterest expense	179,904	57,159	(20,780)	216,283
Income before income taxes	69,122	11,020	16,898	97,040
Provision for income taxes	21,360	3,248	5,221	29,829
Net income	47,762	7,772	11,677	67,211
Less: Net income attributable to noncontrolling interest		510		510
Net income attributable to City National Corporation	\$ 47,762	\$ 7,262	\$ 11,677	\$ 66,701
Selected Average Balances:				
Loans and leases, excluding covered loans	\$ 17,901,508	\$	\$ 57,683	\$ 17,959,191
Covered loans	643,690			643,690
Total assets	18,705,693	693,473	10,579,781	29,978,947
Deposits	25,584,025	73,784	254,272	25,912,081
Goodwill	393,177	249,445		642,622
Customer-relationship intangibles, net	2,692	35,778		38,470

Table of Contents**Note 18. Segment Results (Continued)**

(in thousands)	For the three months ended June 30, 2013			Consolidated Company
	Commercial and Private Banking	Wealth Management	Other	
Earnings Summary:				
Net interest income	\$ 185,040	\$ 247	\$ 17,632	\$ 202,919
(Reversal of) provision for losses on covered loans	(11,927)			(11,927)
Noninterest income	30,555	58,472	(6,818)	82,209
Depreciation and amortization	3,624	1,876	4,680	10,180
Noninterest expense	171,254	48,720	(18,725)	201,249
Income before income taxes	52,644	8,123	24,859	85,626
Provision for income taxes	15,715	2,287	7,420	25,422
Net income	36,929	5,836	17,439	60,204
Less: Net income attributable to noncontrolling interest		463		463
Net income attributable to City National Corporation	\$ 36,929	\$ 5,373	\$ 17,439	\$ 59,741

Selected Average Balances:				
Loans and leases, excluding covered loans	\$ 15,379,372	\$	\$ 54,730	\$ 15,434,102
Covered loans	909,728			909,728
Total assets	16,503,312	652,737	10,313,532	27,469,581
Deposits	22,409,159	120,702	588,957	23,118,818
Goodwill	393,177	249,445		642,622
Customer-relationship intangibles, net	5,176	40,199		45,375

(in thousands)	For the six months ended June 30, 2014			Consolidated Company
	Commercial and Private Banking	Wealth Management	Other	
Earnings Summary:				
Net interest income	\$ 398,206	\$ 800	\$ 19,894	\$ 418,900
(Reversal of) provision for credit losses on loans and leases, excluding covered loans	(1,000)			(1,000)
Provision for losses on covered loans	3,194			3,194
Noninterest income	89,140	133,564	(20,357)	202,347
Depreciation and amortization	5,595	3,513	9,546	18,654
Noninterest expense	351,972	109,892	(40,003)	421,861
Income before income taxes	127,585	20,959	29,994	178,538
Provision for income taxes	40,375	6,250	9,492	56,117
Net income	87,210	14,709	20,502	122,421
Less: Net income attributable to noncontrolling interest		1,209		1,209
Net income attributable to City National Corporation	\$ 87,210	\$ 13,500	\$ 20,502	\$ 121,212

Selected Average Balances:				
Loans and leases, excluding covered loans	\$ 17,594,167	\$	\$ 56,353	\$ 17,650,520
Covered loans	669,781			669,781
Total assets	18,473,951	675,663	10,554,566	29,704,180

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Deposits	25,319,356	80,738	243,238	25,643,332
Goodwill	393,177	249,445		642,622
Customer-relationship intangibles, net	2,912	36,346		39,258

Table of Contents**Note 18. Segment Results (Continued)**

(in thousands)	For the six months ended June 30, 2013			Consolidated Company
	Commercial and Private Banking	Wealth Management	Other	
Earnings Summary:				
Net interest income	\$ 369,017	\$ 565	\$ 34,410	\$ 403,992
(Reversal of) provision for losses on covered loans	(2,035)			(2,035)
Noninterest income	80,818	113,925	(19,006)	175,737
Depreciation and amortization	7,243	3,776	9,265	20,284
Noninterest expense	342,201	95,749	(35,465)	402,485
Income before income taxes	102,426	14,965	41,604	158,995
Provision for income taxes	30,273	4,113	12,297	46,683
Net income	72,153	10,852	29,307	112,312
Less: Net income attributable to noncontrolling interest		1,048		1,048
Net income attributable to City National Corporation	\$ 72,153	\$ 9,804	\$ 29,307	\$ 111,264
Selected Average Balances:				
Loans and leases, excluding covered loans	\$ 15,068,756	\$	\$ 54,691	\$ 15,123,447
Covered loans	949,370			949,370
Total assets	16,244,521	648,561	10,695,626	27,588,708
Deposits	22,126,242	113,563	527,035	22,766,840
Goodwill	393,177	249,445		642,622
Customer-relationship intangibles, net	5,543	40,794		46,337

Note 19. Subsequent Events

On June 25, 2014, City National Bank announced that it had entered into an agreement to sell its retirement services recordkeeping business to OneAmerica Retirement Services, LLC. The sale is expected to close in the third quarter of 2014. The transaction, after sale expenses, is not expected to have a significant impact on the Bank's financial results.

As of June 30, 2014, the Bank had notified the holders of the \$50 million 9.00% Subordinated Notes due July 2019 and \$55 million Fixed and Floating Subordinated Notes due August 2019 of its election to redeem in full the outstanding obligations of these issues in accordance with the terms and provisions of the notes. Redemption of the \$50 million Subordinated Notes, including all accrued and unpaid interest, was completed on July 15, 2014. Redemption of the \$55 million Fixed and Floating Subordinated Notes will be completed on August 12, 2014.

Table of Contents

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

**CAUTIONARY STATEMENT FOR PURPOSES OF THE SAFE HARBOR PROVISIONS
OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995**

We have made forward-looking statements in this document about the Company, for which the Company claims the protection of the safe harbor provisions contained in the Private Securities Litigation Reform Act of 1995.

A number of factors, many of which are beyond the Company's ability to control or predict, could cause future results to differ materially from those contemplated by such forward-looking statements. These factors include: (1) changes in general economic, political, or industry conditions and the related credit and market conditions and the impact they have on the Company and its customers, including changes in consumer spending, borrowing and savings habits; (2) the impact on financial markets and the economy of the level of U.S. and European debt; (3) the effects of and changes in trade and monetary and fiscal policies and laws, including the interest rate policies of the Board of Governors of the Federal Reserve System; (4) continued delay in the pace of economic recovery and continued stagnant or decreasing employment levels; (5) the effect of the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the rules and regulations to be promulgated by supervisory and oversight agencies implementing the new legislation, taking into account that the precise timing, extent and nature of such rules and regulations and the impact on the Company is uncertain; (6) the impact of revised capital requirements under Basel III; (7) significant changes in applicable laws and regulations, including those concerning taxes, banking and securities; (8) volatility in the municipal bond market; (9) changes in the level of nonperforming assets, charge-offs, other real estate owned and provision expense; (10) incorrect assumptions in the value of the loans acquired in FDIC-assisted acquisitions resulting in greater than anticipated losses in the acquired loan portfolios exceeding the losses covered by the loss-sharing agreements with the FDIC; (11) changes in inflation, interest rates, and market liquidity which may impact interest margins and impact funding sources; (12) the Company's ability to attract new employees and retain and motivate existing employees; (13) increased competition in the Company's markets and our ability to increase market share and control expenses; (14) changes in the financial performance and/or condition of the Company's customers, or changes in the performance or creditworthiness of our customers' suppliers or other counterparties, which could lead to decreased loan utilization rates, delinquencies, or defaults and could negatively affect our customers' ability to meet certain credit obligations; (15) a substantial and permanent loss of either client accounts and/or assets under management at the Company's investment advisory affiliates or its wealth management division; (16) soundness of other financial institutions which could adversely affect the Company; (17) protracted labor disputes in the Company's markets; (18) the impact of natural disasters, terrorist activities or international hostilities on the operations of our business or the value of collateral; (19) the effect of acquisitions and integration of acquired businesses and de novo branching efforts; (20) changes in accounting policies or procedures as may be required by the Financial Accounting Standards Board or regulatory agencies; (21) the impact of cyber security attacks or other disruptions to the Company's information systems and any resulting compromise of data or disruptions in service; and (22) the success of the Company at managing the risks involved in the foregoing.

Forward-looking statements speak only as of the date they are made, and the Company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the statements are made, or to update earnings guidance, including the factors that influence earnings.

For a more complete discussion of these risks and uncertainties, see the Company's Annual Report on Form 10-K for the year ended December 31, 2013 and particularly, Item 1A, titled "Risk Factors."

Table of Contents

CITY NATIONAL CORPORATION

FINANCIAL HIGHLIGHTS

(in thousands, except per share amounts) (1)	At or for the three months ended			Percent change June 30, 2014 from	
	June 30, 2014 (Unaudited)	March 31, 2014 (Unaudited)	June 30, 2013 (Unaudited)	March 31, 2014	June 30, 2013
For The Quarter					
Total revenue	\$ 320,201	\$ 301,046	\$ 285,128	6%	12%
Net income attributable to City National Corporation	66,701	54,511	59,741	22	12
Net income available to common shareholders	62,607	50,417	57,335	24	9
Net income per common share, basic	1.13	0.91	1.05	24	8
Net income per common share, diluted	1.11	0.90	1.04	23	7
Dividends per common share	0.33	0.33	0.25		32
At Quarter End					
Assets	\$ 30,819,092	\$ 29,738,252	\$ 27,379,502	4	13
Securities	8,832,942	8,651,359	8,597,199	2	3
Loans and leases, excluding covered loans	18,474,788	17,751,385	15,819,252	4	17
Covered loans (2)	605,770	673,294	867,996	(10)	(30)
Deposits	26,651,525	25,731,766	23,651,757	4	13
Common shareholders equity	2,585,537	2,528,344	2,374,848	2	9
Total shareholders equity	2,853,153	2,795,960	2,544,768	2	12
Book value per common share	47.38	46.38	44.16	2	7
Average Balances					
Assets	\$ 29,978,947	\$ 29,426,360	\$ 27,469,581	2	9
Securities	8,668,011	8,585,220	8,866,911	1	(2)
Loans and leases, excluding covered loans	17,959,191	17,338,419	15,434,102	4	16
Covered loans (2)	643,690	696,163	909,728	(8)	(29)
Deposits	25,912,081	25,371,598	23,118,818	2	12
Common shareholders equity	2,562,555	2,512,775	2,412,148	2	6
Total shareholders equity	2,830,171	2,780,392	2,582,068	2	10
Selected Ratios					
Return on average assets (annualized)	0.89%	0.75%	0.87%	19	2
Return on average common equity (annualized)	9.80	8.14	9.53	20	3
Corporation's tier 1 leverage	7.43	7.41	7.00	0	6
Corporation's tier 1 risk-based capital	10.00	10.18	9.74	(2)	3
Corporation's total risk-based capital	12.81	13.08	12.78	(2)	0
Period-end common equity to period-end assets	8.39	8.50	8.67	(1)	(3)
Period-end equity to period-end assets	9.26	9.40	9.29	(1)	(0)
Common dividend payout ratio	29.26	36.15	23.81	(19)	23
Net interest margin	3.21	3.02	3.24	6	(1)
Expense to revenue ratio (3)	68.48	69.73	71.51	(2)	(4)
Asset Quality Ratios (4)					
Nonaccrual loans to total loans and leases	0.35%	0.40%	0.48%	(13)	(27)
	0.37	0.45	0.61	(18)	(39)

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Nonaccrual loans and OREO to total loans and leases and OREO

Allowance for loan and lease losses to total loans and leases	1.68	1.72	1.83	(2)	(8)
Allowance for loan and lease losses to nonaccrual loans	480.50	429.21	378.12	12	27
Net (charge-offs) recoveries to average total loans and leases (annualized)	(0.08)	0.10	0.20	(180)	(140)

At Quarter End

Assets under management (5)	\$ 47,123,652	\$ 46,374,203	\$ 41,256,549	2	14
Assets under management or administration (5)	65,780,023	66,399,813	59,755,285	(1)	10

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- (1) Certain prior period amounts have been reclassified to conform to the current period presentation.
 - (2) Covered loans represent acquired loans that are covered under loss-sharing agreements with the Federal Deposit Insurance Corporation (FDIC).
 - (3) The expense to revenue ratio is defined as noninterest expense excluding other real estate owned (OREO) expense divided by total net interest income on a fully taxable-equivalent basis and noninterest income.
 - (4) Excludes covered assets, which consist of acquired loans and OREO that are covered under loss-sharing agreements with the FDIC.
 - (5) Excludes \$27.85 billion, \$26.09 billion and \$25.11 billion of assets under management for asset managers in which the Company held a noncontrolling ownership interest as of June 30, 2014, March 31, 2014 and June 30, 2013, respectively.

Table of Contents

CRITICAL ACCOUNTING POLICIES

The accounting and reporting policies of the Company conform with U.S. generally accepted accounting principles. The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. The Company has identified 11 policies as critical because they require management to make estimates, assumptions and judgments that affect the reported amount of assets and liabilities, contingent assets and liabilities, and revenues and expenses included in the consolidated financial statements. The judgments and assumptions used by management are based on historical experience and other factors, which are believed to be reasonable under the circumstances. Circumstances and events that differ significantly from those underlying the Company's estimates, assumptions and judgments could cause the actual amounts reported to differ significantly from these estimates.

The Company's critical accounting policies include those that address accounting for business combinations, financial assets and liabilities reported at fair value, securities, acquired impaired loans, allowance for loan and lease losses and reserve for off-balance sheet credit commitments, OREO, goodwill and other intangible assets, noncontrolling interest, share-based compensation plans, income taxes, and derivatives and hedging activities. The Company has not made any significant changes in its critical accounting policies or its estimates and assumptions from those disclosed in its 2013 Annual Report other than the adoption of new accounting pronouncements and other authoritative guidance that became effective for the Company on or after January 1, 2014. Refer to Note 1, *Summary of Significant Accounting Policies*, of the Notes to the Unaudited Consolidated Financial Statements for further discussion. Management has applied its critical accounting policies and estimation methods consistently in all periods presented in these financial statements.

HIGHLIGHTS

- Consolidated net income attributable to City National Corporation (CNC) was \$66.7 million for the second quarter of 2014, up 12 percent from \$59.7 million in the year-ago period and up 22 percent from \$54.5 million for the first quarter of 2014. For the second quarter of 2014, consolidated net income available to common shareholders was \$62.6 million, or \$1.11 per diluted share. Net income available to common shareholders was \$57.3 million, or \$1.04 per diluted share, for the year-earlier quarter and \$50.4 million, or 0.90 per diluted share for the quarter ended March 31, 2014.
- Revenue, which consists of net interest income and noninterest income, was \$320.2 million for the second quarter of 2014, up 12 percent from \$285.1 million in the year-earlier quarter and up 6 percent from \$301.0 million in the first quarter of 2014.
- Fully taxable-equivalent net interest income, including dividend income, amounted to \$226.1 million for the second quarter of 2014, up 9 percent from the second quarter of 2013 and 10 percent higher from the first quarter of 2014.
- The Company's net interest margin in the second quarter of 2014 was 3.21 percent, down from 3.24 percent in the second quarter of 2013, but up from 3.02 percent in the first quarter of 2014. The increase from the first quarter of 2014 was primarily due to higher income on covered loans that were paid off or fully-charged off in the second quarter of 2014.

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- Noninterest income was \$101.1 million for the second quarter of 2014, up 23 percent from the second quarter of 2013 and down slightly from the first quarter of 2014. The increase from the year-earlier quarter was primarily attributable to higher wealth management fee income and lower FDIC loss-sharing expense, as well as a higher net gain on the disposal of assets. The decrease from the first quarter was due largely to higher FDIC loss-sharing expense offset by higher wealth management fee income and higher net gain on disposal of assets. Results for the second quarter of 2014 also included a \$5.1 million net gain on securities, compared to a \$5.6 million net gain in the second quarter of 2013 and a \$2.1 million net gain in the first quarter of 2014.
- Trust and investment fee income grew to \$54.6 million in the second quarter of 2014, up 10 percent from the year-earlier quarter and up 2 percent from the first quarter of 2014. Assets under management or administration totaled \$65.8 billion, up 10 percent from the second quarter of 2013, but down 1 percent from the first quarter of 2014.
- Noninterest expense for the second quarter of 2014 was \$225.6 million, up 7 percent from the second quarter of 2013 and 5 percent higher from the first quarter of 2014. The increase from the year-ago period largely reflects higher compensation costs, as well as an increase in legal and professional fees. Legal and professional fees for the second

Table of Contents

quarter of 2014 included sub-advisory expense related to the merger of two funds. These costs were offset in part by lower other real estate owned expenses and FDIC assessments.

- The base yield on the covered loan portfolio generated net interest income of \$12.4 million in the second quarter of 2014, compared to \$16.7 million for the year-earlier quarter and \$12.5 million in the first quarter of 2014. Base yield is the yield on covered loans, excluding income from covered loans that were paid off or fully charged-off. The Company recognizes other components of other income and expense related to its covered assets including income from covered loans that were paid off or fully charged-off, net impairment charges and other covered assets income and expenses. These components fluctuate from period to period. When aggregated, the impact of those items to the income statement, excluding the base yield, was total net expense of \$2.8 million for the second quarter of 2014, compared to net expense of \$2.0 million for the second quarter of 2013 and \$3.6 million for the first quarter of 2014. Refer to the Net Interest Income, Provision for Credit Losses and Covered Assets sections included elsewhere in this report for further discussion.
- The Company's effective tax rate was 30.7 percent for the second quarter of 2014, compared with 29.7 percent for the year-earlier period and 32.3 percent for the first quarter of 2014.
- Total assets were \$30.82 billion at June 30, 2014, up 13 percent from \$27.38 billion at June 30, 2013 and up 4 percent from \$29.74 billion at March 31, 2014. Total average assets were \$29.98 billion for the second quarter of 2014, up 9 percent from \$27.47 billion for the second quarter of 2013 and up 2 percent from \$29.43 billion for the first quarter of 2014.
- Loans and leases, excluding covered loans, grew to \$18.47 billion at June 30, 2014, an increase of 17 percent from \$15.82 billion at June 30, 2013 and 4 percent from \$17.75 billion at March 31, 2014. Average loan and lease balances, excluding covered loans, were \$17.96 billion for the second quarter of 2014, up 16 percent from the same period of last year and 4 percent from the first quarter of 2014. Average commercial loan balances were up 18 percent from the year-earlier period and 4 percent from the first quarter of 2014. Average commercial real estate balances increased 18 percent from the second quarter of 2013 and 3 percent from the first quarter of 2014.
- Excluding covered loans, second quarter 2014 results included a \$1.0 million reversal of provision for loan and lease losses. The Company recorded no provisions or provision reversal in either the second quarter of 2013 or first quarter of 2014. The allowance for loan and lease losses on non-covered loans was \$311.3 million at June 30, 2014, compared with \$289.9 million at June 30, 2013 and \$305.8 million at March 31, 2014. The Company remains appropriately reserved at 1.68 percent of total loans and leases, excluding covered loans, at June 30, 2014, compared with 1.83 percent at June 30, 2013 and 1.72 percent at March 31, 2014.
- In the second quarter of 2014, net loan charge-offs totaled \$3.6 million, or 0.08 percent of average total loans and leases, excluding covered loans, on an annualized basis, compared with net recoveries of \$7.5 million, or 0.20 percent, in the year-earlier quarter, and net recoveries of \$4.2 million, or 0.10 percent, for the first quarter of 2014. Nonaccrual loans, excluding covered loans, totaled \$64.8 million at June 30, 2014, down from \$76.7 million at June 30, 2013 and \$71.2 million at March 31, 2014. At June 30, 2014, nonperforming assets, excluding covered assets, were \$69.1 million, down from \$96.3 million at June 30, 2013 and \$80.7 million at March 31, 2014.

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- Average securities for the second quarter of 2014 totaled \$8.67 billion, down 2 percent from the second quarter of 2013, but up 1 percent from the first quarter of 2014.
- Period-end deposits at June 30, 2014 were \$26.65 billion, up 13 percent from \$23.65 billion at June 30, 2013 and 4 percent from \$25.73 billion at March 31, 2014. Deposit balances for the second quarter of 2014 averaged \$25.91 billion, up 12 percent from \$23.12 billion for the second quarter of 2013 and 2 percent from \$25.37 billion for the first quarter of 2014. Average core deposits, which equal 98 percent of total deposit balances for the second quarter of 2014, were up 14 percent from the second quarter of 2013 and 2 percent from the first quarter of 2014.
- The Company remains well capitalized. The ratio of Tier 1 common shareholders' equity to risk-based assets was 8.8 percent at June 30, 2014, compared with 8.8 percent at June 30, 2013 and 8.9 percent at March 31, 2014. Refer to the "Capital" section included elsewhere in this report for further discussion of this non-GAAP measure. All of the Company's pro-forma capital ratios are above the Basel III rules, which were approved by the Federal Reserve on July 2, 2013. These rules are expected to be fully implemented by January 1, 2019.

Table of Contents

OUTLOOK

Management expects moderate net income growth in 2014. Loan and deposit balances are expected to continue to increase, and credit quality should remain strong, though rising loan balances are expected to require a loan-loss provision later this year. Low interest rates and competitive loan pricing continue to put pressure on the Company's net interest margin. This outlook reflects management's expectations for moderate economic growth throughout the remainder of 2014. This does not take into account the effect that any changes in monetary policy could have on short-term interest rates, which are not expected to rise this year.

RESULTS OF OPERATIONS

Net Interest Income

Net interest income is the difference between interest income (which includes yield-related loan fees) and interest expense. Net interest income on a fully taxable-equivalent basis expressed as a percentage of average total earning assets is referred to as the net interest margin, which represents the average net effective yield on earning assets. The following table presents the components of net interest income on a fully taxable-equivalent basis for the three and six months ended June 30, 2014 and 2013:

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Table of Contents

Net Interest Income Summary

(in thousands) (1)	For the three months ended June 30, 2014			For the three months ended June 30, 2013		
	Average balance	Interest income/ expense (2)(3)	Average interest rate	Average balance	Interest income/ expense (2)(3)	Average interest rate
Assets						
Interest-earning assets						
Loans and leases						
Commercial	\$ 8,605,421	\$ 74,969	3.49%	\$ 7,300,447	\$ 65,156	3.58%
Commercial real estate mortgages	3,354,672	29,838	3.57	2,847,979	28,397	4.00
Residential mortgages	4,715,528	41,359	3.51	4,083,044	37,927	3.72
Real estate construction	418,353	3,915	3.75	352,775	3,733	4.24
Home equity loans and lines of credit	697,178	6,411	3.69	704,418	6,315	3.60
Installment	168,039	1,820	4.34	145,439	1,702	4.69
Total loans and leases, excluding covered loans (4)	17,959,191	158,312	3.54	15,434,102	143,230	3.72
Covered loans	643,690	31,061	19.30	909,728	32,610	14.34
Total loans and leases	18,602,881	189,373	4.08	16,343,830	175,840	4.32
Due from banks - interest-bearing	577,591	378	0.26	236,119	158	0.27
Federal funds sold and securities purchased under resale agreements	355,747	1,477	1.67	277,019	1,555	2.25
Securities	8,668,011	46,924	2.17	8,866,911	43,829	1.98
Other interest-earning assets	72,166	1,165	6.47	96,004	1,073	4.48
Total interest-earning assets	28,276,396	239,317	3.39	25,819,883	222,455	3.46
Allowance for loan and lease losses	(327,820)			(325,043)		
Cash and due from banks	187,710			128,489		
Other non-earning assets	1,842,661			1,846,252		
Total assets	\$ 29,978,947			\$ 27,469,581		
Liabilities and Equity						
Interest-bearing deposits						
Interest checking accounts	\$ 2,327,248	\$ 327	0.06%	\$ 2,173,015	\$ 390	0.07%
Money market accounts	6,617,913	1,142	0.07	5,758,428	1,645	0.11
Savings deposits	462,316	68	0.06	414,478	99	0.10
Time deposits - under \$100,000	169,455	86	0.20	192,550	178	0.37
Time deposits - \$100,000 and over	451,197	437	0.39	707,980	678	0.38
Total interest-bearing deposits	10,028,129	2,060	0.08	9,246,451	2,990	0.13
Federal funds purchased and securities sold under repurchase agreements	934		0.07	374,571	123	0.13
Other borrowings	737,159	11,163	6.07	927,829	10,963	4.74
Total interest-bearing liabilities	10,766,222	13,223	0.49	10,548,851	14,076	0.54
Noninterest-bearing deposits	15,883,952			13,872,367		
Other liabilities	498,602			466,295		
Total equity	2,830,171			2,582,068		
Total liabilities and equity	\$ 29,978,947			\$ 27,469,581		
Net interest spread			2.90%			2.92%
Fully taxable-equivalent net interest and dividend income		\$ 226,094			\$ 208,379	
Net interest margin			3.21%			3.24%
Less: Dividend income included in other income		1,165			1,073	
Fully taxable-equivalent net interest income		\$ 224,929			\$ 207,306	

-
- (1) Certain prior period balances have been reclassified to conform to the current period presentation.
 - (2) Net interest income is presented on a fully taxable-equivalent basis.
 - (3) Loan income includes loan fees of \$8,884 and \$6,534 for 2014 and 2013, respectively.
 - (4) Includes average nonaccrual loans of \$63,934 and \$74,981 for 2014 and 2013, respectively.

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Table of Contents

Net Interest Income Summary

(in thousands) (1)	For the six months ended June 30, 2014			For the six months ended June 30, 2013		
	Average balance	Interest income/ expense (2)(3)	Average interest rate	Average balance	Interest income/ expense (2)(3)	Average interest rate
Assets						
Interest-earning assets						
Loans and leases						
Commercial	\$ 8,435,115	\$ 143,138	3.42%	\$ 7,089,246	\$ 128,115	3.64%
Commercial real estate mortgages	3,305,008	59,164	3.61	2,808,007	55,522	3.99
Residential mortgages	4,656,094	82,224	3.53	4,032,470	76,014	3.77
Real estate construction	397,409	7,385	3.75	342,906	7,539	4.43
Home equity loans and lines of credit	696,137	12,620	3.66	707,971	12,778	3.64
Installment	160,757	3,515	4.41	142,847	3,162	4.46
Total loans and leases, excluding covered loans (4)	17,650,520	308,046	3.52	15,123,447	283,130	3.78
Covered loans	669,781	52,913	15.80	949,370	64,726	13.64
Total loans and leases	18,320,301	360,959	3.97	16,072,817	347,856	4.36
Due from banks - interest-bearing	621,146	820	0.27	214,535	270	0.25
Federal funds sold and securities purchased under resale agreements	317,569	2,848	1.81	215,880	2,690	2.51
Securities	8,626,844	91,699	2.13	9,329,014	90,660	1.94
Other interest-earning assets	74,538	2,375	6.42	100,364	2,035	4.09
Total interest-earning assets	27,960,398	458,701	3.31	25,932,610	443,511	3.45
Allowance for loan and lease losses	(325,595)			(326,483)		
Cash and due from banks	217,631			128,596		
Other non-earning assets	1,851,746			1,853,985		
Total assets	\$ 29,704,180			\$ 27,588,708		
Liabilities and Equity						
Interest-bearing deposits						
Interest checking accounts	\$ 2,373,545	\$ 710	0.06%	\$ 2,195,086	\$ 807	0.07%
Money market accounts	6,492,299	2,242	0.07	5,725,378	3,242	0.11
Savings deposits	458,293	136	0.06	416,652	214	0.10
Time deposits - under \$100,000	171,749	179	0.21	196,363	360	0.37
Time deposits - \$100,000 and over	467,224	927	0.40	656,425	1,307	0.40
Total interest-bearing deposits	9,963,110	4,194	0.08	9,189,904	5,930	0.13
Federal funds purchased and securities sold under repurchase agreements	470		0.07	606,058	400	0.13
Other borrowings	738,021	22,316	6.10	1,188,474	22,473	3.81
Total interest-bearing liabilities	10,701,601	26,510	0.50	10,984,436	28,803	0.53
Noninterest-bearing deposits	15,680,222			13,576,936		
Other liabilities	516,938			469,454		
Total equity	2,805,419			2,557,882		
Total liabilities and equity	\$ 29,704,180			\$ 27,588,708		
Net interest spread			2.81%			2.92%
Fully taxable-equivalent net interest and dividend income		\$ 432,191			\$ 414,708	
Net interest margin			3.12%			3.22%
Less: Dividend income included in other income		2,375			2,035	
Fully taxable-equivalent net interest income		\$ 429,816			\$ 412,673	

-
- (1) Certain prior period balances have been reclassified to conform to the current period presentation.
 - (2) Net interest income is presented on a fully taxable-equivalent basis.
 - (3) Loan income includes loan fees of \$15,115 and \$12,719 for 2014 and 2013, respectively.
 - (4) Includes average nonaccrual loans of \$66,116 and \$83,945 for 2014 and 2013, respectively.

Table of Contents

Net interest income is impacted by the volume (changes in volume multiplied by prior rate), interest rate (changes in rate multiplied by prior volume) and mix of interest-earning assets and interest-bearing liabilities. The following table provides a breakdown of the changes in net interest income and dividend income on a fully taxable-equivalent basis due to volume and rate between the second quarter and first six months of 2014 and 2013, as well as the second quarter and first six months of 2013 and 2012. The impact of interest rate swaps, which affect interest income on loans and leases and interest expense on deposits and borrowings, is included in rate changes.

Changes in Net Interest Income

(in thousands)	For the three months ended June 30, 2014 vs 2013			For the three months ended June 30, 2013 vs 2012		
	Increase (decrease) due to		Net increase (decrease)	Increase (decrease) due to		Net increase (decrease)
	Volume	Rate		Volume	Rate	
Interest earned on:						
Total loans and leases (1)	\$ 23,362	\$ (9,829)	\$ 13,533	\$ 22,848	\$ (34,909)	\$ (12,061)
Securities	(996)	4,091	3,095	6,058	(8,156)	(2,098)
Due from banks - interest-bearing	224	(4)	220	(36)	21	(15)
Federal funds sold and securities purchased under resale agreements	381	(459)	(78)	188	1,271	1,459
Other interest-earning assets	(309)	401	92	(142)	521	379
Total interest-earning assets	22,662	(5,800)	16,862	28,916	(41,252)	(12,336)
Interest paid on:						
Interest checking deposits	26	(89)	(63)	62	(128)	(66)
Money market deposits	219	(722)	(503)	(30)	(201)	(231)
Savings deposits	10	(41)	(31)	17	(45)	(28)
Time deposits	(243)	(90)	(333)	(67)	(184)	(251)
Total borrowings	(6,139)	6,216	77	4,894	(3,652)	1,242
Total interest-bearing liabilities	(6,127)	5,274	(853)	4,876	(4,210)	666
	\$ 28,789	\$ (11,074)	\$ 17,715	\$ 24,040	\$ (37,042)	\$ (13,002)

(in thousands)	For the six months ended June 30, 2014 vs 2013			For the six months ended June 30, 2013 vs 2012		
	Increase (decrease) due to		Net increase (decrease)	Increase (decrease) due to		Net increase (decrease)
	Volume	Rate		Volume	Rate	
Interest earned on:						
Total loans and leases (1)	\$ 45,985	\$ (32,882)	\$ 13,103	\$ 44,165	\$ (54,089)	\$ (9,924)
Securities	(7,047)	8,086	1,039	15,925	(18,776)	(2,851)
Due from banks - interest-bearing	536	14	550	(19)	23	4
Federal funds sold and securities purchased under resale agreements	1,045	(887)	158	492	2,092	2,584
Other interest-earning assets	(617)	957	340	(242)	892	650
Total interest-earning assets	39,902	(24,712)	15,190	60,321	(69,858)	(9,537)
Interest paid on:						
Interest checking deposits	62	(159)	(97)	125	(298)	(173)
Money market deposits	391	(1,391)	(1,000)	(143)	(693)	(836)
Savings deposits	19	(97)	(78)	37	(77)	(40)

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Time deposits	(385)	(176)	(561)	(218)	(402)	(620)
Total borrowings	(19,003)	18,446	(557)	14,816	(10,633)	4,183
Total interest-bearing liabilities	(18,916)	16,623	(2,293)	14,617	(12,103)	2,514
	\$ 58,818	\$ (41,335)	\$ 17,483	\$ 45,704	\$ (57,755)	\$ (12,051)

(1) Includes covered loans.

Table of Contents

Net interest income was \$219.1 million for the second quarter of 2014, an increase of 10 percent from \$199.8 million for the first quarter of 2014, and an 8 percent increase from \$202.9 million for the second quarter of 2013. The increase in net interest income from the first quarter of 2014 was largely due to growth in non-covered loans, higher interest income from covered loans and higher interest income from the securities portfolio. The increase in net interest income from the prior-year quarter was due to higher income on loans and securities and lower interest expense on deposits and borrowings. Fully taxable-equivalent net interest income and dividend income was \$226.1 million for the second quarter of 2014, compared to \$206.1 million for the first quarter of 2014 and \$208.4 million for the second quarter of 2013.

Interest income on total loans was \$187.0 million for the second quarter of 2014, up 10 percent from the first quarter of 2014 and up 7 percent from the second quarter of 2013. The increase in loan interest income from the prior quarter was driven by growth in the loan portfolio and higher income from the net accelerated accretable yield recognition on covered loans that were paid off or fully charged off in the second quarter of 2014. Compared to the year-earlier quarter, the increase in loan interest income was largely due to growth in non-covered loans. Income from accelerated accretable yield recognition during the second quarter of 2014 was \$18.7 million, compared to \$9.3 million in the first quarter of 2014 and \$15.9 million in the year-earlier quarter. Refer to Covered Assets included elsewhere in this report for further discussion of interest income on covered loans.

Average loans and leases, excluding covered loans, totaled \$18.00 billion for the second quarter of 2014, an increase of 4 percent from \$17.34 billion for the first quarter of 2014 and up 16 percent from \$15.43 billion for the second quarter of 2013. Average commercial loans grew 4 percent and 18 percent from the first quarter of 2014 and second quarter of 2013, respectively. Average commercial real estate loans grew 3 percent and 18 percent for the same periods. Average covered loans decreased to \$643.7 million for the second quarter of 2014 from \$696.2 million for the first quarter of 2014 and \$909.7 million for the year-ago quarter.

Interest income on securities was \$43.5 million for the second quarter of 2014, a 5 percent increase from both \$41.6 million for the first quarter of 2014 and \$41.2 million for the second quarter of 2013. Average total securities were \$8.67 billion for the second quarter of 2014, up by 1 percent from \$8.59 billion for the first quarter of 2014 and down 2 percent from \$8.87 billion for the year-earlier quarter. The decrease from the second quarter of 2013 was largely due to sales of longer-duration securities in the second half of 2013 to shorten the duration of the investment portfolio in anticipation of higher interest rates.

Total interest expense was \$13.2 million for the second quarter of 2014, virtually unchanged from the first quarter of 2014 and down 6 percent from \$14.1 million for the second quarter of 2013. Interest expense on borrowings was \$11.2 million for the second quarter of 2014, unchanged from \$11.2 million for the first quarter of 2014 and up 1 percent from \$11.1 million for the second quarter of 2013. The decrease in total interest expense from the year-earlier quarter was attributable to lower expense on interest-bearing deposits.

Interest expense on deposits was \$2.1 million for the second quarter of 2014, unchanged from \$2.1 million for the first quarter of 2014 and down 31 percent from \$3.0 million for the year-earlier quarter. The decrease in interest expense from the year-earlier quarter was due to lower deposit rates. The impact of lower rates more than offset the impact of higher average interest-bearing deposit balances in the second quarter of 2014. Average deposits were \$25.91 billion for the second quarter of 2014, up 2 percent from \$25.37 billion for the first quarter of 2014, and up 12 percent from \$23.12 billion for the second quarter of 2013. Average core deposits, which do not include certificates of deposits of \$100,000 or more, were \$25.46 billion for the second quarter of 2014, \$24.89 billion for the first quarter of 2014 and \$22.41 billion for the year-earlier quarter. Average core deposits represented 98 percent of total average deposits for the second and first quarter of 2014, and 97 percent for the second quarter of 2013. Average interest-bearing deposits were \$10.03 billion for the second quarter of 2014, up 1 percent from the first quarter of 2014, and up 8 percent from the second quarter of 2013. Average noninterest-bearing deposits were \$15.88 billion, up 3 percent from the first quarter of 2014 and up 15 percent from the year-earlier quarter.

Table of Contents

Net interest margin was 3.21 percent for the second quarter of 2014, up from 3.02 percent for the first quarter of 2014 and down from 3.24 percent for the second quarter of 2013. The average yield on earning assets for the second quarter of 2014 was 3.39 percent, up 17 basis points from 3.22 percent for the first quarter of 2014 and down 7 basis points from 3.46 percent for the year-earlier quarter. The average cost of interest-bearing liabilities was 0.49 percent, down from 0.51 percent for the first quarter of 2014 and down from 0.54 percent for the same period in 2013. The increase in the net interest margin from the first quarter of 2014 was primarily attributable to higher income from the net accelerated accretable yield recognition on covered loans that were paid off or fully charged off. The decrease in the net interest margin compared to the year-earlier quarter was primarily due to lower yields on loans and leases and declining volumes of covered loans, partially offset by higher fees and interest recoveries and a lower cost of interest-bearing liabilities.

Provision for Credit Losses

The Company accounts for the credit risk associated with lending activities through its allowance for loan and lease losses, reserve for off-balance sheet credit commitments and provision for credit losses. The provision for credit losses on loans and leases, excluding covered loans, is the expense recognized in the consolidated statements of income to adjust the allowance and the reserve for off-balance sheet credit commitments to the levels deemed appropriate by management, as determined through application of the Company's allowance methodology procedures. See *Critical Accounting Policies Allowance for Loan and Lease Losses and Reserve for Off-Balance Sheet Credit Commitments* in the Company's Form 10-K for the year ended December 31, 2013.

The Company recorded a \$1.0 million reversal of provision for credit losses on loans and leases, excluding covered loans, in the three months and six months ended June 30, 2014. The Company recorded no provision for credit losses on loans and leases, excluding covered loans, during the comparable periods in 2013. The provision reflects management's continuing assessment of the credit quality of the Company's loan portfolio, which is affected by a broad range of economic factors. Additional factors affecting the provision include net loan charge-offs or recoveries, nonaccrual loans, specific reserves, risk rating migration and changes in the portfolio size and composition. See *Balance Sheet Analysis Allowance for Loan and Lease Losses and Reserve for Off-Balance Sheet Credit Commitments* included elsewhere in this report for further information on factors considered by the Company in assessing the credit quality of the loan portfolio and establishing the allowance for loan and lease losses.

Covered loans represent loans acquired from the FDIC that are subject to loss-sharing agreements, and are primarily accounted for as acquired impaired loans under Accounting Standards Codification Topic 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality* (ASC 310-30). The provision for losses on covered loans is the expense recognized in the consolidated statements of income related to impairment losses resulting from the Company's quarterly review and update of cash flow projections on its covered loan portfolio. The Company recorded a \$1.5 million reversal of provision for losses on covered loans during the second quarter of 2014, compared to a \$4.7 million provision on covered loans in the first quarter of 2014 and an \$11.9 million reversal of provision during the second quarter of 2013. Refer to *Covered Assets* included elsewhere in this report for further discussion of the provision for losses on covered loans.

Credit quality will be influenced by underlying trends in the economic cycle, particularly in California, New York and Nevada, and other factors which are beyond management's control. Consequently, no assurances can be given that the Company will not sustain loan or lease losses, in any particular period, that are sizable in relation to the allowance for loan and lease losses.

Refer to *Loans and Leases Asset Quality* included elsewhere in this report for further discussion of credit quality.

Noninterest Income

Noninterest income was \$101.1 million in the second quarter of 2014, down slightly from the first quarter of 2014 but up 23 percent from the second quarter of 2013. Higher FDIC loss sharing expense in the second quarter of 2014 compared with the first quarter was largely offset by higher wealth management fee income and higher gains on sales of securities and foreclosed assets. The increase from the year-earlier quarter was due largely to strong growth in wealth management fee income, higher gains on sales of foreclosed assets and lower FDIC loss sharing expense. Noninterest income represented 32 percent of the Company's revenue in the second quarter of 2014, compared to 34 percent in the first quarter of 2014 and 29 percent for the second quarter of 2013.

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Table of Contents

The following table provides a summary of noninterest income by category:

(in thousands)	For the three months ended		
	June 30, 2014	March 31, 2014	June 30, 2013
Trust and investment fees	\$ 54,599	\$ 53,306	\$ 49,830
Brokerage and mutual fund fees	14,240	10,042	8,107
Total wealth management fees	68,839	63,348	57,937
Cash management and deposit transaction charges	12,128	12,033	12,880
International services	11,483	10,395	10,911
FDIC loss sharing expense, net	(24,161)	(7,083)	(26,477)
Other noninterest income	20,853	17,607	20,401
Total noninterest income before gain (loss)	89,142	96,300	75,652
Gain on disposal of assets	6,838	2,826	949
Gain on sale of securities	5,367	2,122	5,790
Impairment loss on securities	(248)		(182)
Total noninterest income	\$ 101,099	\$ 101,248	\$ 82,209

Wealth Management

The Company provides various trust, investment and wealth advisory services to its individual, institutional and business clients. The Company delivers these services through the Bank's wealth management division as well as through its wealth management affiliates. Trust services are provided only by the Bank. Trust and investment fee revenue includes fees from trust, investment and asset management, and other wealth advisory services. The majority of these fees are based on the market value of client assets managed, advised, administered or held in custody. The remaining portion of these fees is based on the specific service provided, such as estate and financial planning services, or may be fixed fees. For those fees based on market valuations, the mix of assets held in client accounts, as well as the type of managed account, impacts how closely changes in trust and investment fee income correlate with changes in the financial markets. Changes in market valuations are reflected in fee income on a trailing day, month or quarter basis. Also included in total trust and investment fees is the Company's portion of income from certain investments accounted for under the equity method. Trust and investment fees were \$54.6 million for the second quarter of 2014, an increase of 2 percent from \$53.3 million for the first quarter of 2014 and an increase of 10 percent from \$49.8 million for the second quarter of 2013. The increases compared to prior periods were largely due to the growth in assets under management (AUM) generated through asset inflows and market appreciation. Money market mutual fund and brokerage fees were \$14.2 million for the second quarter of 2014, an increase of 42 percent from \$10.0 million for the first quarter of 2014, and up 76 percent from \$8.1 million for the year-earlier quarter. Second quarter 2014 brokerage and mutual fund fees included the recognition of \$3.8 million in performance fees related to the merger of two funds. The higher fee income was partially offset by a \$1.9 million increase in legal and professional fees for sub-advisory expense related to the merged funds. See Noninterest Expense below. The increase in fee income compared to the second quarter of 2013 was also due to asset inflows and market appreciation.

AUM includes assets for which the Company makes investment decisions on behalf of its clients and assets under advisement for which the Company receives advisory fees from its clients. Assets under administration (AUA) are assets the Company holds in a fiduciary capacity or for which it provides non-advisory services. The table below provides a summary of AUM and AUA for the dates indicated:

(in millions)	2014	June 30, 2013	% Change	March 31, 2014	% Change
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Assets Under Management	\$	47,124	\$	41,257	14	\$	46,374	2
Assets Under Administration								
Brokerage		5,218		5,251	(1)		5,628	(7)
Custody and other fiduciary		13,438		13,247	1		14,398	(7)
Subtotal		18,656		18,498	1		20,026	(7)
Total assets under management or administration (1)	\$	65,780	\$	59,755	10	\$	66,400	(1)

(1) Excludes \$27.85 billion, \$26.09 billion and \$25.11 billion of assets under management for asset managers in which the Company held a noncontrolling ownership interest as of June 30, 2014, March 31, 2014 and June 30, 2013, respectively.

Table of Contents

AUM totaled \$47.12 billion as of June 30, 2014, up 14 percent from the year-earlier quarter and up 2 percent from the first quarter of 2014. Assets under management or administration were \$65.78 billion at June 30, 2014, an increase of 10 percent from the year-earlier quarter but down 1 percent from the first quarter of 2014. The growth in AUM from the prior year period was primarily attributable to the addition of client assets and higher market valuations.

A distribution of AUM by type of investment is provided in the following table:

Investment	% of Assets Under Management		
	June 30, 2014	March 31, 2014	June 30, 2013
Equities	49%	48%	46%
U.S. fixed income	26	27	25
Cash and cash equivalents	15	16	18
Other (1)	10	9	11
	100%	100%	100%

(1) Includes private equity and other alternative investments.

Other Noninterest Income

Cash management and deposit transaction fees for the second quarter of 2014 were \$12.1 million, up 1 percent from the first quarter of 2014 and down 6 percent from the second quarter of 2013. The decrease from the year-earlier quarter was due largely to higher deposit balances used to offset service charge fees.

International services income for the second quarter of 2014 was \$11.5 million, up 10 percent from the first quarter of 2014, and up 5 percent from the year-earlier quarter. International services income is comprised of foreign exchange fees, fees on commercial letters of credit and standby letters of credit, foreign collection fees, and gains and losses associated with fluctuations in foreign currency exchange rates. The increases from prior periods were due to increased client activity and the addition of new clients.

Net FDIC loss sharing expense increased to \$24.2 million for the second quarter of 2014 from \$7.1 million for the first quarter of 2014. Net FDIC loss sharing expense was \$26.5 million for the year-earlier quarter. See *Covered Assets* included elsewhere in this report for further discussion of FDIC loss sharing income and expense.

Net gain on disposal of assets was \$6.8 million in the second quarter of 2014, compared to \$2.8 million in the first quarter of 2014 and \$0.9 million in the year-earlier quarter. The increase from the prior periods was due primarily to the sale of assets that served as collateral for previously charged-off loans, as well as higher gains recognized on the sale of covered and non-covered OREO.

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The Company recognized net gains on sales of securities of \$5.4 million during the second quarter of 2014. Net gains on sales of securities were \$2.1 million in the first quarter of 2014 and \$5.8 million for the second quarter of 2013. Impairment losses of \$0.2 million were recognized in earnings on securities available-for-sale in the second quarter of 2014 and 2013. There were no impairment losses recognized in earnings on securities available-for-sale in the first quarter of 2014.

Other income for the second quarter of 2014 was \$20.9 million, up 18 percent from \$17.6 million for the first quarter of 2014, and up 2 percent from \$20.4 million for the second quarter of 2013. The increase from the first quarter of 2014 was due primarily to higher lease residual income and credit card and interchange fees. Compared to the year-earlier quarter, the increase was mainly due to higher income from private equity investments and credit card and interchange fee income, largely offset by lower income from client swap transactions in the second quarter of 2014.

Table of Contents**Noninterest Expense**

Noninterest expense was \$225.6 million for the second quarter of 2014, up 5 percent from \$214.9 million for the first quarter of 2014, and up 7 percent from \$211.4 million for the second quarter of 2013. The following table provides a summary of noninterest expense by category:

(in thousands)	June 30, 2014	For the three months ended March 31, 2014	June 30, 2013
Salaries and employee benefits	\$ 138,859	\$ 136,833	\$ 127,168
All other:			
Net occupancy of premises	16,595	16,094	16,205
Legal and professional fees	18,393	12,950	13,514
Information services	9,463	9,346	9,183
Depreciation and amortization	7,885	7,828	8,249
Amortization of intangibles	1,454	1,487	1,931
Marketing and advertising	8,982	9,775	8,293
Office services and equipment	5,287	4,910	5,034
Other real estate owned	2,372	1,433	4,385
FDIC assessments	2,765	1,391	3,663
Other operating	13,567	12,846	13,804
Total all other	86,763	78,060	84,261
Total noninterest expense	\$ 225,622	\$ 214,893	\$ 211,429

Salaries and employee benefits expense was \$138.9 million for the second quarter of 2014, up 1 percent from \$136.8 million for the first quarter of 2014, and up 9 percent from \$127.2 million for the year-earlier quarter. Full-time equivalent staff was 3,638 at June 30, 2014, up from 3,587 at March 31, 2014 and 3,551 at June 30, 2013. The increase in salaries and employee benefits expense in the second quarter compared with the prior and year-earlier quarters was primarily attributable to the addition of staff and higher incentive compensation. The increase in incentive compensation expense in the second quarter of 2014 compared with the first quarter was partially offset by lower payroll taxes.

Salaries and employee benefits expense for the second quarter of 2014 includes \$5.2 million of share-based compensation expense compared with \$5.4 million for the first quarter of 2014 and \$5.4 million for the year-earlier quarter. The decrease from the first quarter of 2014 was attributable to expense associated with cash-settled restricted stock units, which fluctuates based on the Company's stock price. Cash-settled restricted stock unit expense was higher during the first quarter of 2014 due to a higher average stock price during that quarter. See Note 10, *Share-Based Compensation*, of the Notes to the Unaudited Consolidated Financial Statements for further discussion of share-based compensation.

The remaining noninterest expense categories totaled \$86.8 million for the second quarter of 2014, up 11 percent from \$78.1 million for the first quarter of 2014 and 3 percent from \$84.3 million for the second quarter of 2013. The increase from the first quarter of 2014 was mostly due to higher legal and professional fees, OREO expense and FDIC assessments. The increase from the year-earlier quarter was primarily due to higher legal and professional fees that were partially offset by lower OREO expense and FDIC assessments.

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Legal and professional fees were \$18.4 million for the second quarter of 2014, up 42 percent from \$13.0 million in the first quarter of 2014, and up 36 percent from \$13.5 million in the year-earlier quarter. The increase from the first quarter of 2014 and second quarter of 2013 was primarily due to higher legal and professional fees recognized in the current quarter from collection and defense matters, and \$1.9 million of sub-advisory fees associated with the merger of two City National Rochdale funds. Legal and professional fees associated with covered loans and OREO declined to \$1.0 million for the second quarter of 2014, from \$1.6 million for the first quarter of 2014 and \$1.7 million for the second quarter of 2013. Under the loss-sharing agreements, 80 percent of qualifying legal and professional fees associated with covered loans and OREO are reimbursable by the FDIC and reflected in FDIC loss sharing income (expense), net in the noninterest income section of the consolidated statements of income.

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Table of Contents

The following table provides a summary of OREO expense for non-covered and covered OREO. Qualifying covered OREO expense is reimbursable by the FDIC at 80 percent.

(in thousands)	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Non-covered OREO expense				
Valuation write-downs	\$	\$ 61	\$ 14	\$ 171
Holding costs and foreclosure expense	72	246	178	458
Total non-covered OREO expense	\$ 72	\$ 307	\$ 192	\$ 629
Covered OREO expense				
Valuation write-downs	\$ 934	\$ 2,184	\$ 1,089	\$ 5,219
Holding costs and foreclosure expense	1,366	1,894	2,524	3,787
Total covered OREO expense	\$ 2,300	\$ 4,078	\$ 3,613	\$ 9,006
Total OREO expense	\$ 2,372	\$ 4,385	\$ 3,805	\$ 9,635

Table of Contents**Covered Assets**

The following table summarizes the components of income and expense related to covered assets for the three and six months ended June 30, 2014 and 2013:

(in thousands)	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Interest income on covered loans				
Base yield	\$ 12,379	\$ 16,730	\$ 24,907	\$ 33,221
Income on loans paid-off or fully charged-off	18,682	15,880	28,006	31,505
Total interest income on covered loans	\$ 31,061	\$ 32,610	\$ 52,913	\$ 64,726
(Reversal of) provision for losses on covered loans				
(Reversal of) provision for losses on covered loans	\$ (1,461)	\$ (11,927)	\$ 3,194	\$ (2,035)
Noninterest income related to covered assets				
FDIC loss sharing expense, net				
Loss on indemnification asset	\$ (4,392)	\$ (13,102)	\$ (793)	\$ (2,486)
Indemnification asset amortization	(3,320)	(4,746)	(6,484)	(9,645)
Net FDIC reimbursement for OREO and loan expenses	2,160	4,995	3,813	10,188
Removal of indemnification asset for loans paid-off or fully charged-off	(4,994)	(7,650)	(7,993)	(13,723)
Removal of indemnification asset for unfunded loan commitments and loans transferred to OREO	(773)	(1,163)	(1,449)	(3,732)
Removal of indemnification asset for OREO and net reimbursement to FDIC for OREO sales	(1,827)	(428)	(2,138)	(1,272)
Loan recoveries shared with FDIC	(9,866)	(4,095)	(14,088)	(9,076)
Increase in FDIC clawback liability	(1,149)	(288)	(2,112)	(1,083)
Total FDIC loss sharing expense, net	(24,161)	(26,477)	(31,244)	(30,829)
Gain on disposal of assets				
Net gain on sale of OREO	2,613	616	3,002	1,590
Other income				
Net gain on transfers of covered loans to OREO	867	1,445	1,730	4,951
Amortization of fair value on acquired unfunded loan commitments	218	283	433	677
OREO income	289	456	724	1,282
Other	543	(318)	387	(652)
Total other income	1,917	1,866	3,274	6,258
Total noninterest income related to covered assets	\$ (19,631)	\$ (23,995)	\$ (24,968)	\$ (22,981)
Noninterest expense related to covered assets (1)				
Other real estate owned				
Valuation write-downs	\$ 934	\$ 2,184	\$ 1,089	\$ 5,219
Holding costs and foreclosure expense	1,366	1,894	2,524	3,787
Total other real estate owned	2,300	4,078	3,613	9,006

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Legal and professional fees	992	1,701	2,572	3,721
Other operating expense				
Other covered asset expenses	5	16	24	30
Total noninterest expense related to covered assets (2)	\$ 3,297	\$ 5,795	\$ 6,209	\$ 12,757

-
- (1) OREO, legal and professional fees and other expenses related to covered assets must meet certain FDIC criteria in order for the expense amounts to be reimbursed. Certain amounts reflected in these categories may not be reimbursed by the FDIC.
- (2) Excludes personnel and other corporate overhead expenses that the Company incurs to service covered assets and costs associated with the branches acquired in FDIC-assisted acquisitions.

Table of Contents

The Company accounts for its covered loans under ASC 310-30. Loans are accounted for under ASC 310-30 when there is evidence of credit deterioration since origination and for which it is probable, at acquisition, that the Company would be unable to collect all contractually required payments. These loans were recorded at fair value at the time of acquisition. In connection with its FDIC-assisted acquisitions, the Company entered into loss-sharing agreements with the FDIC under which the FDIC will reimburse the Company for 80 percent of eligible losses with respect to covered loans, OREO and unfunded loan commitments. The expected reimbursements under the loss-sharing agreements were recorded as an indemnification asset at their initial estimated fair value on the date of acquisition.

Covered Loan Base Yield and FDIC Indemnification Asset Amortization/Accretion

For covered loans, the excess of cash flows expected to be collected over the carrying value of the underlying acquired impaired loans is referred to as accretable yield. The accretion of this amount is recognized in interest income over the expected life of the covered loans and is herein referred to as base yield. For the FDIC indemnification asset, the difference between the cash flows the Company expects to collect from the FDIC (FDIC cash flows) and the carrying value of the indemnification asset is amortized or accreted into noninterest income up until the expiration date of the FDIC loss sharing. Both the base yield and the amortization or accretion of the indemnification asset are calculated using a level yield method that takes into consideration the remaining life of the covered loans and the terms of the FDIC loss-sharing agreements.

The quarterly review and update of cash flow projections (further discussed below) may adjust the rates used for loan accretion and indemnification asset amortization or accretion. As credit improves, expected loan cash flows will generally improve, resulting in higher accretable yield. Accordingly, as credit improves, expected FDIC cash flows will decrease, resulting in a larger difference between FDIC cash flows and indemnification asset carrying value. Such increases would result in higher rates of loan accretion and indemnification asset amortization.

The Company recorded base yield on covered loans of \$12.4 million in the second quarter of 2014, compared to \$12.5 million in the first quarter of 2014 and \$16.7 million in the second quarter of 2013. The decrease in base yield on covered loans compared to prior periods was a result of portfolio run-off. Average covered loans were \$643.7 million during the second quarter of 2014, down from \$696.2 million during the first quarter of 2014 and \$909.7 million for the year-earlier quarter. The Company recorded indemnification asset amortization expense of \$3.3 million in the second quarter of 2014, compared to \$3.2 million and \$4.7 million for the first quarter of 2014 and second quarter of 2013, respectively. The indemnification asset amortization expense did not change significantly from prior periods because the effects of portfolio run-off were offset by an increase in the rate of amortization, which was higher due to portfolio credit improvement.

Quarterly Update of Cash Flow Projections

The Company reviews and updates cash flow projections on covered loans and the related FDIC loss-sharing agreements on a quarterly basis. These projections take into consideration such inputs as the contractual terms of the covered loans, the contractual terms of the FDIC loss-sharing agreements, credit assumptions and prepayment assumptions. The quarterly update of cash flow projections impacts the following balance sheet and income statement items:

Balance Sheet Line Item	Corresponding Income Statement Line Item
Covered loan	Base yield in interest income

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Allowance for losses on covered loans	(Reversal of) provision for losses on covered loans
FDIC indemnification asset	FDIC loss sharing income or expense, net <i>- Gain or loss on indemnification asset</i> <i>- Indemnification asset amortization or accretion (on a prospective basis)</i>
FDIC clawback liability	FDIC loss sharing income or expense, net <i>- Increase or decrease in FDIC clawback liability</i>

Generally, for covered loans, decreases in estimated loan cash flows over those expected at the acquisition date and subsequent measurement periods are recognized by recording a provision for losses on covered loans. Decreases in estimated loan cash flows are typically accompanied by higher expected losses which would result in increases in FDIC cash flows. Increases in expected FDIC cash flows are recognized as gains on the FDIC indemnification asset.

Table of Contents

Increases in estimated loan cash flows over those expected at the acquisition date and subsequent measurement periods are recognized as interest income, prospectively, after previously recorded allowances are reversed. Increases in estimated loan cash flows are typically accompanied by lower expected losses which would result in decreases in FDIC cash flows. Decreases in expected FDIC cash flows are recognized as indemnification asset amortization expense on a prospective basis, after previously recorded gains on the indemnification asset have been reversed.

The FDIC clawback liability represents contingent consideration expected to be paid to the FDIC. The Company is required to reimburse the FDIC if actual cumulative losses are lower than the adjusted intrinsic losses contractually set forth in the FDIC loss-sharing agreements. The total FDIC clawback liability may increase as actual and expected losses decrease. The liability to the FDIC may decrease if actual and expected losses grow. The Company measures the FDIC clawback liability at fair value.

As a result of improvements in the portfolio's credit quality and general market conditions, the Company recorded a \$1.5 million reversal of provision for losses on covered loans during the second quarter of 2014, compared to a \$4.7 million provision for losses in the first quarter of 2014 and an \$11.9 million reversal of provision during the second quarter of 2013. Loss on indemnification asset was \$4.4 million in the second quarter of 2014, compared to a gain of \$3.6 million and a loss of \$13.1 million for the first quarter of 2014 and second quarter of 2013, respectively. Expense from the increase in FDIC clawback liability was \$1.1 million, \$1.0 million and \$0.3 million for the second quarter of 2014, first quarter of 2014, and second quarter of 2013, respectively. The provision for losses on covered loans, the gain on indemnification asset and the change in FDIC clawback liability are the result of changes, both in amount and timing, in expected loan cash flows and FDIC cash flows due to actual loan performance and the Company's revised loan loss and prepayment forecasts. During the second quarter of 2014, the expected lifetime cash flows of the covered loan portfolio improved. The covered loans that were removed, mostly due to pay-offs, performed better than previously expected. Loans are removed when they have been fully paid off, fully charged-off, sold or transferred to OREO. The credit performance of the remaining covered loans improved, which resulted in the recognition of the reversal of provision for losses on covered loans and the loss on indemnification asset during the second quarter of 2014 and the year-earlier quarter. The provision for losses on covered loans and the gain on indemnification asset in the first quarter of 2014 were attributable to credit deterioration for the remaining covered loans during the quarter. The increase in the FDIC clawback liability was driven by an overall improvement in portfolio credit.

The revisions of the loss forecasts were based on the results of management's review of market conditions, the credit quality of the outstanding covered loans and loan performance data since the acquisition of covered loans. The Company will continue updating cash flow projections on covered loans and related FDIC loss-sharing agreements on a quarterly basis. Due to the uncertainty in the future performance of the covered loans, additional provision expense or provision reversal, gain or loss on indemnification asset and changes in FDIC clawback liability may be recognized in future periods.

Covered Asset Removals

A covered asset removal event occurs when a loan is fully paid-off, fully charged-off, sold or transferred to OREO, or when OREO is liquidated. The difference between the carrying value of the covered asset and the cash or non-cash proceeds received upon its removal is recognized as a gain or loss in the income statement. The gain or loss on covered loans that are fully paid-off and fully charged-off, also referred to as net accelerated accretable yield recognition, is recorded in interest income. Gain or loss recognized on the transfer of covered loans to OREO is calculated as the difference between the carrying value of the covered loan and the fair value of the underlying foreclosed collateral, and is recognized in other noninterest income. The Company also recognizes gains and losses from the sale of covered OREO through noninterest income.

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When a covered asset is removed, the FDIC indemnification asset associated with the covered asset is also removed. The FDIC indemnification asset balance associated with unfunded loan commitments is also removed when an unfunded commitment has been funded. The difference between the FDIC indemnification asset and the expected payment from the FDIC for the removed asset represents the expense or income on removal of the indemnification asset. These amounts are recognized in FDIC loss sharing income or expense.

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Table of Contents

Interest income from net accelerated accretable yield recognition increased to \$18.7 million in the second quarter of 2014, compared to \$9.3 million in the first quarter of 2014 and \$15.9 million in the year-earlier quarter. The net expense from the removal of indemnification asset for loans that were paid off or fully charged-off was \$5.0 million, \$3.0 million and \$7.7 million in the second quarter of 2014, first quarter of 2014 and second quarter of 2013, respectively. The increase in both balances in the second quarter of 2014 compared to the first quarter of 2014 was due to higher volumes of covered loans that were paid off or fully charged-off.

Net gains on transfers of covered loans to OREO were \$0.9 million in both the second and first quarter of 2014, down from \$1.4 million in the year-earlier quarter. Net gain on sale of covered OREO was \$2.6 million in the second quarter of 2014, an increase from \$0.4 million in the first quarter of 2014 and \$0.6 million in the year-earlier quarter. Total net expense from the removal of the indemnification asset for all other covered asset removals, which excludes the removal of indemnification asset for loans that were paid off or fully charged-off, was \$2.6 million in the second quarter of 2014, \$1.0 million in the first quarter of 2014 and \$1.6 million in the year-earlier quarter. The increase in net gain on sale of covered OREO and related expense from the indemnification asset recognized in the second quarter of 2014 was driven by higher OREO sale volume.

Loan recoveries on previously charged-off covered loans are also shared with the FDIC. The portion that is payable to the FDIC is recognized as Loan recoveries shared with FDIC under FDIC loss sharing income or expense. The Company recognized expenses of \$9.9 million in the second quarter of 2014, \$4.2 million in the first quarter of 2014 and \$4.1 million in the year-earlier quarter. The Company recognized significant loan recoveries during the first two quarters of 2014 and past two years as a result of increases in the value of real estate collateral and improvements in the financial condition of borrowers or guarantors.

Other Expenses

Noninterest expense related to covered assets includes OREO expense, legal and professional expense, and other covered asset expenses. These expenses are subject to FDIC reimbursement, but must meet certain FDIC criteria in order to be reimbursed. Certain amounts reflected in the table above may not be reimbursable by the FDIC. The FDIC reimbursements related to qualified expenses are recognized as income in Net FDIC reimbursement for OREO and loan expenses under FDIC loss sharing income or expense.

Total OREO expense, which includes valuation write-downs, holding costs and foreclosure expenses was \$2.3 million for the second quarter of 2014, up from \$1.3 million for the first quarter of 2014, but down from \$4.1 million for the year-earlier quarter. The decrease in total OREO expense from the prior-year period was due primarily to lower OREO volume and improvements in property values. Legal and professional fees related to covered assets were \$1.0 million in the second quarter of 2014, down from \$1.6 million in the first quarter of 2014 and \$1.7 million in the year-earlier quarter. Correspondingly, net FDIC reimbursement for these expenses of \$2.2 million for the second quarter of 2014 increased from \$1.7 million for the first quarter of 2014, but was down from \$5.0 million for the second quarter of 2013.

Other Information on the FDIC Indemnification Asset

The following table is a summary of activity in the FDIC indemnification asset for the three and six months ended June 30, 2014 and 2013:

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(in thousands)	For the three months ended		For the six months ended	
	2014	2013	2014	2013
Balance, beginning of period	\$ 84,851	\$ 142,906	\$ 89,227	\$ 150,018
Indemnification asset amortization	(3,320)	(4,746)	(6,484)	(9,645)
Loss on indemnification asset	(4,392)	(13,102)	(793)	(2,486)
Reductions (1)	(9,101)	(7,763)	(13,912)	(20,592)
Balance, end of period	\$ 68,038	\$ 117,295	\$ 68,038	\$ 117,295

(1) The FDIC indemnification asset is reduced upon covered asset removals, funding of covered unfunded loan commitments, partial charge-offs and OREO write-downs.

Table of Contents

The indemnification asset amortization, gain on indemnification asset, and the impact of the reduction of indemnification asset for covered asset removals and funding of unfunded commitments are recognized in the FDIC loss sharing income or expense line item on the consolidated statements of income.

When a covered asset is charged-off or written down and is subject to FDIC reimbursement under the FDIC loss-sharing agreements, the Company records the estimated amount of reimbursement in an FDIC receivable account, which is classified in the Other Assets line of the consolidated balance sheet.

Segment Operations

The Company's reportable segments are Commercial and Private Banking, Wealth Management and Other. For a more complete description of the segments, including summary financial information, see Note 18, *Segment Results*, of the Notes to the Unaudited Consolidated Financial Statements.

Commercial and Private Banking

Net income for the Commercial and Private Banking segment increased to \$47.8 million for the second quarter of 2014 from \$36.9 million for the second quarter of 2013. Net income for the six months ended June 30, 2014 was \$87.2 million, up from \$72.2 million for the year-earlier period. The increase from the prior year quarter was largely due to higher net interest income and noninterest income, partially offset by a lower reversal of provision for losses on covered loans. Net interest income increased to \$208.4 million for the second quarter of 2014 from \$185.0 million for the year-earlier quarter. Net interest income for the six months ended June 30, 2014 increased to \$398.2 million from \$369.0 million for the same period in 2013. The increase in net interest income from the year-earlier periods was largely attributable to an increase in interest income from non-covered loans driven by loan growth and lower deposit rates. Average loans, excluding covered loans, increased to \$17.90 billion, or by 16 percent, for the second quarter of 2014 from \$15.38 billion for the year-earlier quarter. Average loans, excluding covered loans, increased to \$17.59 billion, or by 17 percent, for the six months ended June 30, 2014 from \$15.07 billion for the year-earlier period. Average covered loans were \$643.7 million for the second quarter of 2014, compared to \$909.7 million for the second quarter of 2013, and \$669.8 million for the first six months of 2014 compared to \$949.4 million for the same period in 2013. The growth in net interest income was also a result of an increase in deposits, as the Asset Liability Funding Center (*Funding Center*), which is used for funds transfer pricing, pays the business line units for generating deposits. Average deposits increased to \$25.58 billion for the three months ended June 30, 2014 from \$22.41 billion for the year-earlier quarter, and increased to \$25.32 billion for the six months ended June 30, 2014 from \$22.13 billion for the same period in 2013, reflecting a 14 percent increase for both respective periods. The growth in average deposits compared with the prior-year period was driven by new client relationships and growth in deposits of existing clients.

The segment recorded a \$1.0 million reversal of provision for credit losses on loans and leases, excluding covered loans, for the three months and six months ended June 30, 2014, while no provision was recorded for the same periods in 2013. On covered loans, the segment recorded a \$1.5 million reversal of provision for losses and a \$3.2 million provision during the three months and six months ended June 30, 2014, respectively, compared to an \$11.9 million and \$2.0 million reversal of provision for losses during the three months and six months ended June 30, 2013, respectively. Refer to *Results of Operations Provision for Credit Losses* and *Balance Sheet Analysis Loan and Lease Portfolio Asset Quality* included elsewhere in this report for further discussion of the provision. Refer to *Results of Operations Covered Assets* included elsewhere in this report for further discussion of the provision for losses on covered loans.

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Noninterest income for the second quarter of 2014 was \$40.9 million, up 34 percent from \$30.6 million for the prior-year quarter. Noninterest income for the six months ended June 30, 2014 increased 10 percent to \$89.1 million compared to \$80.8 million for the year-earlier period. The increase from the prior periods was due primarily to the sale of assets that served as collateral for previously charged-off loans, as well as higher gains recognized on the sale of covered and non-covered OREO. Noninterest expense, including depreciation and amortization, increased to \$182.7 million, or by 4 percent, for the second quarter of 2014 from \$174.9 million for the year-earlier quarter. Noninterest expense, including depreciation and amortization, increased to \$357.6 million, or by 2 percent, for the first half of 2014 from \$349.4 million for the same period in 2013.

Table of Contents

Wealth Management

The Wealth Management segment had net income attributable to CNC of \$7.3 million for the second quarter of 2014, an increase from net income of \$5.4 million for the year-earlier quarter. Net income attributable to CNC for the six months ended June 30, 2014 was \$13.5 million compared to \$9.8 million for the year-earlier period. Noninterest income increased 19 percent to \$69.5 million for the second quarter of 2014 from \$58.5 million for the year-earlier quarter, and by 17 percent to \$133.6 million for the six months ended June 30, 2014 from \$113.9 million for the same period in 2013. The increases from the year-earlier periods were mainly due to higher wealth management fees, driven by asset inflows and equity markets appreciation. Additionally, second quarter 2014 brokerage and mutual fund fees included the recognition of \$3.8 million in performance fees related to the merger of two funds. Refer to Results of Operations Noninterest Income Wealth Management included elsewhere in this report for further discussion of the factors impacting fee income for the Wealth Management segment. Noninterest expense, including depreciation and amortization, was \$58.9 million for the second quarter of 2014, an increase of 16 percent from \$50.6 million for the year-earlier quarter. Noninterest expense, including depreciation and amortization, increased 14 percent to \$113.4 million in the first six months of 2014 from \$99.5 million in the year-earlier period. The increase in expense compared with the year-earlier period was primarily due to higher incentive compensation expense and sub-advisory expenses, which included \$1.9 million in expense related to the merged funds.

Other

Net income for the Other segment decreased to \$11.7 million for the second quarter of 2014 from \$17.4 million for the second quarter of 2013. Net income decreased to \$20.5 million for the six months ended June 30, 2014, from \$29.3 million for the same period in 2013. The decrease in net income was due mostly to lower net interest income, partially offset by lower noninterest expense. Net interest income was \$10.2 million and \$19.9 million for the three and six months ended June 30, 2014, respectively, down from \$17.6 million and \$34.4 million for the same periods in 2013. The Funding Center, which is included in the Other segment and is used for funds transfer pricing, charges the business line units for loans and pays them for generating deposits. During the second quarter of 2014, funding credit given to the Commercial and Private Banking segment increased compared with the year-earlier quarter due to higher average deposit balances. Also, funding charges applied to loan balances in the lending units remain low due to the low interest rate environment. Both of these circumstances resulted in lower net interest income in the Other segment and higher net interest income in the Commercial and Private Banking segment.

Noninterest income (loss) increased to (\$9.3) million for the current quarter from (\$6.8) million for the year-earlier quarter. Noninterest income (loss) increased to (\$20.4) million for the six months ended June 30, 2014 from (\$19.0) million for the year-earlier period. The change in noninterest income (loss) for the three and six months ended June 30, 2014 compared with the same periods in 2013 was primarily due to an increase in the elimination of inter-segment revenues (recorded in the Other segment) due to higher wealth management income compared to the year-earlier periods.

Income Taxes

The Company recognized income tax expense of \$29.8 million during the second quarter of 2014, compared with tax expense of \$26.3 million in the first quarter of 2014 and \$25.4 million in the year-earlier quarter. The effective tax rate was 30.7 percent of pretax income for the second quarter of 2014, compared with 32.3 percent for the first quarter of 2014 and 29.7 percent for the year-earlier quarter. The lower tax rate during the second quarter of 2014, when compared to the prior quarter was attributable to tax refunds resulting from ordinary tax audits during 2014. The effective tax rates differ from the applicable statutory federal and state tax rates due to various factors, including tax benefits from investments in affordable housing partnerships, tax-exempt income on municipal bonds, bank-owned life insurance and other adjustments. See Note 13, *Income Taxes*, of the Notes to the Unaudited Consolidated Financial Statements for further discussion of income taxes.

BALANCE SHEET ANALYSIS

Total assets were \$30.82 billion at June 30, 2014, an increase of 13 percent from \$27.38 billion at June 30, 2013 and 4 percent from \$29.72 billion at December 31, 2013. Average assets for the second quarter of 2014 increased to \$29.98 billion from \$27.47 billion for the second quarter of 2013. Total average interest-earning assets for the second quarter of 2014 were \$28.28 billion, up from \$25.82 billion for the second quarter of 2013. The increase in assets from the year-earlier quarter primarily reflects higher loan balances.

Table of Contents**Securities**

At June 30, 2014, the Company had total securities of \$8.83 billion, comprised of securities available-for-sale at fair value of \$5.33 billion, securities held-to-maturity at amortized cost of \$3.42 billion and trading securities at fair value of \$86.1 million. The Company had total securities of \$9.28 billion at December 31, 2013, comprised of securities available-for-sale at fair value of \$6.24 billion, securities held-to-maturity at amortized cost of \$2.96 billion and trading securities at fair value of \$82.4 million. At June 30, 2013, the Company had total securities of \$8.60 billion, comprised of securities available-for-sale at fair value of \$7.04 billion, securities held-to-maturity at amortized cost of \$1.50 billion and trading securities at fair value of \$48.7 million. The increase in the held-to-maturity category from the year-earlier quarter was due primarily to the transfer of \$994.3 million of debt securities from the available-for-sale category to the held-to-maturity category during the fourth quarter of 2013. The transfer was made as part of a change in the Company's strategy to mitigate the potential volatility of higher interest rates on market values in the available-for-sale securities portfolio. The decrease in total securities from December 31, 2013 is due to growth in loan balances in excess of deposit growth.

The following is a summary of amortized cost and estimated fair value for the major categories of securities available-for-sale and held-to-maturity:

(in thousands)	June 30, 2014		December 31, 2013		June 30, 2013	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available-for-sale:						
U.S. Treasury	\$ 36,213	\$ 36,258	\$ 35,312	\$ 35,335	\$ 30,293	\$ 30,285
Federal agency - Debt	1,027,192	1,026,516	1,417,509	1,410,536	987,467	980,025
Federal agency - MBS	121,501	123,229	156,399	157,226	422,699	438,182
CMOs - Federal agency	3,552,834	3,539,319	4,037,348	3,997,298	4,736,335	4,728,613
CMOs - Non-agency	27,168	26,903	38,383	37,462	47,079	45,327
State and municipal	384,359	392,593	407,312	415,995	457,869	466,760
Other debt securities	174,723	177,987	175,091	178,822	351,171	350,244
Total available-for-sale debt securities	5,323,990	5,322,805	6,267,354	6,232,674	7,032,913	7,039,436
Equity securities and mutual funds	621	5,687	337	8,443	337	5,135
Total available-for-sale securities	\$ 5,324,611	\$ 5,328,492	\$ 6,267,691	\$ 6,241,117	\$ 7,033,250	\$ 7,044,571
Securities held-to-maturity (1):						
Federal agency - Debt	\$ 302,918	\$ 306,381	\$ 178,413	\$ 173,424	\$ 109,562	\$ 108,033
Federal agency - MBS	554,421	559,691	445,360	434,435	315,529	308,011
CMOs - Federal agency	1,883,461	1,889,954	1,781,219	1,742,437	797,715	783,754
State and municipal	579,473	587,591	454,155	435,562	281,167	266,759
Other debt securities	98,080	98,367	98,696	98,077		
Total held-to-maturity securities	\$ 3,418,353	\$ 3,441,984	\$ 2,957,843	\$ 2,883,935	\$ 1,503,973	\$ 1,466,557

(1) Securities held-to-maturity are presented in the consolidated balance sheets at amortized cost.

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The average duration of the \$5.33 billion available-for-sale portfolio was 2.2 years at June 30, 2014, down from 3.2 years at June 30, 2013 and 2.4 years at December 31, 2013. The decrease in average duration reflects the transfer of debt securities from the available-for-sale category to the held-to-maturity category in the fourth quarter of 2013 and a rotation from longer-duration to shorter-duration securities in the available-for-sale portfolio. The decrease was also partly the result of the sale of some longer duration securities from the available-for-sale portfolio in the second half of 2013.

Changes in the fair value of securities available-for-sale will impact other comprehensive income, and thus shareholders' equity, on an after-tax basis. Securities held-to-maturity are presented in the consolidated balance sheets at amortized cost. Changes in the fair value of securities held-to-maturity do not have an impact on other comprehensive income. At June 30, 2014, the available-for-sale securities portfolio had a net unrealized gain of \$3.9 million, consisting of \$49.1 million of unrealized gains and \$45.2 million of unrealized losses. At December 31, 2013, the available-for-sale securities portfolio had a net unrealized loss of \$26.6 million, comprised of \$56.1 million of unrealized gains and \$82.6 million of unrealized losses. At June 30, 2013, the available-for-sale securities portfolio had a net unrealized gain of \$11.3 million, comprised of \$89.7 million of unrealized gains and \$78.4 million of unrealized losses. The net unrealized gain at June 30, 2014 compared to the net unrealized loss at December 31, 2013 was due to lower market rates. The decrease in the unrealized gain compared to June 30, 2013 was primarily due to an increase in medium and long-term interest rates as well as an overall decrease in the size of the available-for-sale portfolio.

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Table of Contents

The following table provides the expected remaining maturities of debt securities included in the securities portfolio at June 30, 2014, except for maturities of mortgage-backed securities which are allocated according to the average life of expected cash flows. Average expected maturities will differ from contractual maturities because of the amortizing nature of the loan collateral and prepayment behavior of borrowers.

(in thousands)	One year or less	Over 1 year through 5 years	Over 5 years through 10 years	Over 10 years	Total
Securities available-for-sale:					
U.S. Treasury	\$ 23,194	\$ 13,064	\$	\$	\$ 36,258
Federal agency - Debt	639,733	347,513	39,270		1,026,516
Federal agency - MBS		105,432	17,797		123,229
CMOs - Federal agency	98,070	3,236,456	204,793		3,539,319
CMOs - Non-agency	2,237	24,666			26,903
State and municipal	100,959	288,314		3,320	392,593
Other	58,751	119,236			177,987
Total debt securities available-for-sale	\$ 922,944	\$ 4,134,681	\$ 261,860	\$ 3,320	\$ 5,322,805
Amortized cost	\$ 919,336	\$ 4,135,324	\$ 265,930	\$ 3,400	\$ 5,323,990
Securities held-to-maturity:					
Federal agency - Debt	\$	\$ 26,000	\$ 86,170	\$ 190,748	\$ 302,918
Federal agency - MBS		75,854	467,171	11,396	554,421
CMOs - Federal agency		805,601	1,077,860		1,883,461
State and municipal		80,107	399,352	100,014	579,473
Other		98,080			98,080
Total debt securities held-to-maturity at amortized cost	\$	\$ 1,085,642	\$ 2,030,553	\$ 302,158	\$ 3,418,353

Impairment Assessment

The Company performs a quarterly assessment of the debt and equity securities held in its investment portfolio to determine whether a decline in fair value below amortized cost is other-than-temporary. If a decline in fair value is determined to be other-than-temporary, the cost basis of the individual security is written down to fair value which then becomes the security's new cost basis. The new cost basis is not adjusted for subsequent recoveries in fair value.

The Company recorded impairment losses in earnings on securities available-for-sale of \$0.2 million for the three and six months ended June 30, 2014 and 2013, respectively. The Company recognized \$0.3 million and \$0.2 million of non-credit-related other-than-temporary impairment in accumulated other comprehensive income or loss (AOCI) on securities available-for-sale at June 30, 2014 and 2013, respectively. No impairment losses were recognized in earnings or AOCI for securities held-to-maturity during the three and six months ended June 30, 2014 and 2013.

Of the total securities available-for-sale in an unrealized loss position at June 30, 2014, approximately \$739.0 million of securities with unrealized losses of \$2.0 million were in a continuous unrealized loss position for less than 12 months, and \$1.67 billion of securities with unrealized losses of \$43.2 million were in a continuous loss position for more than 12 months. Securities in a loss position and total gross unrealized losses were comprised mostly of federal agency CMOs and federal agency debt securities. At December 31, 2013, approximately

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\$2.71 billion of securities with unrealized losses of \$44.3 million were in a continuous unrealized loss position for less than 12 months and \$784.3 million of securities with unrealized losses of \$38.4 million were in a continuous loss position for more than 12 months. At June 30, 2013, approximately \$3.91 billion of securities with unrealized losses of \$72.6 million were in a continuous unrealized loss position for less than 12 months and \$27.7 million of securities with unrealized losses of \$5.8 million were in a continuous loss position for more than 12 months. Unrealized losses on debt securities generally decreased in the first half of 2014 compared to December 31, 2013 due to lower market interest rates. Unrealized losses decreased compared to the year-earlier period largely due to the decrease in the size of the available-for-sale portfolio.

Table of Contents

See Note 3, *Securities*, of the Notes to the Unaudited Consolidated Financial Statements for further disclosures related to the securities portfolio.

Loan and Lease Portfolio

A comparative period-end loan and lease table is presented below:

Loans and Leases

(in thousands) (1)	June 30, 2014	December 31, 2013	June 30, 2013
Commercial	\$ 8,230,112	\$ 7,562,300	\$ 6,910,175
Commercial real estate mortgages	3,464,918	3,223,001	2,978,975
Residential mortgages	4,814,435	4,554,311	4,153,051
Real estate construction	457,557	367,004	340,002
Home equity loans and lines of credit	716,816	709,344	700,681
Installment	183,518	151,955	149,438
Lease financing	607,432	602,523	586,930
Loans and leases, excluding covered loans	18,474,788	17,170,438	15,819,252
Less: Allowance for loan and lease losses	(311,276)	(302,584)	(289,914)
Loans and leases, excluding covered loans, net	18,163,512	16,867,854	15,529,338
Covered loans	605,770	716,911	867,996
Less: Allowance for loan losses	(9,103)	(15,922)	(24,414)
Covered loans, net	596,667	700,989	843,582
Total loans and leases	\$ 19,080,558	\$ 17,887,349	\$ 16,687,248
Total loans and leases, net	\$ 18,760,179	\$ 17,568,843	\$ 16,372,920

(1) Commercial loans as of December 31, 2013 and June 30, 2013 have been corrected to include \$158.2 million and \$136.3 million, respectively, of loans that were previously reported as lease financing. Real estate construction loans as of June 30, 2013 have been corrected to include \$122.2 million of loans that were previously reported as commercial real estate mortgages.

Total loans and leases were \$19.08 billion, \$17.89 billion and \$16.69 billion at June 30, 2014, December 31, 2013 and June 30, 2013, respectively. Total loans, excluding covered loans, were \$18.47 billion, \$17.17 billion and \$15.82 billion at June 30, 2014, December 31, 2013 and June 30, 2013, respectively.

Total loans and leases, excluding covered loans, at June 30, 2014 increased 8 percent from December 31, 2013 and 17 percent from June 30, 2013. Commercial loans, including lease financing, were up 8 percent from year-end 2013 and 18 percent from the year-earlier quarter. Commercial real estate mortgage loans increased by 8 percent from year-end 2013 and 16 percent from the year-earlier quarter. Residential mortgages grew by 6 percent and 16 percent from the same periods, respectively. Real estate construction loans increased 25 percent from

year-end 2013 and 35 percent from the second quarter of 2013.

Covered Loans

Covered loans represent loans acquired from the FDIC that are subject to loss-sharing agreements and were \$605.8 million at June 30, 2014, \$716.9 million as of December 31, 2013 and \$868.0 million as of June 30, 2013. Covered loans, net of allowance for loan losses, were \$596.7 million as of June 30, 2014, \$701.0 million as of December 31, 2013 and \$843.6 million as of June 30, 2013.

Table of Contents

The following is a summary of the major categories of covered loans:

(in thousands)	June 30, 2014	December 31, 2013	June 30, 2013
Commercial	\$ 6,992	\$ 10,009	\$ 8,675
Commercial real estate mortgages	568,902	666,628	789,521
Residential mortgages	5,525	4,976	5,560
Real estate construction	20,742	31,184	60,007
Home equity loans and lines of credit	3,342	3,695	3,673
Installment	267	419	560
Covered loans	605,770	716,911	867,996
Less: Allowance for loan losses	(9,103)	(15,922)	(24,414)
Covered loans, net	\$ 596,667	\$ 700,989	\$ 843,582

Other

To grow loans and diversify and manage concentration risk of the Company's loan portfolio, the Company purchases and sells participations in loans. Included in this portfolio are purchased participations in Shared National Credits (SNC). Purchased SNC commitments at June 30, 2014 totaled \$3.79 billion or 14 percent of total loan commitments, compared to \$3.49 billion or 13 percent at December 31, 2013 and \$3.11 billion or 13 percent at June 30, 2013. Outstanding loan balances on purchased SNCs were \$1.83 billion, or approximately 10 percent of total loans outstanding, excluding covered loans, at June 30, 2014, compared to \$1.60 billion or 9 percent at December 31, 2013 and \$1.39 billion or 9 percent at June 30, 2013.

Bank regulatory guidance on risk management practices for financial institutions with high or increasing concentrations of commercial real estate (CRE) loans on their balance sheets emphasizes the need for sound internal risk management practices for those institutions that have experienced rapid growth in CRE lending, have notable exposure to specific types of CRE, or are approaching or exceeding the supervisory criteria used to evaluate CRE concentration risk. The supervisory criteria are: total reported loans for construction, land development and other land represent 100 percent of the institution's total risk-based capital, and both total CRE loans represent 300 percent or more of the institution's total risk-based capital and the institution's CRE loan portfolio has increased 50 percent or more within the last 36 months. As of June 30, 2014, total loans for construction, land development and other land represented 17 percent of total risk-based capital; total CRE loans represented 126 percent of total risk-based capital and the total portfolio of loans for construction, land development, other land and CRE increased 9 percent over the last 36 months.

Asset Quality*Credit Risk Management*

The Company has a comprehensive methodology to monitor credit quality and prudently manage credit concentration within each portfolio. The methodology includes establishing concentration limits to ensure that the loan portfolio is diversified. The limits are evaluated quarterly and are intended to mitigate the impact of any segment on the Company's capital and earnings. The limits cover major industry groups, geography, product type, loan size and customer relationship. Additional sub-limits are established for certain industries where the bank has higher

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exposure. The concentration limits are approved by the Bank's Credit Policy Committee and reviewed annually by the Audit & Risk Committee of the Board of Directors.

The loan portfolios are monitored through delinquency tracking and a dynamic risk rating process that is designed to detect early signs of deterioration. In addition, once a loan has shown signs of deterioration, it is transferred to a Special Assets Department that consists of professionals who specialize in managing problem assets. An oversight group meets quarterly or more frequently to review the progress of problem loans and OREO. Also, the Company has established portfolio review requirements that include a periodic review and risk assessment by the Risk Management Division that reports to the Audit & Risk Committee of the Board of Directors.

Table of Contents

Geographic Concentrations and Economic Trends by Geographic Region

Although the Company's lending activities are predominantly in California, and to a lesser extent, New York and Nevada, the Company has various specialty lending businesses that lend to businesses located throughout the United States of America. Excluding covered loans, California represented 73 percent of total loans outstanding and New York and Nevada represented 9 percent and 2 percent, respectively, as of June 30, 2014. The remaining 16 percent of total loans outstanding represented other states. Concentrations of credit risk arise when a number of clients are engaged in similar business activities, or activities in the same geographic region, or have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic conditions. Although the Company has a diversified loan portfolio, a substantial portion of the loan portfolio and credit performance depends on the economic stability of California. The Company has most of its loans in large metropolitan California cities such as Los Angeles, San Francisco and San Diego, rather than in the outlying suburban communities that have seen higher declines in real estate values during the recession. Within the Company's Commercial loan portfolio, the five California counties with the largest exposures at June 30, 2014 are Los Angeles (39 percent), Orange (5 percent), San Diego (3 percent), San Bernardino (2 percent) and Ventura (2 percent). Within the Commercial Real Estate Mortgage loan portfolio, the five California counties with the largest exposures are Los Angeles (35 percent), Orange (8 percent), San Diego (8 percent), Santa Clara (4 percent) and San Bernardino (4 percent). For the Real Estate Construction loan portfolio, the concentration in California is predominately in Los Angeles (26 percent), San Diego (14 percent), Orange (12 percent), Ventura (8 percent) and Alameda (7 percent).

Within the Company's covered loan portfolio at June 30, 2014, the five states with the largest concentration were California (35 percent), Texas (12 percent), Nevada (7 percent), Arizona (6 percent) and Ohio (5 percent). The remaining 35 percent of total covered loans outstanding represented other states.

Allowance for Loan and Lease Losses and Reserve for Off-Balance Sheet Credit Commitments

A consequence of lending activities is that losses may be experienced. The amount of such losses will vary from time to time depending upon the risk characteristics of the loan portfolio as affected by economic conditions, changing interest rates, and the financial performance of borrowers. The allowance for loan and lease losses and the reserve for off-balance sheet credit commitments which provide for the risk of losses inherent in the credit extension process, are increased by the provision for credit losses charged to operating expense. The allowance for loan and lease losses is decreased by the amount of charge-offs, net of recoveries. There is no exact method of predicting specific losses or amounts that ultimately may be charged off on particular segments of the loan portfolio.

The Company has an internal credit risk analysis and review staff that issues reports to the Audit & Risk Committee of the Board of Directors and continually reviews loan quality. This analysis includes a detailed review of the classification and categorization of problem loans, potential problem loans and loans to be charged off, an assessment of the overall quality and collectability of the portfolio, consideration of the credit loss experience, trends in problem loans and concentration of credit risk, as well as current economic conditions, particularly in California. Management then evaluates the allowance, determines its appropriate level and the need for additional provisions, and presents its analysis to the Audit & Risk Committee which ultimately reviews and approves management's recommendation.

The provision is the expense recognized in the consolidated statements of income to adjust the allowance and reserve to the level deemed appropriate by management, as determined through application of the Company's allowance methodology procedures. See "Critical Accounting Policies - Allowance for Loan and Lease Losses and Reserve for Off-Balance Sheet Credit Commitments" in the Company's 2013 Annual Report on Form 10-K. The process used for determining the adequacy of the reserve for off-balance sheet credit commitments is consistent with the process for the allowance for loan and lease losses.

Table of Contents

The following table summarizes activity in the allowance for loan and lease losses and the reserve for off-balance sheet credit commitments, excluding covered loans, for the three and six months ended June 30, 2014 and 2013. Activity is provided by loan type which is consistent with the Company's methodology for determining the allowance for loan and lease losses:

Changes in Allowance for Loan and Lease Losses

(in thousands)	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Loans and leases outstanding, excluding covered loans	\$ 18,474,788	\$ 15,819,252	\$ 18,474,788	\$ 15,819,252
Average loans and leases outstanding, excluding covered loans	\$ 17,959,191	\$ 15,434,102	\$ 17,650,520	\$ 15,123,447
Allowance for loan and lease losses (1)				
Balance, beginning of period	\$ 305,790	\$ 282,328	\$ 302,584	\$ 277,888
Loan charge-offs:				
Commercial	(12,862)	(2,869)	(14,821)	(4,231)
Commercial real estate mortgages			(5)	(45)
Residential mortgages		(1)	(482)	(106)
Real estate construction		(100)		(100)
Home equity loans and lines of credit	(149)	(35)	(165)	(275)
Installment	(142)	(81)	(188)	(352)
Total charge-offs	(13,153)	(3,086)	(15,661)	(5,109)
Recoveries of loans previously charged-off:				
Commercial	7,503	5,724	9,235	9,259
Commercial real estate mortgages	27	1,034	127	1,082
Residential mortgages	190	38	225	75
Real estate construction	687	2,782	5,075	5,448
Home equity loans and lines of credit	43	410	202	538
Installment	1,068	603	1,332	1,020
Total recoveries	9,518	10,591	16,196	17,422
Net (charge-offs) recoveries	(3,635)	7,505	535	12,313
(Reversal of) provision for credit losses	(1,000)		(1,000)	
Transfers from (to) reserve for off-balance sheet credit commitments	10,121	81	9,157	(287)
Balance, end of period	\$ 311,276	\$ 289,914	\$ 311,276	\$ 289,914
Net (charge-offs) recoveries to average loans and leases, excluding covered loans (annualized)	(0.08)%	0.20%	0.01%	0.16%
Allowance for loan and lease losses to total period-end loans and leases, excluding covered loans	1.68%	1.83%	1.68%	1.83%
Reserve for off-balance sheet credit commitments				
Balance, beginning of period	\$ 34,908	\$ 25,205	\$ 33,944	\$ 24,837
Transfers (to) from allowance	(10,121)	(81)	(9,157)	287
Balance, end of period	\$ 24,787	\$ 25,124	\$ 24,787	\$ 25,124

(1) The allowance for loan and lease losses in this table excludes amounts related to covered loans.

Table of Contents

During the economic recession, the Company recognized significant charge-offs from 2008 to 2010. Total loan charge-offs have declined significantly in recent years compared to prior periods due to improving economic and business conditions in the markets served by the Company. Higher loan recoveries in recent years were largely due to increases in the value of real estate collateral, improvements in the financial condition of the Company's clients and guarantors, and increases in recoveries related to the use of legal remedies available to the Company. Recoveries occurred throughout the loan portfolio; however the majority of recoveries during the last few years relate to a small group of credit relationships and were primarily concentrated in the commercial and real estate construction portfolios. Approximately 64 percent of total recoveries during the second quarter of 2014 were related to two credit relationships.

The timing and amount of recoveries is inherently uncertain, imprecise and potentially volatile and is subject to a variety of factors, including but not limited to: general economic conditions, the willingness and financial capacity of the borrower, guarantors or third parties; additional changes in the realizable value of the collateral between the date of charge-off and the date of recovery, and the legal remedies available to the Company needed to effect recovery.

Based on an evaluation of individual credits, previous loan and lease loss experience, management's evaluation of the current loan portfolio, and current economic conditions, management has allocated the allowance for loan and lease losses on non-covered loans for June 30, 2014, December 31, 2013 and June 30, 2013 as shown in the table below:

(in thousands) (1)	Allowance amount			Percentage of total allowance		
	June 30, 2014	December 31, 2013	June 30, 2013	June 30, 2014	December 31, 2013	June 30, 2013
Commercial and lease financing	\$ 126,279	\$ 117,103	\$ 116,619	41%	38%	40%
Commercial real estate mortgages	50,651	50,678	53,339	16	17	18
Residential mortgages	10,296	11,540	8,004	3	4	3
Real estate construction	7,191	6,351	8,335	2	2	3
Home equity loans and lines of credit	6,575	6,677	5,400	2	2	2
Installment	2,284	1,842	1,355	1	1	1
Qualitative	108,000	108,393	96,862	35	36	33
Total	\$ 311,276	\$ 302,584	\$ 289,914	100%	100%	100%

(1) Certain balances as of June 30, 2013 have been revised as a result of correcting the real estate construction loan balance to include loans that were previously reported as commercial real estate mortgages.

The Company has a qualitative factor matrix to determine the amount of reserves needed for judgmental factors that are not attributable to or reflected in quantitative models. Examples of these factors include industry concentration, size of loans, general business and economic environment, internal systems and procedures, credit quality trends, changes in underwriting standards, risk appetite, loan growth and acquisitions. The qualitative factor matrix is divided into three segments: CRE, Commercial and Consumer. For each segment, the matrix evaluates the qualitative factors that could cause the quantitative models to vary from historic loss values. Each factor is assigned a risk level and a risk weight in points which is aggregated to determine the level of qualitative reserves. The factors are updated and supported quarterly to reflect changing conditions. At June 30, 2014, the Company had total qualitative reserves of \$108.0 million, of which \$28.7 million, \$52.1 million and \$27.2 million were assigned to the CRE, Commercial and Consumer segments, respectively. Currently, the primary drivers of the qualitative reserves are uncertainty in the macroeconomic environment, industry concentration, loan size and loan growth.

Nonaccrual loans, excluding covered loans, were \$64.8 million at June 30, 2014, down from \$68.7 million at December 31, 2013 and \$76.7 million at June 30, 2013. Net loan charge-offs were \$3.6 million in the second quarter of 2014 and net loan recoveries were \$0.5 million for the six months ended June 30, 2014, compared to net loan recoveries of \$7.5 million and \$12.3 million for the same periods in 2013. Classified loans were \$226.1 million at June 30, 2014, down from \$315.5 million at December 31, 2013 and \$351.3 million at June 30, 2013. In accordance with the Company's allowance for loan and lease losses methodology and in response to continuing credit quality improvement, the Company recorded a \$1.0 million reversal of provision for loan and lease losses for the three months ended June 30, 2014. The Company recorded no provision in the first quarter of 2014 and second quarter of 2013. The reversal of provision for the current quarter reflects management's ongoing assessment of the credit quality of the loan portfolio. Credit quality continued to improve in the second quarter of 2014 as evidenced by the decline in nonaccrual and classified loans from the prior and year-earlier quarters.

Table of Contents

The allowance for loan and lease losses, excluding covered loans, was \$311.3 million as of June 30, 2014, compared with \$302.6 million as of December 31, 2013 and \$289.9 million as of June 30, 2013. The ratio of the allowance for loan and lease losses as a percentage of total loans and leases, excluding covered loans, was 1.68 percent at June 30, 2014, compared to 1.76 percent at December 31, 2013 and 1.83 percent at June 30, 2013. The allowance for loan and lease losses as a percentage of nonperforming assets, excluding covered assets, was 450.79 percent, 372.36 percent and 300.90 percent at June 30, 2014, December 31, 2013 and June 30, 2013, respectively. The Company believes that its allowance for loan and lease losses continues to be appropriate.

The following table summarizes the activity in the allowance for loan losses on covered loans for the three and six months ended June 30, 2014 and 2013:

(in thousands)	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Balance, beginning of period	\$ 18,439	\$ 42,354	\$ 15,922	\$ 44,781
(Reversal of) provision for losses	(1,461)	(11,927)	3,194	(2,035)
Reduction in allowance due to loan removals	(7,875)	(6,013)	(10,013)	(18,332)
Balance, end of period	\$ 9,103	\$ 24,414	\$ 9,103	\$ 24,414

The allowance for losses on covered loans was \$9.1 million as of June 30, 2014, compared to \$15.9 million at December 31, 2013 and \$24.4 million at June 30, 2013. As a result of improvements in the portfolio's credit quality and general market conditions, the Company recorded a \$1.5 million reversal of provision for losses on covered loans during the three months ended June 30, 2014. Provision expense was \$3.2 million for the six months ended June 30, 2014. The Company recorded an \$11.9 million and \$2.0 million reversal of provision during the three and six months ended June 30, 2013, respectively. The Company updates its cash flow projections for covered loans accounted for under ASC 310-30 on a quarterly basis, and may recognize provision expense or reversal of provision for loan losses as a result of that analysis. The provision expense or reversal of provision for losses on covered loans is the result of changes in expected cash flows, both in amount and timing, due to actual loan performance and the Company's revised loan loss and prepayment forecasts. The revisions of these forecasts were based on the results of management's review of the market conditions, the credit quality of the outstanding covered loans and the analysis of loan performance data since the acquisition of covered loans. The allowance for loan losses on covered loans is reversed for any loan removals, which occur when a loan has been fully paid off, fully charged off, sold or transferred to OREO.

Impaired Loans

Loans, other than those included in large groups of smaller-balance homogeneous loans, are considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement, including scheduled interest payments. The assessment for impairment occurs when and while such loans are on nonaccrual, or when the loan has been restructured. When a loan with unique risk characteristics has been identified as being impaired, the amount of impairment will be measured by the Company using discounted cash flows, except when it is determined that the primary (remaining) source of repayment for the loan is the operation or liquidation of the underlying collateral. In these cases, the current fair value of the collateral, reduced by costs to sell, will be used in place of discounted cash flows. As a final alternative, the observable market price of the debt may be used to assess impairment.

If the measurement of the impaired loan is less than the recorded investment in the loan (including accrued interest, net deferred loan fees or costs and unamortized premium or discount), an impairment allowance is recognized by creating or adjusting the existing allocation of the

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allowance for loan and lease losses. Interest payments received on impaired loans are generally applied as follows: (1) to principal if the loan is on nonaccrual principal recapture status, (2) to interest income if the loan is on cash basis nonaccrual and (3) to interest income if the impaired loan has been returned to accrual status.

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Table of Contents

The following table presents information on impaired loans as of June 30, 2014, December 31, 2013 and June 30, 2013. Loan and lease balances reflect the recorded investment as of the reporting date.

(in thousands)	June 30, 2014		December 31, 2013		June 30, 2013	
	Loans and Leases	Related Allowance	Loans and Leases	Related Allowance	Loans and Leases	Related Allowance
Impaired loans, excluding covered loans (1):						
Impaired loans with an allowance	\$ 31,525	\$ 8,833	\$ 21,194	\$ 3,025	\$ 24,444	\$ 2,960
Impaired loans with no related allowance	58,090		79,470		94,085	
Total impaired loans, excluding covered loans	\$ 89,615		\$ 100,664		\$ 118,529	
Total impaired loans by loan type:						
Commercial	\$ 29,231	\$ 8,477	\$ 31,857	\$ 1,961	\$ 34,915	\$ 478
Commercial real estate mortgages	33,456	301	38,154	586	41,932	2,252
Residential mortgages	10,596	5	9,211	478	7,979	230
Real estate construction	12,846		19,097		30,446	
Home equity loans and lines of credit	3,436		2,329		3,257	
Installment	50	50	16			
Total impaired loans, excluding covered loans	\$ 89,615	\$ 8,833	\$ 100,664	\$ 3,025	\$ 118,529	\$ 2,960

(1) Impaired loans include \$34.7 million, \$42.1 million and \$54.3 million of loans that are on accrual status at June 30, 2014, December 31, 2013 and June 30, 2013, respectively.

The recorded investment in impaired loans, excluding covered loans, was \$89.6 million at June 30, 2014, \$100.7 million at December 31, 2013 and \$118.5 million at June 30, 2013. There were no impaired covered loans at June 30, 2014, December 31, 2013 or June 30, 2013.

Troubled Debt Restructured Loans

At June 30, 2014, troubled debt restructured loans were \$45.4 million, before specific reserves of \$1.6 million. Troubled debt restructured loans were \$52.2 million, before specific reserves of \$0.8 million, at December 31, 2013 and \$64.4 million, before specific reserves of \$0.6 million, at June 30, 2013. Troubled debt restructured loans included \$22.0 million, \$25.8 million and \$38.7 million of restructured loans on accrual status at June 30, 2014, December 31, 2013 and June 30, 2013, respectively. At June 30, 2014, commitments to lend additional funds on restructured loans totaled \$0.2 million.

Nonaccrual and Past Due Loans

Total nonperforming assets (nonaccrual loans and OREO), excluding covered assets, were \$69.1 million, or 0.37 percent of total loans and OREO, excluding covered assets, at June 30, 2014, compared with \$81.3 million, or 0.47 percent, at December 31, 2013, and \$96.3 million, or 0.61 percent, at June 30, 2013. Total nonperforming covered assets (nonaccrual covered loans and covered OREO) were \$17.9 million at June 30, 2014, \$25.5 million at December 31, 2013 and \$41.8 million at June 30, 2013.

Company policy requires that a loan be placed on nonaccrual status if either principal or interest payments are 90 days past due, unless the loan is both well secured and in process of collection, or if full collection of interest or principal becomes uncertain regardless of the time period involved. Covered loans accounted for under ASC 310-30 are generally considered accruing and performing loans as the loans accrete interest income over the estimated life of the loan when cash flows are reasonably estimable. Accordingly, acquired impaired covered loans that are contractually past due are still considered to be accruing and performing loans. If the timing and amount of future cash flows is not reasonably estimable, the loans may be classified as nonaccrual loans and interest income is not recognized until the timing and amount of future cash flows can be reasonably estimated.

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Table of Contents

Loans are considered past due following the date when either interest or principal is contractually due and unpaid. A summary of past due loans, excluding loans on nonaccrual status, is provided below:

(in thousands)	June 30, 2014	December 31, 2013	June 30, 2013
Past due loans, excluding covered loans			
30-89 days past due	\$ 13,644	\$ 11,116	\$ 20,420
90 days or more past due on accrual status:			
Commercial real estate mortgages	1,418		
Residential mortgages	379	379	379
Home equity loans and lines of credit		74	249
Installment	4		
Lease financing			15
Total 90 days or more past due on accrual status	\$ 1,801	\$ 453	\$ 643
Past due covered loans			
30-89 days past due	\$ 11,572	\$ 15,494	\$ 3,107
90 days or more past due on accrual status	31,011	45,662	89,439

The following table presents information on nonaccrual loans and OREO as of June 30, 2014, December 31, 2013 and June 30, 2013:

(in thousands)	June 30, 2014	December 31, 2013	June 30, 2013
Nonperforming assets, excluding covered assets			
Nonaccrual loans, excluding covered loans			
Commercial	\$ 27,314	\$ 14,248	\$ 11,654
Commercial real estate mortgages	9,216	18,449	22,433
Residential mortgages	9,031	11,661	10,580
Real estate construction	12,834	19,067	25,718
Home equity loans and lines of credit	6,090	5,144	6,239
Installment	125	32	24
Lease financing	172	50	25
Total nonaccrual loans, excluding covered loans	64,782	68,651	76,673
OREO, excluding covered OREO	4,269	12,611	19,676
Total nonperforming assets, excluding covered assets	\$ 69,051	\$ 81,262	\$ 96,349
Nonperforming covered assets			
OREO	\$ 17,944	\$ 25,481	\$ 41,801
Ratios (excluding covered assets):			
Nonaccrual loans as a percentage of total loans	0.35%	0.40%	0.48%
Nonperforming assets as a percentage of total loans and OREO	0.37	0.47	0.61
Allowance for loan and lease losses to nonaccrual loans	480.50	440.76	378.12
Allowance for loan and lease losses to total nonperforming assets	450.79	372.36	300.90

All nonaccrual loans greater than \$1 million are considered impaired and are individually analyzed. The Company does not maintain a reserve for impaired loans where the carrying value of the loan is less than the fair value of the collateral, reduced by costs to sell. Where the carrying value of the impaired loan is greater than the fair value of the collateral, less costs to sell, the Company specifically establishes an allowance for

loan and lease losses to cover the deficiency. This analysis ensures that the non-accruing loans have been appropriately reserved.

Table of Contents

The table below summarizes the total activity in non-covered and covered nonaccrual loans for the three and six months ended June 30, 2014 and 2013:

Changes in Nonaccrual Loans

(in thousands)	For the three months ended June 30,			For the six months ended June 30,		
	2014	2013		2014	2013	
Balance, beginning of the period	\$ 71,245	\$ 83,275		\$ 68,651	\$ 99,787	
Loans placed on nonaccrual	11,542	22,081		24,097	25,927	
Net (charge-offs) recoveries	(239)	133		(2,159)	5,966	
Loans returned to accrual status	(3,961)	(346)		(5,443)	(11,458)	
Repayments (including interest applied to principal)	(13,694)	(28,218)		(20,253)	(42,915)	
Transfers to OREO	(111)	(252)		(111)	(634)	
Balance, end of the period	\$ 64,782	\$ 76,673		\$ 64,782	\$ 76,673	

In addition to loans disclosed above as past due or nonaccrual, management has also identified \$19.6 million of credit facilities to 17 borrowers as of July 28, 2014, where the ability to comply with the present loan payment terms in the future is questionable. However, the inability of the borrowers to comply with repayment terms was not sufficiently probable to place the loan on nonaccrual status at June 30, 2014, and the identification of these loans is not necessarily indicative of whether the loans will be placed on nonaccrual status. This amount was determined based on analysis of information known to management about the borrowers' financial condition and current economic conditions. In the Form 10-Q for the period ended March 31, 2014, the Company reported that management had identified \$51.4 million of loans to 16 borrowers where the ability to comply with the loan payment terms in the future was questionable. Management's classification of credits as nonaccrual, restructured or problems does not necessarily indicate that the principal is uncollectible in whole or part.

Other Real Estate Owned

The following tables provide a summary of OREO activity for the three and six months ended June 30, 2014 and 2013:

(in thousands)	For the three months ended June 30, 2014			For the three months ended June 30, 2013		
	Non-Covered OREO	Covered OREO	Total	Non-Covered OREO	Covered OREO	Total
Balance, beginning of period	\$ 9,412	\$ 24,855	\$ 34,267	\$ 19,786	\$ 43,751	\$ 63,537
Additions	110	1,987	2,097	341	4,612	4,953
Sales	(5,253)	(7,964)	(13,217)	(390)	(4,378)	(4,768)
Valuation adjustments		(934)	(934)	(61)	(2,184)	(2,245)
Balance, end of period	\$ 4,269	\$ 17,944	\$ 22,213	\$ 19,676	\$ 41,801	\$ 61,477

(in thousands)	For the six months ended June 30, 2014		For the six months ended June 30, 2013	
	Total	Total	Total	Total

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	Non-Covered OREO		Covered OREO		Non-Covered OREO		Covered OREO					
Balance, beginning of period	\$	12,611	\$	25,481	\$	38,092	\$	21,027	\$	58,276	\$	79,303
Additions		111		4,020		4,131		723		13,906		14,629
Sales		(8,439)		(10,468)		(18,907)		(1,781)		(25,162)		(26,943)
Valuation adjustments		(14)		(1,089)		(1,103)		(293)		(5,219)		(5,512)
Balance, end of period	\$	4,269	\$	17,944	\$	22,213	\$	19,676	\$	41,801	\$	61,477

OREO was \$22.2 million at June 30, 2014, \$38.1 million at December 31, 2013 and \$61.5 million at June 30, 2013, respectively. The OREO balance at June 30, 2014 includes covered OREO of \$17.9 million, compared with \$25.5 million at December 31, 2013 and \$41.8 million at June 30, 2013. The balance of OREO at June 30, 2014, December 31, 2013 and June 30, 2013 is net of valuation allowances of \$11.1 million, \$17.4 million and \$28.7 million, respectively.

Table of Contents

The Company recognized \$6.9 million in total net gain on the sale of OREO in the second quarter of 2014, compared to \$2.8 million in the first quarter of 2014 and \$0.8 million in the year-earlier quarter. Net gain on the sale of OREO in the second quarter of 2014 included \$2.6 million of net gain related to the sale of covered OREO, compared to \$0.4 million in the first quarter of 2014 and \$0.6 million in the year-earlier quarter.

Covered OREO expenses and valuation write-downs are recorded in the noninterest expense section of the consolidated statements of income and gains or losses on sale of covered OREO are recognized in the noninterest income section. Under the loss sharing agreements, 80 percent of eligible covered OREO expenses, valuation write-downs, and losses on sales are reimbursable to the Company from the FDIC and 80 percent of covered gains on sales are payable to the FDIC. The portion of these expenses that is reimbursable or income that is payable is recorded in FDIC loss sharing income (expense), net in the noninterest income section of the consolidated statements of income.

Other Assets

The following table presents information on other assets:

(in thousands)	June 30, 2014	December 31, 2013	June 30, 2013
Accrued interest receivable	\$ 74,250	\$ 70,346	\$ 70,154
Deferred compensation fund assets	88,613	81,058	73,433
Stock in government agencies	58,376	64,354	77,962
Private equity and alternative investments	29,748	33,952	34,942
Bank-owned life insurance	86,694	85,596	84,243
Derivative assets	43,264	34,613	40,066
Income tax receivable			13,296
FDIC (payable) receivable	(4,249)	2,782	1,482
Equipment on operating leases, net	26,085	31,982	27,677
Other	96,380	101,484	102,378
Total other assets	\$ 499,161	\$ 506,167	\$ 525,633

Deposits

Deposits totaled \$26.65 billion, \$25.68 billion and \$23.65 billion at June 30, 2014, December 31, 2013 and June 30, 2013, respectively. Average deposits totaled \$25.91 billion for the second quarter of 2014, a slight decrease from \$25.94 billion for the fourth quarter of 2013 and an increase of 12 percent from \$23.12 billion for the second quarter of 2013. Core deposits, which include noninterest-bearing deposits and interest-bearing deposits excluding time deposits of \$100,000 and over, provide a stable source of low cost funding. Average core deposits were \$25.46 billion, \$25.42 billion and \$22.41 billion for the quarters ended June 30, 2014, December 31, 2013 and June 30, 2013, respectively, and represented 98 percent, 98 percent and 97 percent of total deposits for each respective period. Average noninterest-bearing deposits in the second quarter of 2014 decreased 1 percent from the fourth quarter of 2013 and increased 15 percent from the year-earlier quarter.

Treasury Services deposit balances, which consist primarily of title, escrow, community association and property management deposits, averaged \$2.87 billion in the second quarter of 2014, compared with \$2.59 billion in the fourth quarter of 2013 and \$2.59 billion for the second quarter of 2013. The growth in Treasury Services deposits was due primarily to mortgage transaction activity on higher priced homes.

Borrowed Funds

Total borrowed funds were \$788.1 million, \$739.9 million and \$709.2 million at June 30, 2014, December 31, 2013 and June 30, 2013, respectively. Total average borrowed funds were \$738.1 million, \$728.5 million and \$1.30 billion for the quarters ended June 30, 2014, December 31, 2013 and June 30, 2013, respectively.

Short-term borrowings consist of funds with remaining maturities of one year or less and the current portion of long-term debt. Short-term borrowings were \$160.3 million as of June 30, 2014 compared to \$3.9 million as of December 31, 2013 and \$2.7 million as of June 30, 2013. Short-term borrowings at June 30, 2014 consist of federal funds purchased and the current portions of subordinated debt and nonrecourse debt.

Table of Contents

Long-term debt consists of borrowings with remaining maturities greater than one year and is primarily comprised of senior notes, subordinated debt, junior subordinated debt and nonrecourse debt. Long-term debt was \$627.8 million, \$736.0 million and \$706.5 million as of June 30, 2014, December 31, 2013 and June 30, 2013, respectively. The Company's long-term borrowings have maturity dates ranging from July 2015 to November 2034.

Off-Balance Sheet

In the normal course of business, the Company is a party to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and letters of credit, and to invest in affordable housing funds, private equity and other alternative investments. These instruments involve elements of credit, foreign exchange, and interest rate risk, to varying degrees, in excess of the amount reflected in the consolidated balance sheets.

Exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and letters of credit is represented by the contractual notional amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments, and will evaluate each client's creditworthiness on a case-by-case basis.

Commitments to extend credit are agreements to lend to a client as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since a portion of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company had off-balance sheet credit commitments totaling \$8.78 billion at June 30, 2014, \$7.99 billion at December 31, 2013 and \$6.85 billion at June 30, 2013.

Standby letters of credit are commitments issued by the Company to guarantee the obligations of its customer to beneficiaries. Commercial letters of credit are issued on behalf of customers to ensure payment in connection with trade transactions. The Company had \$679.0 million in letters of credit at June 30, 2014, of which \$574.3 million relate to standby letters of credit and \$104.7 million relate to commercial letters of credit. The Company had \$733.5 million outstanding in letters of credit at December 31, 2013, of which \$617.3 million relate to standby letters of credit and \$116.2 million relate to commercial letters of credit.

As of June 30, 2014, the Company had private equity fund and alternative investment fund commitments of \$66.4 million, of which \$58.5 million was funded. As of December 31, 2013 and June 30, 2013, the Company had private equity and alternative investment fund commitments of \$70.9 million and \$67.9 million respectively, of which \$62.2 million and \$61.4 million was funded.

Capital

The ratio of period-end equity to period-end assets was 9.26 percent, 9.22 percent and 9.29 percent as of June 30, 2014, December 31, 2013 and June 30, 2013, respectively. Period-end common shareholders' equity to period-end assets was 8.39 percent, 8.32 percent and 8.67 percent for the

same periods, respectively.

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Table of Contents

The following table presents the regulatory standards for well-capitalized institutions and the capital ratios for the Corporation and the Bank at June 30, 2014, December 31, 2013 and June 30, 2013:

	Regulatory Well-Capitalized Standards	June 30, 2014	December 31, 2013	June 30, 2013
City National Corporation				
Tier 1 leverage	%	7.43%	7.17%	7.00%
Tier 1 risk-based capital	6.00	10.00	10.09	9.74
Total risk-based capital	10.00	12.81	13.00	12.78
Tangible common equity to tangible assets (1)		6.32	6.17	6.32
Tier 1 common equity to risk-based assets (2)		8.75	8.78	8.83
City National Bank				
Tier 1 leverage	5.00%	7.45%	7.25%	7.21%
Tier 1 risk-based capital	6.00	10.00	10.20	10.04
Total risk-based capital	10.00	12.78	13.08	13.03

(1) Tangible common equity to tangible assets is a non-GAAP financial measure that represents total common equity less identifiable intangible assets and goodwill divided by total assets less identifiable assets and goodwill. Management reviews tangible common equity to tangible assets in evaluating the Company's capital levels and has included this ratio in response to market participants' interest in tangible common equity as a measure of capital. See reconciliation of the GAAP financial measure to this non-GAAP financial measure below.

(2) Tier 1 common equity to risk-based assets is calculated by dividing (a) Tier 1 capital less non-common components including qualifying perpetual preferred stock and qualifying trust preferred securities by (b) risk-weighted assets. Tier 1 capital and risk-weighted assets are calculated in accordance with applicable bank regulatory guidelines. This ratio is a non-GAAP measure that is used by investors, analysts and bank regulatory agencies to assess the capital position of financial services companies. Management reviews this measure in evaluating the Company's capital levels and has included this measure in response to market participants' interest in the Tier 1 common equity to risk-based assets ratio. See reconciliation of the GAAP financial measure to this non-GAAP financial measure below.

Reconciliation of GAAP financial measure to non-GAAP financial measure:

(in thousands)	June 30, 2014	December 31, 2013	June 30, 2013
Common equity	\$ 2,585,537	\$ 2,473,370	\$ 2,374,848
Less: Goodwill and other intangible assets	(680,302)	(683,243)	(686,897)
Tangible common equity (A)	\$ 1,905,235	\$ 1,790,127	\$ 1,687,951
Total assets	\$ 30,819,092	\$ 29,717,951	\$ 27,379,502
Less: Goodwill and other intangible assets	(680,302)	(683,243)	(686,897)
Tangible assets (B)	\$ 30,138,790	\$ 29,034,708	\$ 26,692,605
Tangible common equity to tangible assets (A)/(B)	6.32%	6.17%	6.32%
Tier 1 capital	\$ 2,191,711	\$ 2,095,576	\$ 1,874,999

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Less: Preferred stock		(267,616)		(267,616)		(169,920)
Less: Trust preferred securities		(5,155)		(5,155)		(5,155)
Tier 1 common equity (C)	\$	1,918,940	\$	1,822,805	\$	1,699,924
Risk-weighted assets (D)	\$	21,922,982	\$	20,766,237	\$	19,255,862
Tier 1 common equity to risk-based assets (C)/(D)		8.75%		8.78%		8.83%

In July 2013, the FDIC, the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System adopted a final rule that revises its risk-based and leverage capital requirements (referred to as the Basel III rule). A key goal of the Basel III agreement is to strengthen the capital resources of banking organizations during normal and challenging business environments. The Basel III final rule implements a revised definition of regulatory capital, a new common equity Tier 1 minimum capital requirement, and a higher minimum Tier 1 capital requirement. For banking organizations not subject to the advanced approaches rule, compliance with the standardized approach for determining risk-weighted assets and compliance with the transition period for the revised minimum regulatory capital ratios will begin on January 1, 2015. The transition period for the capital conservation buffer will begin on January 1, 2016 and the fully implemented regulatory capital ratios will be effective on January 1, 2019. Important elements of the Basel III rule include the following:

Table of Contents

- Increased minimum capital requirements;
- Higher quality of capital so banks are better able to absorb losses;
- A leverage ratio concept for international banks and U.S. bank holding companies;
- Specific capital conservation buffers; and
- A more uniform supervisory standard for U.S. financial institution regulatory agencies.

Based on the final Basel III rules, the Company has estimated its capital ratios as of June 30, 2014 using the new standards and the pro forma ratios already exceed the requirements of the fully implemented capital rules.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

ASSET/LIABILITY MANAGEMENT

Market risk results from the variability of future cash flows and earnings due to changes in the financial markets. These changes may also impact the fair values of loans, securities and borrowings. The values of financial instruments may fluctuate because of interest rate changes, foreign currency exchange rate changes or other market changes. The Company's asset/liability management process entails the evaluation, measurement and management of market risk and liquidity risk. The principal objective of asset/liability management is to optimize net interest income subject to margin volatility and liquidity constraints over the long term. Margin volatility results when the rate reset (or repricing) characteristics of assets are materially different from those of the Company's liabilities. The Board of Directors approves asset/liability policies and annually reviews and approves the limits within which the risks must be managed. The Asset/Liability Management Committee (ALCO), which is comprised of senior management and key risk management individuals, sets risk management guidelines within the broader limits approved by the Board, monitors the risks and periodically reports results to the Board.

A quantitative and qualitative discussion about market risk is included on pages 68 to 72 of the Corporation's Form 10-K for the year ended December 31, 2013.

Liquidity Risk

Liquidity risk results from the mismatching of asset and liability cash flows. Funds for this purpose can be obtained in cash markets, by borrowing, or by selling certain assets. The objective of liquidity management is to manage cash flow and liquidity reserves so that they are adequate to fund the Company's operations and meet obligations and other commitments on a timely basis and at a reasonable cost. The Company achieves this objective through the selection of asset and liability maturity mixes that it believes best meet its needs. The Company's liquidity position is enhanced by its ability to raise additional funds as needed in the wholesale markets. Liquidity risk management is an

important element in the Company's ALCO process, and is managed within limits approved by the Board of Directors and guidelines set by management. Attention is also paid to potential outflows resulting from disruptions in the financial markets or to unexpected credit events. These factors are incorporated into the Company's contingency funding analysis, and provide the basis for the identification of primary and secondary liquidity reserves.

In recent years, the Company's core deposit base has provided the majority of the Company's funding requirements. This relatively stable and low-cost source of funds, along with shareholders' equity, provided 94 percent of funding for average total assets in both the second quarter and first six months of 2014, and 91 percent and 89 percent for the year-earlier periods, respectively. Strong core deposits are indicative of the strength of the Company's franchise in its chosen markets and reflect the confidence that clients have in the Company. The Company places a very high priority in maintaining this confidence through conservative credit and capital management practices and by maintaining significant on-balance sheet liquidity reserves.

Funding obtained through short-term wholesale or market sources averaged \$0.9 million and \$0.5 million for the three and six months ended June 30, 2014, respectively, and \$594.4 million and \$1.04 billion for the year-earlier periods. The Company's liquidity position was also supported through longer-term borrowings (including the current portion of long-term debt) which averaged \$737.2 million and \$738.0 million for the three and six months ended June 30, 2014, respectively, compared with \$708.0 million and \$758.9 million for the year-earlier periods. Market sources of funds comprise a modest portion of total Bank funding and are managed within concentration and maturity guidelines reviewed by management and implemented by the Company's treasury department.

Table of Contents

Liquidity is further provided by assets such as federal funds sold, reverse repurchase agreements, balances held at the Federal Reserve Bank, and trading securities, which may be immediately converted to cash at minimal cost. The aggregate of these assets averaged \$930.9 million and \$917.1 million for the second quarter and first six months of 2014, respectively, compared with \$496.7 million and \$415.6 million in the year-earlier periods, respectively. In addition, the Company has committed and unutilized secured borrowing capacity of \$5.32 billion as of June 30, 2014 from the Federal Home Loan Bank of San Francisco, of which the Bank is a member. The Company's investment portfolio also provides a substantial liquidity reserve. The portfolio of securities available-for-sale averaged \$5.28 billion and \$5.40 billion for the quarter and six months ended June 30, 2014, respectively. The portfolio of securities available-for-sale averaged \$7.38 billion and \$7.86 billion for the quarter and six months ended June 30, 2013, respectively. The unpledged portion of securities available-for-sale and held-to-maturity at fair value totaled \$7.03 billion at June 30, 2014. These securities could be used as collateral for borrowing or a portion of the securities available-for-sale could be sold.

Interest Rate Risk

Net Interest Income Simulation: As part of its overall interest rate risk management process, the Company performs stress tests on net interest income projections based on a variety of factors, including interest rate levels, changes in the relationship between the prime rate and short-term interest rates, and the shape of the yield curve. The Company uses a simulation model to estimate the severity of this risk and to develop mitigation strategies, including interest-rate hedges. The magnitude of the change is determined from historical volatility analysis. The assumptions used in the model are updated periodically and reviewed and approved by ALCO. In addition, the Board of Directors has adopted limits within which interest rate exposure must be contained. Within these broader limits, ALCO sets management guidelines to further contain interest rate risk exposure.

The Company is naturally asset-sensitive due to its large portfolio of rate-sensitive commercial loans that are funded in part by noninterest bearing and rate-stable core deposits. As a result, if there are no significant changes in the mix of assets and liabilities, the net interest margin increases when interest rates increase and decreases when interest rates decrease. The Company uses on and off-balance sheet hedging vehicles to manage risk. The Company uses a simulation model to estimate the impact of changes in interest rates on net interest income. Interest rate scenarios include stable rates and a 400 basis point parallel shift in the yield curve occurring gradually over a two-year period. The model is used to project net interest income assuming no changes in loans or deposit mix as it stood at June 30, 2014, as well as a dynamic simulation that includes changes to balance sheet mix in response to changes in interest rates. In the dynamic simulation, loan and deposit balances are modeled based on experience in previous vigorous economic recovery cycles. Loans, excluding covered loans which are in a runoff mode, increase 10 percent per year compared to the base case. Similarly, deposits decline 7.5 percent per year. Loan yields and deposit rates change over the simulation horizon based on current spreads and adjustment factors that are statistically derived using historical rate and balance sheet data.

As of June 30, 2014, the Federal funds target rate was at a range of zero percent to 0.25 percent. Further declines in interest rates are not expected to significantly reduce earning asset yields or liability costs, nor have a meaningful effect on net interest margin. At June 30, 2014, a gradual 400 basis point parallel increase in the yield curve over the next 24 months assuming a static balance sheet would result in an increase in projected net interest income of approximately 11.3 percent in year one and a 42.3 percent increase in year two over the base case. This compares to an increase in projected net interest income of 9.7 percent in year one and a 33.0 percent increase in year two over the base case at June 30, 2013. Interest rate sensitivity has increased due to changes in the mix of the balance sheet, primarily significant growth in floating rate loans and non-rate sensitive deposits. The dynamic simulation incorporates balance sheet changes resulting from a gradual 400 basis point increase in rates. In combination, these rate and balance sheet effects result in an increase in projected net interest income of approximately 13.8 percent in year one and 45.1 percent increase in year two over the base case. The Company's asset sensitivity is primarily tied to changes in short-term rates due to its large portfolio of rate-sensitive loans and funding provided by noninterest bearing and rate-stable core deposits. The Company's interest rate risk exposure remains within Board limits and ALCO guidelines.

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The Company's loan portfolio includes floating rate loans which are tied to short-term market index rates, adjustable rate loans for which the initial rate is fixed for a period from one year to as much as ten years, and fixed-rate loans whose interest rate does not change through the life of the transaction. The following table shows the composition of the Company's loan portfolio, including covered loans, by major loan category as of June 30, 2014. Each loan category is further divided into Floating, Adjustable and Fixed rate components. Floating rate loans are generally tied to either the Prime rate or to a LIBOR-based index.

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Table of Contents

(in millions)	Prime	Floating Rate LIBOR	Total	Adjustable	Fixed	Total Loans
Commercial and lease financing	\$ 2,568	\$ 4,936	\$ 7,504	\$ 49	\$ 1,285	\$ 8,838
Commercial real estate mortgages	294	1,948	2,242	64	1,159	3,465
Residential mortgages				3,387	1,427	4,814
Real estate construction	68	368	436		22	458
Home equity loans and lines of credit	701		701	4	12	717
Installment	106		106		77	183
Covered loans	31	79	110	400	96	606
Total loans and leases	\$ 3,768	\$ 7,331	\$ 11,099	\$ 3,904	\$ 4,078	\$ 19,081
Percentage of portfolio	20%	38%	58%	21%	21%	100%

Certain floating rate loans have a floor rate which is absolute and below which the loan rate will not fall even though market rates may be unusually low. At June 30, 2014, \$11.10 billion (58 percent) of the Company's loan portfolio was floating rate, of which \$9.20 billion (83 percent) was not impacted by rate floors. This is because either the loan contract does not specify a minimum or floor rate, or because the contractual loan rate is above the minimum rate specified in the loan contract. Of the loans which were at their contractual minimum rate, \$1.43 billion (13 percent) were within 0.75 percent of the contractual loan rate absent the effects of the floor. Thus, the rate on these loans will be relatively responsive to increases in the underlying Prime or LIBOR index, and all will adjust upwards should the underlying index increase by more than 0.75 percent. Only \$46.2 million of floating rate loans have floors that are more than 2 percent above the contractual rate formula. Thus, the yield on the Company's floating rate loan portfolio is expected to be highly responsive to changes in market rates. The following table shows the balance of loans in the Floating Rate portfolio stratified by spread between the current loan rate and the floor rate as of June 30, 2014:

(in millions)	Loans with No Floor and Current Rate Greater than Floor	Interest Rate Increase Needed for Loans Currently at Floor Rate to Become Floating			Total
		< 0.75%	0.76% - 2.00%	> 2.00%	
Prime	\$ 2,675	\$ 739	\$ 347	\$ 7	\$ 3,768
LIBOR	6,524	691	77	39	7,331
Total floating rate loans	\$ 9,199	\$ 1,430	\$ 424	\$ 46	\$ 11,099
% of total floating rate loans	83%	13%	4%	0%	100%

Economic Value of Equity: The economic value of equity (EVE) model is used to evaluate the vulnerability of the market value of shareholders equity to changes in interest rates. The EVE model calculates the expected cash flow of all of the Company's assets and liabilities under sharply higher and lower interest rate scenarios. The present value of these cash flows is calculated by discounting them using the interest rates for that scenario. The difference between the present value of assets and the present value of liabilities in each scenario is the EVE. The assumptions about the timing of cash flows, level of interest rates and shape of the yield curve are the same as those used in the net interest income simulation. They are updated periodically and are reviewed by ALCO at least annually.

As of June 30, 2014, an instantaneous 200 basis point increase in interest rates results in a 4.7 percent decline in EVE. This compares to an 8.6 percent decline in EVE a year-earlier. Prior year percentages have been restated to conform with current methodology. The decrease in sensitivity is primarily due to changes in the mix of the balance sheet and decline in long-term interest rates. Measurement of a 200 basis point decrease in rates as of June 30, 2014 and June 30, 2013 is not meaningful due to the current low rate environment.

Table of Contents

Interest-Rate Risk Management

Interest-rate swaps may be used to reduce cash flow variability and to moderate changes in the fair value of long-term financial instruments. Net interest income or expense associated with interest-rate swaps (the difference between the fixed and floating rates paid or received) is included in net interest income in the reporting periods in which they are earned. Derivatives are recorded on the consolidated balance sheets at their fair value. The treatment of changes in the fair value of derivatives depends on the character of the transaction. The Company had no interest-rate swaps designated as hedging instruments at June 30, 2014, December 31, 2013 and June 30, 2013.

The Company has not entered into any hedge transactions involving any other interest-rate derivative instruments, such as interest-rate floors, caps, and interest-rate futures contracts for its own portfolio in 2014. Under existing policy, the Company could use such financial instruments in the future if deemed appropriate.

Other Derivatives

The Company also offers various derivative products to clients and enters into derivative transactions in due course. These derivative contracts are offset by paired trades with unrelated bank counterparties. These transactions are not linked to specific Company assets or liabilities in the consolidated balance sheets or to forecasted transactions in a hedge relationship and, therefore, do not qualify for hedge accounting. The contracts are marked-to-market each reporting period with changes in fair value recorded as part of Other noninterest income in the consolidated statements of income. Fair values are determined from verifiable third-party sources that have considerable experience with the derivative markets. The Company provides client data to the third-party source for purposes of calculating the credit valuation component of the fair value measurement of client derivative contracts. At June 30, 2014 and 2013, the Company had entered into derivative contracts with clients (and offsetting derivative contracts with counterparties) having a notional balance of \$3.30 billion and \$2.93 billion, respectively.

Counterparty Risk and Collateral

Interest-rate swap agreements involve the exchange of fixed and variable-rate interest payments based upon a notional principal amount and maturity date. The Company's interest-rate swaps had \$0.2 million and \$1.4 million of credit risk exposure at June 30, 2014 and June 30, 2013, respectively. The credit exposure represents the cost to replace, on a present value basis and at current market rates, all contracts outstanding by trading counterparty having an aggregate positive market value, net of margin collateral received. The Company's swap agreements require the deposit of cash or marketable debt securities as collateral for this risk if it exceeds certain market value thresholds. These requirements apply individually to the Corporation and to the Bank. No collateral had been received from swap counterparties at June 30, 2014 and June 30, 2013. The Company delivered cash and securities collateral valued at \$29.4 million on swap agreements at June 30, 2014 and \$15.0 million at June 30, 2013.

Market Risk Foreign Currency Exchange

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The Company enters into foreign-exchange contracts with its clients and counterparty banks primarily for the purpose of offsetting or hedging clients' transaction and economic exposures arising out of commercial transactions. The Company's policies also permit taking proprietary currency positions within certain approved limits. The Company actively manages its foreign exchange exposures within prescribed risk limits and controls. At June 30, 2014, the Company's outstanding foreign exchange contracts, both proprietary and for customer accounts, totaled \$483.7 million. The mark-to-market on foreign exchange contracts included in other assets and other liabilities totaled \$3.5 million and \$2.8 million, respectively, at June 30, 2014.

Table of Contents

ITEM 4. CONTROLS AND PROCEDURES

DISCLOSURE CONTROLS AND PROCEDURES

Under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, the Company has evaluated the effectiveness of its disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)). Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective.

INTERNAL CONTROL OVER FINANCIAL REPORTING

There was no change in the Company's internal control over financial reporting that occurred during the Company's last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents

PART II OTHER INFORMATION

ITEM 1A. RISK FACTORS

For a discussion of risk factors relating to the Company's business, refer to Item 1A of Part I of the Company's Annual Report on Form 10-K for the year ended December 31, 2013 (Form 10-K). There has been no material change in the risk factors as previously disclosed in the Company's Form 10-K.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(c) Purchase of Equity Securities by the Issuer and Affiliated Purchaser.

The information required by subsection (c) of this item regarding purchases by the Company during the quarter ended June 30, 2014 of equity securities that are registered by the Company pursuant to Section 12 of the Exchange Act is incorporated by reference from the relevant portion of Part I, Item 1 of this report under Note 8.

ITEM 6. EXHIBITS

No.	
12	Statement Re: Computation of Ratio of Earnings to Fixed Charges and Preferred Stock Requirements.
31.1	Chief Executive Officer certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Chief Financial Officer certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

Table of Contents

SIGNATURES

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

CITY NATIONAL CORPORATION
(Registrant)

DATE: August 8, 2014

/s/ Christopher J. Carey

CHRISTOPHER J. CAREY
Executive Vice President and
Chief Financial Officer
(Authorized Officer and
Principal Financial Officer)