Cole Credit Property Trust II Inc
Form 10-Q
May 15, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended March 31, 2012

OR

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

For the transition period from to

Commission file number 000-51963

COLE CREDIT PROPERTY TRUST II, INC.

(Exact name of registrant as specified in its charter)

Maryland	**20-1676382**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**
2325 East Camelback Road, Suite 1100 Phoenix, Arizona, 85016	**(602) 778-8700**
(Address of principal executive offices; zip code)	**(Registrant s telephone number, including area code)**

Not Applicable

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x 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 x 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 x (Do not check if smaller reporting company)	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 x

As of May 14, 2012, there were 209,622,273 shares of common stock, par value $0.01, of Cole Credit Property Trust II, Inc. outstanding.

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COLE CREDIT PROPERTY TRUST II, INC.

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PART I

FINANCIAL INFORMATION

The accompanying condensed consolidated unaudited interim financial statements as of and for the three months ended March 31, 2012 have been prepared by Cole Credit Property Trust II, Inc. (the Company, we, us or our) pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America (GAAP) for complete financial statements, and should be read in conjunction with the audited consolidated financial statements and related notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2011. The financial statements herein should also be read in conjunction with the notes to the financial statements and Management s Discussion and Analysis of Financial Condition and Results of Operations contained in this Quarterly Report on Form 10-Q. The results of operations for the three months ended March 31, 2012 are not necessarily indicative of the operating results expected for the full year. The information furnished in our accompanying condensed consolidated unaudited balance sheets and condensed consolidated unaudited statements of operations, comprehensive income, stockholders equity, and cash flows reflects all adjustments that are, in our opinion, necessary for a fair presentation of the aforementioned financial statements. Such adjustments are of a normal recurring nature.

Forward-looking statements that were true at the time made may ultimately prove to be incorrect or false. We caution readers not to place undue reliance on forward-looking statements, which reflect our management s view only as of the date of this Quarterly Report on Form 10-Q. We make no representation or warranty (expressed or implied) about the accuracy of any such forward-looking statements contained in the Quarterly Report on Form 10-Q. We undertake no obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes to future operating results. The forward-looking statements should be read in light of the risk factors identified in the Item 1A Risk Factors section of the Company s Annual Report on Form 10-K for the year ended December 31, 2011.

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COLE CREDIT PROPERTY TRUST II, INC.

CONDENSED CONSOLIDATED UNAUDITED BALANCE SHEETS

(in thousands, except share and per share amounts)

	March 31, 2012	December 31, 2011
ASSETS		
Investment in real estate assets:		
Land	$ 863,257	$ 863,257
Buildings and improvements, less accumulated depreciation of $253,900 and $238,688, respectively	1,945,603	1,959,922
Real estate assets under direct financing leases, less unearned income of $12,870 and $13,342, respectively	35,741	35,999
Acquired intangible lease assets, less accumulated amortization of $136,624 and $128,544, respectively	315,633	323,298
Total investment in real estate assets, net	3,160,234	3,182,476
Investment in mortgage notes receivable, net	75,946	76,745
Total investment in real estate and mortgage assets, net	3,236,180	3,259,221
Cash and cash equivalents	29,396	53,205
Restricted cash	9,777	11,811
Investment in unconsolidated joint venture	21,617	22,334
Rents and tenant receivables, less allowance for doubtful accounts of $352 and $547, respectively	58,674	57,403
Prepaid expenses and other assets	3,296	3,739
Deferred financing costs, less accumulated amortization of $19,256 and $17,751, respectively	20,843	22,609
Total assets	$ 3,379,783	$ 3,430,322
LIABILITIES AND STOCKHOLDERS EQUITY		
Notes payable and line of credit	$ 1,745,757	$ 1,767,591
Accounts payable and accrued expenses	16,146	16,100
Due to affiliates	1,660	1,069
Acquired below market lease intangibles, less accumulated amortization of $45,626 and $42,880, respectively	127,934	130,680
Distributions payable	11,127	11,157
Deferred rental income, derivative and other liabilities	13,380	17,530
Total liabilities	1,916,004	1,944,127
Commitments and contingencies		
Redeemable common stock	14,584	14,482
STOCKHOLDERS EQUITY:		
Preferred stock, $0.01 par value; 10,000,000 shares authorized, none issued and outstanding		
Common stock, $0.01 par value; 240,000,000 shares authorized, 210,164,068 and 210,151,692 shares issued and outstanding, respectively	2,102	2,101
Capital in excess of par value	1,883,098	1,882,971
Accumulated distributions in excess of earnings	(432,662)	(409,801)
Accumulated other comprehensive loss	(3,343)	(3,558)

Total stockholders equity		1,449,195		1,471,713
Total liabilities and stockholders equity	$	3,379,783	$	3,430,322

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

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COLE CREDIT PROPERTY TRUST II, INC.

CONDENSED CONSOLIDATED UNAUDITED STATEMENTS OF OPERATIONS

(in thousands, except share and per share amounts)

	Three Months Ended March 31, 2012	2011
Revenues:		
Rental and other property income	$ 65,004	$ 60,983
Tenant reimbursement income	4,524	4,787
Earned income from direct financing leases	472	486
Interest income on mortgage notes receivable	1,565	1,621
Interest income on marketable securities		1,938
Total revenue	71,565	69,815
Expenses:		
General and administrative expenses	2,228	2,002
Property operating expenses	5,765	5,812
Property and asset management expenses	4,661	4,356
Acquisition related expenses	17	362
Depreciation	15,212	14,657
Amortization	6,982	7,397
Total operating expenses	34,865	34,586
Operating income	36,700	35,229
Other income (expense):		
Equity in income of unconsolidated joint ventures and other income	128	168
Gain on sale of marketable securities		7,859
Interest expense	(27,025)	(26,521)
Total other expense	(26,897)	(18,494)
Net income	$ 9,803	$ 16,735
Weighted average number of common shares outstanding:		
Basic	210,176,186	209,271,540
Diluted	210,177,282	209,271,540
Net income per common share:		
Basic and diluted	$ 0.05	$ 0.08
Distributions declared per common share:		
Basic and diluted	$ 0.16	$ 0.15

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

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COLE CREDIT PROPERTY TRUST II, INC.

CONDENSED CONSOLIDATED UNAUDITED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

	Three Months Ended March 31, 2012	2011
Net Income	$ 9,803	$ 16,735
Other comprehensive income:		
Unrealized loss on marketable securities		(1,713)
Reclassification of previous unrealized gain on marketable securities into net income		(7,748)
Unrealized gain on interest rate swaps	215	258
Total other comprehensive income (loss)	215	(9,203)
Comprehensive income	$ 10,018	$ 7,532

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

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COLE CREDIT PROPERTY TRUST II, INC.

CONDENSED CONSOLIDATED UNAUDITED STATEMENT OF STOCKHOLDERS EQUITY

(in thousands, except share amounts)

	Common Stock		Capital in Excess of Par Value	Accumulated Distributions in Excess of Earnings	Accumulated Other Comprehensive Loss	Total Stockholders Equity
	Number of Shares	Par Value				
Balance, January 1, 2012	210,151,692	$ 2,101	$ 1,882,971	$ (409,801)	$ (3,558)	$ 1,471,713
Issuance of common stock	1,559,836	16	14,568			14,584
Distributions to investors				(32,664)		(32,664)
Redemptions of common stock	(1,547,460)	(15)	(14,339)			(14,354)
Changes in redeemable common stock			(102)			(102)
Comprehensive income				9,803	215	10,018
Balance, March 31, 2012	210,164,068	$ 2,102	$ 1,883,098	$ (432,662)	$ (3,343)	$ 1,449,195

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

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COLE CREDIT PROPERTY TRUST II, INC.

CONDENSED CONSOLIDATED UNAUDITED STATEMENTS OF CASH FLOWS

(in thousands)

	Three Months Ended March 31, 2012	2011
Cash flows from operating activities:		
Net income	$ 9,803	$ 16,735
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	15,212	14,657
Amortization of intangible lease assets and below market lease intangibles, net	5,334	6,045
Amortization of deferred financing costs	1,766	1,679
Amortization of premiums on mortgage notes receivable	179	173
Accretion of discount on marketable securities		(684)
Amortization of fair value adjustments of mortgage notes payable assumed	470	478
Bad debt expense	57	18
Equity in income of unconsolidated joint ventures	(121)	(153)
Return on investment from unconsolidated joint ventures	121	226
Gain on sale of marketable securities		(7,859)
Changes in assets and liabilities:		
Rents and tenant receivables	(1,328)	(1,457)
Prepaid expenses and other assets	443	981
Accounts payable and accrued expenses	46	(392)
Due to affiliates, deferred rental income and other liabilities	(3,344)	(4,379)
Net cash provided by operating activities	28,638	26,068
Cash flows from investing activities:		
Investment in real estate and related assets and other capital expenditures	(1,308)	(22,765)
Proceeds from sale of marketable securities		20,206
Principal repayments from mortgage notes receivable and real estate assets under direct financing leases	878	809
Return of investment from unconsolidated joint ventures	717	1,011
Payment of property escrow deposits		(1,150)
Change in restricted cash	2,034	997
Net cash provided by (used in) investing activities	2,321	(892)
Cash flows from financing activities:		
Redemptions of common stock	(14,354)	(11,903)
Distributions to investors	(18,110)	(17,351)
Proceeds from notes payable, line of credit and repurchase agreement	37,000	37,189
Repayment of notes payable, line of credit and repurchase agreement	(59,304)	(44,265)
Deferred financing costs paid		(409)
Net cash used in financing activities	(54,768)	(36,739)
Net decrease in cash and cash equivalents	(23,809)	(11,563)
Cash and cash equivalents, beginning of period	53,205	45,791
Cash and cash equivalents, end of period	$ 29,396	$ 34,228

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

COLE CREDIT PROPERTY TRUST II, INC.

NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS

March 31, 2012

NOTE 1 ORGANIZATION AND BUSINESS

Cole Credit Property Trust II, Inc. (the Company) is a Maryland corporation formed on September 29, 2004, that has elected to be taxed, and currently qualifies, as a real estate investment trust (REIT) for federal income tax purposes. Substantially all of the Company s business is conducted through Cole Operating Partnership II, LP (Cole OP II), a Delaware limited partnership. The Company is the sole general partner of and owns a 99.99% partnership interest in Cole OP II. Cole REIT Advisors II, LLC (Cole Advisors II), the advisor to the Company, is the sole limited partner and owner of an insignificant noncontrolling partnership interest of less than 0.01% of Cole OP II.

As of March 31, 2012, the Company owned 753 properties comprising 21.2 million rentable square feet of single and multi-tenant retail and commercial space located in 45 states and the U.S. Virgin Islands. As of March 31, 2012, the rentable space at these properties was 96% leased. As of March 31, 2012, the Company also owned 69 mortgage notes receivable secured by 43 restaurant properties and 26 single-tenant retail properties, each of which is subject to a net lease. Through an unconsolidated joint venture, the Company also had a non-controlling majority interest in a 386,000 square foot multi-tenant retail building in Independence, Missouri as of March 31, 2012.

The Company ceased offering shares of common stock in its initial primary offering (the Initial Offering) on May 22, 2007, and ceased offering shares of common stock in its follow-on offering (the Follow-on Offering) on January 2, 2009. The Company continues to issue shares of common stock under its distribution reinvestment plan (the DRIP Offering , and collectively with the Initial Offering and the Follow-on Offering, the Offerings). As of March 31, 2012, the Company had issued approximately 226.6 million shares of common stock in its Offerings for aggregate gross proceeds of $2.2 billion (including proceeds from the issuance of shares pursuant to the DRIP Offering of $218.8 million), before share redemptions of $149.1 million. As of March 31, 2012, the Company had incurred an aggregate of $188.3 million in offering costs, selling commissions, and dealer manager fees in the Offerings.

The Company s stock is not currently listed on a national securities exchange. The Company may seek to list its common stock for trading on a national securities exchange only if a majority of its independent directors believes listing would be in the best interest of its stockholders. The Company disclosed in its prospectus a targeted liquidity event by May 22, 2017 and in the event it does not obtain listing prior to such date, its charter requires that it either (1) seek stockholder approval of an extension or elimination of this listing deadline; or (2) seek stockholder approval to adopt a plan of liquidation. If neither proposal is approved, the Company may continue to operate as before. On June 28, 2011, the Company disclosed that its sponsor, Cole Real Estate Investments, is actively exploring options to successfully exit the Company s portfolio. The potential exit strategies the Company is evaluating include, but are not limited to, a sale of the Company or all or a portion of its portfolio, a merger or other business combination, or a listing of the Company s stock on a national securities exchange. The targeted liquidity date has not yet occurred, and the Company has not finalized a plan for, or had, a liquidity event.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

The condensed consolidated unaudited financial statements of the Company have been prepared in accordance with the rules and regulations of the SEC, including the instructions to Form 10-Q and Article 10 of Regulation S-X, and do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, the statements for the interim periods presented include all adjustments, which are of a normal and recurring nature, necessary to present a fair presentation of the results for such periods. Results for these interim periods are not necessarily indicative of full year results. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with the Company s audited consolidated financial statements as of and for the year ended December 31, 2011, and related notes thereto set forth in the Company s Annual Report on Form 10-K for the year ended December 31, 2011.

The accompanying condensed consolidated unaudited financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

The Company is required to continually evaluate its variable interest entity (VIE) relationships and consolidate investments in these entities when it is determined to be the primary beneficiary of their operations. A VIE is broadly defined as an entity where either (1) the equity investors as a group, if any, lack the power through voting or similar rights to direct the activities of an entity that most significantly impact the entity s economic performance or (2) the equity investment at risk is insufficient to finance that entity s activities without additional subordinated financial support.

COLE CREDIT PROPERTY TRUST II, INC.

NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

March 31, 2012

A variable interest holder is considered to be the primary beneficiary of a VIE if it has the power to direct the activities of a variable interest entity that most significantly impact the entity s economic performance and has the obligation to absorb losses of, or the right to receive benefits from, the entity that could potentially be significant to the VIE. The Company qualitatively assesses whether it is or is not the primary beneficiary of a VIE. Consideration of various factors include, but are not limited to, the Company s ability to direct the activities that most significantly impact the entity s economic performance, its form of ownership interest, its representation on the entity s governing body, the size and seniority of its investment, its ability and the rights of other investors to participate in policy making decisions and to replace the manager of and/or liquidate the entity.

The Company continually evaluates the need to consolidate its joint venture based on standards set forth in GAAP. In determining whether the Company has a controlling interest in its joint venture and the requirement to consolidate the accounts of that entity, management considers factors such as ownership interest, power to make decisions and contractual and substantive participating rights of the partners/members as well as whether the entity is a VIE for which the Company is the primary beneficiary.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Valuation of Real Estate and Related Assets

The Company continually monitors events and changes in circumstances that could indicate that the carrying amounts of its real estate and related assets may not be recoverable. Impairment indicators that the Company considers include, but are not limited to, bankruptcy or other credit concerns of a property s major tenant, such as a history of late payments, rental concessions, and other factors, a significant decrease in a property s revenues due to lease terminations, vacancies, co-tenancy clauses, reduced lease rates or other circumstances. When indicators of potential impairment are present, the Company assesses the recoverability of the assets by determining whether the carrying value of the assets will be recovered through the undiscounted future cash flows expected from the use of the assets and their eventual disposition. In the event that such expected undiscounted future cash flows do not exceed the carrying value, the Company will adjust the real estate and related assets to their respective fair values and recognize an impairment loss. Generally fair value is determined using a discounted cash flow analysis and recent comparable sales transactions.

The Company continually monitors certain properties for which it has identified impairment indicators. As of March 31, 2012, the Company had seven properties with an aggregate book value of $53.5 million for which it had assessed the recoverability of the carrying values. For each of these properties, the undiscounted future cash flows expected as a result of the use of the real estate and related assets and the eventual disposition of the assets continued to exceed their carrying value as of March 31, 2012. Should the conditions related to any of these, or any of the Company s other properties change, the underlying assumptions used to determine the expected undiscounted future cash flows may change and adversely affect the recoverability of the respective real estate and related assets carrying value. No impairment losses were recorded during each of the three months ended March 31, 2012 or 2011.

When developing estimates of future cash flows, the Company makes assumptions such as future market rental income amounts subsequent to the expiration of current lease agreements, property operating expenses, terminal capitalization and discount rates, the number of months needed to re-lease the property, required tenant improvements and the number of years the property will be held for investment. The use of alternative assumptions in estimating future cash flows could result in a different assessment of the property s future cash flows and a different conclusion regarding the existence of an impairment, the extent of such loss, if any, as well as the fair value of the real estate and related assets.

When a real estate asset is identified as held for sale, the Company will cease depreciation and amortization of the assets and estimate the fair value, net of selling costs. If, in management s opinion, the fair value, net of selling costs, is less than the carrying value of the asset, an adjustment to the carrying value would be recorded to reflect the estimated fair value of the property, net of selling costs. There were no properties identified as held for sale as of March 31, 2012 or December 31, 2011.

COLE CREDIT PROPERTY TRUST II, INC.

NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

March 31, 2012

Concentration of Credit Risk

As of March 31, 2012, the Company had cash on deposit, including restricted cash, in four financial institutions, all of which had deposits in excess of federally insured limits totaling $12.2 million; however, the Company has not experienced any losses in such accounts. The Company limits significant cash on deposit to accounts held by financial institutions with high credit standing; therefore, the Company believes it is not exposed to any significant credit risk on its cash deposits.

Investment in Unconsolidated Joint Venture

Investment in unconsolidated joint venture as of March 31, 2012 consisted of the Company s non-controlling majority interest in a joint venture that owns a multi-tenant property in Independence, Missouri. Consolidation of this investment is not required as the entity does not qualify as a VIE and does not meet the requirements for consolidation, as defined by GAAP. Both the Company and the joint venture partner must approve decisions about the joint venture s activities that significantly influence the economic performance of the joint venture. As of March 31, 2012, the aggregate carrying value of assets held within the unconsolidated joint venture was $58.6 million and the face value of the non-recourse mortgage note payable was $34.0 million. As of December 31, 2011, the aggregate carrying value of assets held within the unconsolidated joint ventures was $59.3 million and the face value of the non-recourse mortgage notes payable was $34.1 million.

The Company accounts for its unconsolidated joint venture using the equity method of accounting. The equity method of accounting requires investments to be initially recorded at cost and subsequently adjusted for the Company s share of equity in the joint venture s earnings and distributions. The Company evaluates the carrying amount of its investments for impairment which requires the unconsolidated joint venture to be evaluated for potential impairment if the carrying amount of the investment exceeds its estimated fair value. An impairment charge is recorded when an impairment is deemed to be other than temporary. To determine whether impairment is other-than-temporary, the Company considers whether it has the ability and intent to hold the investment until the carrying value is fully recovered. The evaluation of an investment in a joint venture for potential impairment requires the Company s management to exercise significant judgment and to make certain assumptions. The use of different judgments and assumptions could result in different conclusions. No impairment losses were recorded related to the unconsolidated joint ventures for the three months ended March 31, 2012 or 2011. The Company recognizes gains on the sale of interests in joint ventures to the extent the economic substance of the transaction is a sale.

New Accounting Pronouncements

In June 2011, the U.S. Financial Accounting Standards Board issued Accounting Standards Update 2011-05, *Presentation of Comprehensive Income* (ASU 2011-05). ASU 2011-05 requires the presentation of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. ASU 2011-05 became effective for the Company beginning January 1, 2012, and its provisions were applied to the condensed consolidated unaudited statements of operations and comprehensive income.

NOTE 3 FAIR VALUE MEASUREMENTS

GAAP defines fair value, establishes a framework for measuring fair value and requires disclosures about fair value measurements. GAAP emphasizes that fair value is intended to be a market-based measurement, as opposed to a transaction-specific measurement.

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Depending on the nature of the asset or liability, various techniques and assumptions can be used to estimate the fair value. Assets and liabilities are measured using inputs from three levels of the fair value hierarchy, as follows:

Level 1 Inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date. An active market is defined as a market in which transactions for the assets or liabilities occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

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COLE CREDIT PROPERTY TRUST II, INC.

NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

March 31, 2012

Level 2 Inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active (markets with few transactions), inputs other than quoted prices that are observable for the asset or liability (i.e. interest rates, yield curves, etc.), and inputs that are derived principally from or corroborated by observable market data correlation or other means (market corroborated inputs).

Level 3 Unobservable inputs, only used to the extent that observable inputs are not available, reflect the Company s assumptions about the pricing of an asset or liability.

The following describes the methods the Company uses to estimate the fair value of the Company s financial assets and liabilities:

Cash and cash equivalents, restricted cash, rents and tenant receivables, and accounts payable and accrued expenses The Company considers the carrying values of these financial assets and liabilities to approximate fair value because of the short period of time between their origination and their expected realization.

Mortgage notes receivable The fair value is estimated by discounting the expected cash flows on the notes at rates at which management believes similar loans would be made as of March 31, 2012 and December 31, 2011. The estimated fair value of these notes was $86.0 million and $85.3 million as of March 31, 2012 and December 31, 2011, respectively, as compared to the carrying value of $75.9 million and $76.7 million as of March 31, 2012 and December 31, 2011, respectively. The fair value of the Company s mortgage notes receivable is estimated using Level 2 inputs.

Notes payable and line of credit The fair value is estimated using a discounted cash flow analysis based on estimated borrowing rates available to the Company as of March 31, 2012 and December 31, 2011. The estimated fair value of the notes payable and line of credit was $1.8 billion as of March 31, 2012 and December 31, 2011, respectively, as compared to the carrying value of $1.7 billion and $1.8 billion, as of as March 31, 2012 and December 31, 2011, respectively. The fair value of the Company s notes payable and line of credit is estimated using Level 2 inputs.

Derivative Instruments The Company s derivative instruments represent interest rate swaps. All derivative instruments are carried at fair value and are valued using Level 2 inputs. The fair value of these instruments is determined using interest rate market pricing models. The Company includes the impact of credit valuation adjustments on derivative instruments measured at fair value.

Considerable judgment is necessary to develop estimated fair values of financial instruments. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize, or be liable for, on disposition of the financial instruments.

In accordance with the fair value hierarchy described above, the following table shows the fair value of the Company s financial liabilities that are required to be measured at fair value on a recurring basis as of March 31, 2012 (in thousands):

	Balance as of March 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Liabilities:				
Interest rate swaps	$ 3,343	$	$ 3,343	$

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COLE CREDIT PROPERTY TRUST II, INC.

NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

March 31, 2012

In accordance with the fair value hierarchy described above, the following table shows the fair value of the Company s financial liabilities that are required to be measured at fair value on a recurring basis as of December 31, 2011 (in thousands):

	Balance as of December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Liabilities:				
Interest rate swaps	$ 3,558	$	$ 3,558	$

The following table shows a reconciliation of the change in fair value of the Company s financial assets and liabilities with significant unobservable inputs (Level 3) for the three months ended March 31, 2012 and 2011 (in thousands):

	Three months ended March 31, 2012	2011
Balance at beginning of period	$	$ 81,995
Total gains or losses		
Realized gain included in earnings		(7,748)
Unrealized loss included in other comprehensive income		(1,713)
Purchases, issuances, settlements, sales and accretion		
Purchases		
Issuances		
Settlements		
Sales		(12,347)
Accretion of discount included in earnings		684
Balance at end of period	$	$ 60,871

NOTE 4 INVESTMENT IN DIRECT FINANCING LEASES

The components of investment in direct financing leases as of March 31, 2012 and December 31, 2011 were as follows (in thousands):

	March 31, 2012	December 31, 2011
Minimum lease payments receivable	$ 20,757	$ 21,487
Estimated residual value of leased assets	27,854	27,854
Unearned income	(12,870)	(13,342)
Total	$ 35,741	$ 35,999

NOTE 5 REAL ESTATE ACQUISITIONS

2012 Property Acquisitions

The Company made no property acquisitions during the three months ended March 31, 2012.

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COLE CREDIT PROPERTY TRUST II, INC.

NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

March 31, 2012

2011 Property Acquisitions

During the three months ended March 31, 2011, the Company acquired a 100% interest in two commercial properties for an aggregate purchase price of $8.7 million (the 2011 Acquisitions). The Company purchased the 2011 Acquisitions with a combination of proceeds from the DRIP Offering, cash flows from operations and net proceeds from borrowings. The Company allocated the purchase price of the 2011 Acquisitions to the fair value of the assets acquired and liabilities assumed. The following table summarizes the purchase price allocation (in thousands):

	March 31, 2011
Land	$ 2,225
Building and improvements	5,058
Acquired in-place leases	1,289
Acquired above-market leases	98
Total purchase price	$ 8,670

The Company recorded revenue for the three months ended March 31, 2011 of $85,000 and a net loss of $213,000 related to the 2011 Acquisitions. In addition, the Company expensed $362,000 of acquisition costs for the three months ended March 31, 2011.

2011 Other Investment in Real Estate

During the three months ended March 31, 2011, the Company paid a tenant improvement allowance of $12.0 million for an expansion and improvements to an existing property, including the conversion of an existing warehouse into office space and the construction of a parking area, for which the Company will receive additional rents. Such costs were capitalized to buildings and improvements and will be depreciated over their estimated useful life.

NOTE 6 INVESTMENT IN MORTGAGE NOTES RECEIVABLE

As of March 31, 2012, the Company owned 69 mortgage notes receivable, which were secured by 43 restaurant properties and 26 single-tenant retail properties (each, a Mortgage Note , and collectively, the Mortgage Notes). As of March 31, 2012, the Mortgage Notes balance of $75.9 million consisted of the face amount of the Mortgage Notes of $70.0 million, a $6.9 million premium, $2.0 million of acquisition costs, and was net of accumulated amortization of premium and acquisition costs of $3.0 million. As of December 31, 2011, the Mortgage Notes balance of $76.7 million consisted of the face amount of the Mortgage Notes of $70.6 million, a $6.9 million premium, $2.0 million of acquisition costs, and was net of accumulated amortization of premium and acquisition costs of $2.8 million. The premium and acquisition costs are amortized into interest income over the term of each Mortgage Note using the effective interest rate method. The Mortgage Notes mature on various dates from August 1, 2020 to January 1, 2021. Interest and principal are due each month at interest rates ranging from 8.60% to 10.47% per annum with a weighted average interest rate of 9.89%. There were no amounts past due as of March 31, 2012.

The Company evaluates the collectability of both interest and principal on each Mortgage Note to determine whether it is collectible, primarily through the evaluation of credit quality indicators, such as underlying collateral and payment history. No impairment losses were recorded related to the Mortgage Notes for the three months ended March 31, 2012 or 2011. In addition, no allowances for uncollectability were recorded related to the Mortgage Notes as of March 31, 2012 or December 31, 2011.

NOTE 7 MARKETABLE SECURITIES

During the three months ended March 31, 2011, the Company sold two of its investments in commercial mortgage backed securities (CMBS) for $20.2 million, and realized a gain on the sale of $7.9 million. Realized gains and losses from the sale of available-for-sale securities are determined on a specific identification basis. The Company had no investments in CMBS as of March 31, 2012.

COLE CREDIT PROPERTY TRUST II, INC.

NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

March 31, 2012

NOTE 8 DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

In the normal course of business, the Company uses certain types of derivative instruments for the purpose of managing or hedging its interest rate risks. The table below summarizes the notional amount and fair value of the Company s derivative instruments (in thousands):

Derivatives designated as hedging instruments	Balance Sheet Location	Notional Amount	Interest Rate	Effective Date	Maturity Date	Fair Value of Liability March 31, 2012	Fair Value of Liability December 31, 2011
Interest Rate Swap	Deferred rental income, derivative and other liabilities	$ 31,875	6.2%	11/4/2008	10/31/2012	$ (634)	$ (869)
Interest Rate Swap	Deferred rental income, derivative and other liabilities	14,847	6.2%	6/12/2009	6/11/2012	(79)	(172)
Interest Rate Swap	Deferred rental income, derivative and other liabilities	7,070	5.8%	2/20/2009	3/1/2016	(481)	(497)
Interest Rate Swap	Deferred rental income, derivative and other liabilities	30,000	6.0%	11/24/2009	10/16/2012	(236)	(310)
Interest Rate Swap	Deferred rental income, derivative and other liabilities	111,111	4.9%(1)	2/28/2011	11/30/2013	(1,673)	(1,558)
Interest Rate Swap	Deferred rental income derivative and other liabilities	38,250	3.5%	9/26/2011	9/26/2014	(240)	(152)
		$ 233,153				$ (3,343)	$ (3,558)

(1) The interest ra