CAPITAL AUTOMOTIVE REIT
Form 10-Q
November 13, 2003

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

(Mark One)

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

For quarterly period ended September 30, 2003

( ) 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 000-23733

CAPITAL AUTOMOTIVE REIT

(Exact name of registrant as specified in its charter)

Maryland	54-1870224
(State of organization)	(I.R.S. Employer Identification Number)

8270 Greensboro Drive, Suite 950, McLean, Virginia 22102
(Address of principal executive offices and zip code)

(703) 288-3075
(Registrant s telephone Number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes (X) No ( )

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes (X) No ( )

Number of common shares of beneficial interest outstanding as of October 31, 2003 was 32,594,289.

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PART I - FINANCIAL INFORMATION
ITEM I - FINANCIAL STATEMENTS
CAPITAL AUTOMOTIVE REIT
CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share data)

	September 30, 2003	December 31, 2002
	(Unaudited)	
ASSETS		
Real estate:		
Land	$ 688,115	$ 632,868
Buildings and improvements	1,014,656	941,285
Accumulated depreciation	(108,124)	(85,523)
	1,594,647	1,488,630
Cash and cash equivalents	18,143	7,442
Other assets, net	53,643	46,398
Total Assets	$ 1,666,433	$ 1,542,470
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Mortgage debt	$ 1,017,616	$ 898,733
Borrowings under credit facilities	30,002	111,096
Accounts payable and accrued expenses	30,867	29,022
Security deposits payable	7,230	6,948
Total Liabilities	1,085,715	1,045,799
Minority Interest	118,596	116,048
Shareholders Equity		
Preferred shares, par value $.01 per share; 20 million shares authorized, no shares issued or outstanding		
Common shares, par value $.01 per share; 100 million shares authorized, 32,449,746 shares issued and outstanding as of September 30, 2003 and 28,321,396 shares issued and outstanding as of December 31, 2002	324	283
Additional paid-in-capital		413,688
Deferred compensation		(1,550)
Accumulated other comprehensive income (loss)		(16,274)
Distributions in excess of accumulated earnings	37,718	(15,524)
Total Shareholders Equity	38,042	380,623
Total Liabilities and Shareholders Equity	$ 1,242,353	$ 1,542,470

See accompanying Notes to Consolidated Financial Statements.

CAPITAL AUTOMOTIVE REIT
UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Three Months Ended September 30, 2003	Three Months Ended September 30, 2002	Nine Months Ended September 30, 2003	Nine Months Ended September 30, 2002
Revenue:				
Rental	$43,013	$36,067	$125,309	$102,243
Interest and other	144	241	783	505
Total revenue	43,157	36,308	126,092	102,748
Expenses:				
Depreciation and amortization	7,834	6,776	22,936	18,933
General and administrative	2,546	2,026	7,172	6,136
Interest	16,323	13,558	48,160	35,376
Total expenses	26,703	22,360	78,268	60,445
Income from continuing operations before minority interest	16,454	13,948	47,824	42,303
Minority interest	(3,383)	(3,286)	(10,335)	(10,013)
Income from continuing operations	13,071	10,662	37,489	32,290
Income from discontinued operations		40	171	180
Gain on sale of real estate		222	58	222
Total discontinued operations		262	229	402
Net income	$13,071	$10,924	$ 37,718	$ 32,692
Shares of common stock outstanding used to compute basic earnings per share	31,919	27,917	30,303	27,291
Basic earning per share:				
Income from continuing operations	$ 0.41	$ 0.38	$ 1.24	$ 1.18
Net income	$ 0.41	$ 0.39	$ 1.24	$ 1.20
Shares of common stock outstanding used to compute diluted earnings per share	32,731	28,956	31,198	28,454
Diluted earnings per share:				
Income from continuing operations	$ 0.40	$ 0.37	$ 1.21	$ 1.15
Net income	$ 0.40	$ 0.38	$ 1.22	$ 1.16
Dividends declared per share	$0.4110	$0.3980	$ 1.2260	$ 1.1805

See accompanying Notes to Consolidated Financial Statements.

CAPITAL AUTOMOTIVE REIT
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Nine Months Ended September 30, 2003	2002
Cash flows from operating activities:		
Net income	$ 37,718	$ 32,692
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on disposition of real estate net of minority interest	(58)	(222)
Stock compensation expense	853	869
Depreciation and amortization	24,797	20,077
Income from continuing operations applicable to minority interest	10,335	10,013
Income from discontinued operations applicable to minority interest	49	57
Increase in other assets	(3,503)	(8,184)
Increase in accounts payable and accrued expenses	1,877	4,329
Increase (decrease) in security deposits payable	282	(67)
Net cash provided by operating activities	72,350	59,564
Cash flows from investing activities:		
Purchase of furniture and equipment	(44)	(71)
Real estate acquisitions	(130,906)	(280,339)
Real estate dispositions	1,928	7,524
Net cash used in investing activities	(129,022)	(272,886)
Cash flows from financing activities:		
Proceeds from borrowings under credit facilities	58,000	251,712
Proceeds from mortgage debt	234,480	205,385
Repayment of borrowings under credit facilities	(139,094)	(169,220)
Repayment of mortgage debt	(91,638)	
Mortgage principal payments	(23,959)	(16,093)
Payments for debt issuance costs	(6,636)	(7,311)
Decrease (increase) in restricted cash	1,178	(12,368)
Payment of cash dividend	(33,673)	(32,432)
Distributions to minority partners	(10,234)	(9,862)
Payment for the purchase of outstanding warrants to purchase common shares		(6,328)
Redemption of units of limited partnership interest in the Partnership		(153)
Proceeds from follow-on offering, net of costs	66,430	
Proceeds from issuance of other common shares, net of costs	12,519	17,132
Net cash provided by financing activities	67,373	220,462
Net increase in cash and cash equivalents	10,701	7,140
Cash and cash equivalents at beginning of period	7,442	9,490
Cash and cash equivalents at end of period	$ 18,143	$ 16,630
Supplemental Data:		
Real estate acquisitions in exchange for equity issuance	$	$ 19,000
Interest paid during the period	$ 45,404	$ 29,465

See accompanying Notes to Consolidated Financial Statements.

CAPITAL AUTOMOTIVE REIT
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY AND OTHER COMPREHENSIVE INCOME
(in thousands, except share data)

	Common Shares		Additional Paid-in	Distributions in Excess of Accumulated	Deferred	Accumulated Other Comprehensive Income		Other Comprehensive
	Shares	Par Value	Capital	Earnings	Compensation	(Loss)	Total	Income
Balance at December 31, 2002 (audited)	28,321,396	$ 283	$413,688	$ (15,524)	$ (1,550)	$ (16,274)	$380,623	
Adjustment to reflect minority interest ownership in Partnership			(6,245)				(6,245)	
Proceeds from follow-on offering, net of costs	2,702,500	27	66,403				66,430	
Issuance of common shares from dividend reinvestment and share purchase plan, net of costs	167,349	1	4,307				4,308	
Issuance of restricted shares, net of forfeitures	60,569	1	1,398		(1,399)			
Amortization of deferred compensation					727		727	
Issuance of phantom shares, net of forfeitures	12,460		103				103	
Exercise of common stock options and warrants	891,898	9	12,431				12,440	
Redemption of units of limited partnership interest in the Partnership to common shares	293,574	3	3,864				3,867	
Accrued compensation			126				126	
Change in valuation of interest rate swap						(162)	(162)	(162)
Change in valuation of interest rate swap attributable to minority interest								35
Dividends declared				(37,813)			(37,813)	
Net income				37,718			37,718	37,718
Balance at September 30, 2003 (unaudited)	32,449,746	$ 324	$496,075	$ (15,619)	$ (2,222)	$ (16,436)	$462,122	$ 37,591

See accompanying Notes to Consolidated Financial Statements.

CAPITAL AUTOMOTIVE REIT
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. ORGANIZATION AND BASIS OF PRESENTATION

Organization

Capital Automotive REIT, which we refer to as the Company, is a Maryland real estate investment trust formed in October 1997. We own interests in real estate and conduct our operations, directly or indirectly, through Capital Automotive L.P., which we refer to as the Partnership, and its subsidiaries. We are the sole general partner of the Partnership and, as of September 30, 2003, owned approximately 79.6% of the units of limited partnership interest in the Partnership, which we refer to as Units. References to we, us and our refer to the Company or, if the context requires, the Partnership and our business and operations conducted through the Partnership and/or directly or indirectly owned subsidiaries.

Our primary business strategy is to purchase real estate (land, buildings and other improvements), which we simultaneously lease to operators of franchised automobile dealerships and motor vehicle service, repair or parts businesses, used vehicle businesses and other related businesses under long-term, triple-net leases. Triple-net leases typically require the tenant to pay all operating expenses of a property, including, but not limited to, all real estate taxes, assessments and other government charges, insurance, utilities, repairs and maintenance. We use (i) the term dealerships to refer to these types of businesses that are operated on our properties, and (ii) the terms dealer group, tenant or operators of dealerships to refer to the persons and companies that lease our properties. We focus on leasing properties to dealer groups that have a long history of operating multi-site, multi-franchised dealerships, generally targeting the largest dealer groups in terms of revenues in the largest metropolitan areas in the U.S. in terms of population. In addition, we provide facility improvement and expansion funding, construction financing and takeout commitments in certain situations.

As of September 30, 2003, we had invested more than $1.7 billion in 313 properties located in 30 states (Alabama, Arizona, California, Colorado, Connecticut, Florida, Georgia, Idaho, Illinois, Indiana, Louisiana, Maryland, Michigan, Mississippi, Missouri, Nevada, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah and Virginia), consisting of approximately 2,234 acres of land and containing approximately 12.8 million square feet of buildings and improvements. Our tenants operate 436 motor vehicle franchises on our properties, representing 43 brands of motor vehicles, which include all of the top selling brands in the U.S. The initial lease terms generally range from 10 to 20 years (with a weighted average initial lease term for leases entered into during the quarter ended September 30, 2003 of approximately 17.7 years), with our entire portfolio having a weighted average initial lease term of approximately 14.4 years. As of September 30, 2003, our portfolio had a weighted average remaining lease term of approximately 11.2 years. The leases typically have options to renew upon generally the same terms and conditions for one or more additional periods of five to 10 years each, exercisable at the option of the tenants (with renewal options typically ranging from a total of five to 40 years).

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared by management in accordance with accounting principles generally accepted in the United States, commonly referred to as GAAP, for interim financial information and in conformity with the rules and regulations of the Securities and Exchange Commission, commonly referred to as the SEC. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The results of operations for the three months and nine months ended September 30, 2003, are not necessarily indicative of the results that may be expected for the full year. These financial statements should be read in conjunction with our audited consolidated financial statements and footnotes thereto, included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2002.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements of the Company have been prepared in accordance with GAAP and include the accounts of the Company, its wholly owned subsidiaries, and other entities where the Company has a majority ownership, all of which it controls. The equity interests of other limited partners are reflected as minority interest. All significant intercompany transactions and balances have been eliminated in consolidation.

Real Estate and Depreciation

The purchase price of real estate properties acquired is allocated to the various components, such as land, buildings and improvements, and in-place leases, in accordance with Statement of Financial Accounting Standards No. 141, commonly referred to SFAS No. 141. The purchase price is allocated based on the fair value of each component at the time of acquisition. The fair value of the buildings and improvements are recorded at their replacement cost. Any significant amounts paid above or below the fair value of the land and building and improvements acquired would be recorded as a lease intangible asset or liability and amortized and recorded as an increase or reduction to rental income over the remaining life of the associated lease. Based on our analysis, we had not recorded any lease intangible assets or liabilities as of September 30, 2003 and December 31, 2002. External acquisition costs directly related to each property are capitalized as a cost of the respective property.

Depreciation is computed using the straight-line method over an estimated useful life of 20 to 45 years for the buildings and improvements. Real estate depreciation expense was approximately \$7.8 million and \$6.7 million for the three months ended September 30, 2003 and 2002, respectively. Real estate depreciation expense was approximately \$22.8 million and \$18.9 million for the nine months ended September 30, 2003 and 2002, respectively.

Furniture, Fixtures and Equipment

Furniture, fixtures and equipment are recorded at cost. Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, ranging from three to five years. Total depreciation expense related to our furniture, fixtures and equipment was approximately \$18,000 and \$20,000 for the three months ended September 30, 2003 and 2002, respectively. Total depreciation expense related to our furniture, fixtures and equipment was approximately \$58,000 and \$55,000 for the nine months ended September 30, 2003 and 2002, respectively.

Cash and Cash Equivalents

Cash and cash equivalents are comprised of highly liquid instruments purchased with original maturities of three months or less.

Restricted Cash

Restricted cash consists primarily of cash reserved to fund debt service payments and funds invested in cash collateral accounts. The purpose of the cash collateral accounts is to hold funds, generally in the amount of the interest rate swap valuations at any point in time, to protect lenders in case of an early termination of the existing swaps by us. The cash collateral accounts are controlled by the lenders, however, we earn the interest on the funds held. Restricted cash is included in other assets and totaled approximately $15.1 million and $16.1 million as of September 30, 2003 and December 31, 2002, respectively.

Deferred Loan Costs

Certain costs incurred in connection with our revolving credit facilities and issuing mortgage debt are capitalized and generally amortized over the terms of the respective revolving credit facility or mortgage debt using the effective interest method or on a straight-line basis, which approximates the effective interest method. Deferred loan costs include lender fees and other third party costs. These costs, net of accumulated amortization, are included in other assets and total approximately $18.4 million and $13.4 million as of September 30, 2003 and December 31, 2002, respectively. Loan cost amortization expense was approximately $675,000 and $550,000 for the three months ended September 30, 2003 and 2002, respectively. Loan cost amortization expense was approximately $1.9 million and $1.0 million for the nine months ended September 30, 2003 and 2002, respectively.

Capitalized Leasing Costs

Certain initial direct costs incurred by us in negotiating and consummating a successful lease are capitalized and generally amortized over the initial base term of the lease. Capitalized leasing costs include employee compensation and payroll-related fringe benefits directly related to time spent performing leasing-related activities. These activities include evaluating the financial condition of prospective clients, evaluating and recording guarantees, collateral and other security arrangements, negotiating lease terms, preparing lease documents and closing the transaction. These costs, net of accumulated amortization, are included in other assets and total approximately $1.4 million and $1.2 million as of September 30, 2003 and December 31, 2002, respectively. Leasing cost amortization expense was approximately $44,000 and $36,000 for the three months ended September 30, 2003 and 2002, respectively. Leasing cost amortization expense was approximately $128,000 and $109,000 for the nine months ended September 30, 2003 and 2002, respectively.

Income Taxes

We believe we are qualified and will continue to qualify as a real estate investment trust, commonly referred to as a REIT, under the provisions of the Internal Revenue Code of 1986, as amended. As a REIT, we are required to distribute at least 90% of our taxable income to our shareholders and comply with certain other requirements. We generally will not be subject to federal income tax on taxable income that we distribute to our shareholders.

Rental Revenue Recognition

We lease our real estate pursuant to long-term, triple-net leases, under which the tenants typically pay all operating expenses of a property, including, but not limited to, all real estate taxes, assessments and other government charges, insurance, utilities, repairs and maintenance. All leases are accounted for as operating leases and rental income attributable to the leases is recorded monthly when due from tenants. Rental income attributable to the majority of our leases is fixed by the lease agreement. However, under our variable rate lease program, monthly base rent is calculated based on a spread over an applicable index, typically LIBOR. As of September 30, 2003, approximately $413 million of our more than $1.7

billion real estate portfolio, or 24%, was subject to variable rate leases. This compares to approximately $367.0 million of our approximately $1.5 billion real estate portfolio, or 24%, that was subject to variable rate leases as of September 30, 2002. The vast majority of our variable rate lease agreements contain minimum lease rates, generally between 8% and 9%, and fixed rate conversion features generally with minimum rates of 10.0% to 10.25%, and none of these leases contains a maximum rate.

Our leases typically provide for upward periodic adjustments in base rent due from our tenants, usually based on a factor of the change in the consumer price index, commonly referred to as CPI. In addition, our leases are generally subject to certain fixed minimum and/or maximum rent escalators during the initial lease term. The fixed minimum rent escalations are straight-lined into rental income over the initial lease term. Any rent adjustments above the fixed minimum escalations are recorded as revenue in the period they are due from the tenants. Straight-lined rents are included in other assets and totaled approximately $15.5 million and $11.8 million as of September 30, 2003 and December 31, 2002, respectively. Straight-lined rental revenue was approximately $1.2 million for the three months ended September 30, 2003 and 2002. Straight-lined rental revenue was approximately $3.7 million and $3.9 million for the nine months ended September 30, 2003 and 2002, respectively.

Derivative Instruments

To minimize interest rate risk, during 2002 and 2001, we entered into three interest rate swap arrangements with third parties to fix the interest rate on the underlying variable rate debt. These swaps were documented as cash flow hedges and were designated as highly effective at the inception of the swap agreements. Therefore, in accordance with GAAP, the unrealized gain or loss upon measuring the swaps at their fair value is recorded as a component of accumulated other comprehensive income (loss) within shareholders equity on our consolidated balance sheets. The fair value of the swaps is recorded as either a derivative instrument asset or a derivative instrument liability on our consolidated balance sheets.

Share-Based Compensation

The Capital Automotive Group 1998 Equity Incentive Plan (as amended in February 1999 and as restated and amended in February 2002), which we refer to as the Plan, provides equity compensation to our employees, officers, non-employee trustees and certain other service providers. At September 30, 2003, we accounted for our Plan under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. All options granted under this plan had exercise prices equal to or greater than the market value of the underlying common stock on the date of grant. Therefore, no compensation expense is reflected in net income for stock option-based awards.

The following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition provisions of the Financial Accounting Standards Board, commonly referred to as FASB, Statement of Financial Accounting Standards, commonly referred to as SFAS, No. 123, Accounting for Stock-Based Compensation, and SFAS No. 148, Accounting For Stock-Based Compensation Transition and Disclosure, to share-based compensation (in thousands, except per share data).

	For the Three Months Ended September 30, 2003	2002	For the Nine Months Ended September 30, 2003	2002
Net income, as reported	$13,071	$10,924	$37,718	$32,692
Add: Share-based compensation expense included in reported net income, net of minority interest	198	225	669	663
Deduct: Total share-based compensation expense determined under the fair value-based method for all awards, net of minority interest	(236)	(332)	(787)	(1,077)
Pro forma net income	$13,033	$10,817	$37,600	$32,278
Basic earnings per share:				
As reported	$ 0.41	$ 0.39	$ 1.24	$ 1.20
Pro forma	$ 0.41	$ 0.39	$ 1.24	$ 1.18
Diluted earnings per share:				
As reported	$ 0.40	$ 0.38	$ 1.22	$ 1.16
Pro forma	$ 0.40	$ 0.38	$ 1.21	$ 1.15

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.

Reclassifications

Certain amounts in the 2002 consolidated financial statements have been reclassified to conform with the current year presentation.

3. NEW ACCOUNTING PRONOUNCEMENTS

In January 2003, the FASB issued FASB Interpretation No. 46, commonly referred to as FIN 46, Consolidation of Variable Interest Entities. Under FIN 46, companies will be required to determine if they are the primary beneficiary of a variable interest entity, commonly referred to as a VIE. If they are the primary beneficiary, the VIE must be consolidated. All companies with variable interests in VIEs created after January 31, 2003 must apply the provisions of FIN 46 immediately. Public companies with a variable interest in a VIE created before February 1, 2003 were originally required to apply the provisions of FIN 46 no later than the beginning of the first interim or annual reporting period beginning after June 15, 2003. This requirement was subsequently deferred by the FASB in October 2003 to the first interim or annual period ending after December 15, 2003. FIN 46 has not had and we do not expect that it will have a significant impact on our financial condition or results of operations.

In April 2002, the FASB issued SFAS No. 145, Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections. SFAS No. 145 requires that any gain or loss on extinguishment of debt that was classified as an extraordinary item in prior periods presented that does not meet the criteria in Accounting Principles Board Opinion No. 30 for classification as an extraordinary item be reclassified. These gains and losses will now be required to be presented within the statement of income in appropriate segregated line items. SFAS No. 145 is effective for our fiscal year beginning on January 1, 2003. As a result, we reclassified expenses related to an extinguishment of debt during 2001 from an extraordinary item, totaling $526,000 net of minority interest, to interest expense totaling $702,000 before minority interest. This reclassification results in a decrease in income from continuing operations before minority interest for 2001, but has no impact on our net income.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity . This Statement establishes standards for classifying and measuring as liabilities certain financial instruments that embody obligations of the issuer and have characteristics of both liabilities and equity. Instruments that are indexed and potentially settled in an issuer s own shares that are not within the scope of SFAS No. 150 remain subject to existing guidance. SFAS No. 150 must be applied immediately to instruments entered into or modified after May 31, 2003 and to all other instruments that exist as of the beginning of the first interim financial reporting period beginning after June 15, 2003. On October 29, 2003, the FASB deferred the application of paragraphs 9 and 10 of SFAS No. 150 and determined that the application would be reconsidered as a component of a separate, ongoing FASB project. Therefore, the effective date of its application is currently undeterminable. The adoption of SFAS No. 150 has not and is not expected to have a significant impact on our financial condition or results of operations.

4. ACQUISITIONS

During the three months ended September 30, 2003, we completed approximately $24.4 million of property acquisitions, bringing total acquisitions for the nine-month period ended September 30, 2003 to $130.8 million. The third quarter acquisitions included one auto mall, four other auto retail properties and construction and improvement fundings. These acquisitions contain nine automotive franchises and added approximately 224,000 square feet of buildings and improvements on approximately 28 acres of land. The leases have initial lease terms ranging from 15 to 20 years, with a weighted average initial lease term of 17.7 years. The leases have renewal options exercisable at the option of the tenants ranging from a total of 20 to 40 years. The acquisitions were funded with cash on hand and borrowings on our short-term revolving credit facilities. A summary of the third quarter acquisitions is as follows:

Two properties totaling approximately $8.7 million leased to affiliates of Sonic Automotive, Inc. (Sonic) located in Alabama. Included in the acquisition is a collision center and an auto mall that currently has three franchises (Audi, Land Rover and Porsche). Three additional franchises (BMW, Cadillac and Lexus) will be constructed on the auto mall during the next six months. We have committed to fund approximately $18 million for the construction of these new dealerships upon satisfactory completion of each facility subject to due diligence and customary closing conditions. As of September 30, 2003, we leased 86 properties to affiliates of Sonic, representing approximately 23% of the Company s total annualized rental revenue.

One property totaling approximately $7.5 million leased to a subsidiary of UnitedAuto Group, Inc. (UnitedAuto) located in Arizona. A Ford franchise is operated on the property. As of

September 30, 2003, we leased 17 properties to subsidiaries of UnitedAuto, representing approximately 11% of the Company s total annualized rental revenue.

Two properties totaling approximately $5.5 million leased to subsidiaries of Asbury Automotive Group, Inc. (Asbury) located in Georgia and Mississippi. Five franchises (Buick, Cadillac, Chevrolet, GMC and Pontiac) and a collision center are operated on these properties. As of September 30, 2003, we leased 11 properties to subsidiaries of Asbury, representing approximately 3% of the Company s total annualized rental revenue.

Construction and improvement fundings, totaling approximately $2.7 million, all of which were transacted with existing tenants.

5. DISCONTINUED OPERATIONS

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (effective for the Company on January 1, 2002). SFAS No. 144 requires that gains and losses from dispositions of properties and all operating earnings from these properties be reported as discontinued operations. This also requires that all past earnings applicable to a property disposed of subsequent to January 1, 2002 be reported as discontinued operations. As a result, previously reported income from continuing operations will be updated each time a property is sold. This requirement is for presentation only and has no impact on net income.

The following table is a summary of revenue from properties sold subsequent to January 1, 2002 (not including the gain on the sale of the properties) and total discontinued operations for the three months and nine months ended September 30, 2003 and 2002:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	**2002**	**2003**	**2002**
Revenue	$	$105,000	$226,000	$536,000
Total discontinued operations	$	$262,000	$229,000	$402,000
Number of properties included in discontinued operations		4	1	4

6. MORTGAGE DEBT AND REVOLVING CREDIT FACILITIES

As of September 30, 2003, we had total mortgage debt outstanding of approximately $1.02 billion (consisting of approximately $792.9 million of fixed rate and approximately $224.7 million of variable rate debt), which was secured by approximately 266 of our properties. In addition, we had approximately $30.0 million outstanding on our revolving credit facilities.

The following is a summary of our total debt outstanding as of September 30, 2003 and December 31, 2002 (dollars in thousands):

Description of Debt	Original Debt Issued	Principal Balance as of September 30, 2003	Principal Balance as of December 31, 2002	Effective Interest Rate*	Term/ Amortization Schedule
7.50% fixed rate debt due 4/20/03 (1)	$ 12,000	$	$ 10,771		(1)
7.59% fixed rate debt due 12/1/08 (2)	38,050	33,415	34,572	7.95%	10 yr/17 yr
7.54% fixed rate debt due 7/6/11 (3)	100,000	92,994	94,413	7.69%	12 yr/25 yr
7.565% fixed rate debt due 11/12/12 (4)	28,500	25,650	26,220	7.62%	12 yr/25 yr
7.5975% fixed rate debt due 12/18/12 (4)	32,054	29,212	29,781	7.59%	12 yr/30 yr
7.50% fixed rate debt due 8/10/13 (5)	82,600	77,093	79,158	7.62%	12 yr/30 yr
Triple Net Lease Mortgage Notes, Series 2002 (6)	325,000	309,535	318,995	7.70%	(6)
Triple Net Lease Mortgage Notes, Series 2003-1 (7)	228,000	225,002		5.86%	(7)
Total Mortgage Fixed Rate Debt		$ 792,901	$ 593,910	7.17%	
Variable rate debt due 9/29/11 (8)	150,000	139,642	143,907	3.40%	12 yr/25 yr
Various variable rate debt (9)	90,030	85,073	80,049	4.12%	10 to 12 yr/25 to 30 yr
Short-term variable rate debt (10)	80,867		80,867		(10)
Total Mortgage Variable Rate Debt		$ 224,715	$ 304,823	3.67%	
TOTAL MORTGAGE DEBT		$1,017,616	$ 898,733	6.40%	
$100 million revolving secured facility (11)		22,002	65,096	4.26%	(11)
$60 million revolving unsecured facility (12)		8,000	46,000	4.21%	(12)
$100 million revolving secured facility (13)					(13)
TOTAL CREDIT FACILITIES		$ 30,002	$ 111,096	4.26%	
TOTAL DEBT OUTSTANDING		**$1,047,618**	**$1,009,829**	**6.39%**	

* For the quarter ended September 30, 2003. Includes deferred loan fees amortized over the life of the loans.

(1) This loan was paid off on March 26, 2003 with the net proceeds from the issuance of the Triple Net Lease Mortgage Notes, Series 2003-1 as discussed in footnote (7) below.

(2) The loan requires monthly payments of principal and interest with a final payment at maturity of approximately $24.2 million. The Partnership has provided a guaranty of collection limited to approximately $8.9 million of this loan, contingent upon the lender first making written demand upon and proceeding against the borrower, including obtaining judgment and foreclosing upon all collateral. All amounts recovered from the borrower or collateral following a default reduce such guarantee.

(3) The loan requires quarterly payments of principal and interest with a final payment at maturity of approximately $72.4 million.

(4) These loans require quarterly interest and level principal payments until maturity, at which time the loans require final payments totaling approximately $33.5 million. These loans bear interest equal to the A1/P1 Commercial Paper Rate plus 215 basis points. We have entered into interest rate swap arrangements with a third party to fix the interest rates

on these loans.

(5) This loan requires quarterly interest and level principal payments with a final payment at maturity of approximately $49.6 million. This loan bears interest equal to the 30-day LIBOR rate plus 175 basis points. We have entered into an interest rate swap arrangement with a third party to fix the interest rate on this loan.

(6) During 2002, we issued $325 million in four classes of Triple Net Lease Mortgage Notes, Series 2002. The notes have a weighted average effective interest rate (including deferred fees amortized over the life of the notes) of approximately 7.7%. CARS Loan Servicer L.L.C., one of our subsidiaries, is servicer of the notes on behalf of the noteholders. The following is a breakdown of the Triple Net Lease Mortgage Notes, Series 2002 by class:

Class	Original Principal Balance	Current Principal Balance	Maturity Date
A-1a	164,136	153,494	8/15/14
A-1b	9,064	9,064	7/15/15
A-2	75,900	71,077	7/15/15
A-3	75,900	75,900	6/15/22

Classes A-1a and A-1b are fully-amortizing in succession over their respective terms and Classes A-2 and A-3 are fully-amortizing in succession over 20 years. The Partnership has provided a guaranty of collection limited to approximately $35 million of this loan, contingent upon the trustee first making written demand upon and proceeding against the borrower, including obtaining judgment and foreclosing upon all collateral. All amounts recovered from the borrower or collateral following a default reduce such guarantee. In connection with the issuance of this debt, in certain situations, the Company guarantees payments of principal and interest and any unpaid debt. The term of the guaranty is the same as the term of the debt.

(7) On March 26, 2003, we issued $228 million in two classes of Triple Net Lease Mortgage Notes, Series 2003-1. CARS Loan Servicer L.L.C. is servicer of the notes on behalf of the noteholders. The following is a breakdown of the Triple Net Lease Mortgage Notes, Series 2003-1 by class:

Class	Original Principal Balance	Current Principal Balance	Maturity Date
A-1	109,000	106,002	9/25/15
A-2	119,000	119,000	3/25/19

The Class A-1 and Class A-2 notes have weighted average effective interest rates (including deferred fees amortized over the life of the notes) of approximately 5.4% and 6.3%, respectively. The notes amortize in succession over a 20-year amortization schedule with the Class A-1 notes fully-amortizing and the Class A-2 notes requiring a final payment at maturity of approximately $70.8 million. In connection with the issuance of this debt, in certain situations, the Company guarantees payments of principal and interest and any unpaid debt. The term of the guaranty is the same as the term of the debt.

(8) The loan bears interest equal to the 30-day LIBOR rate plus 227 basis points and requires monthly level payments of principal and interest with a final payment at maturity of approximately $100.2 million.

(9) These loans bear interest at variable rates ranging from 200 to 357 basis points above the A1/P1 Commercial Paper Rate, the 30-day LIBOR rate, or the 3-month LIBOR rate and have maturity dates ranging from December 22, 2009 to June 2, 2015. The terms of the various loans require either quarterly interest and level principal payments or monthly level payments of principal and interest until maturity, at which time the loans require final payments totaling approximately $65.5 million.

(10) This short-term loan was paid off on March 26, 2003 with the net proceeds from the issuance of the Triple Net Lease Mortgage Notes, Series 2003-1 as discussed in footnote (7) above.

(11) Amounts borrowed under this facility bear interest at market rates determined at the time of each draw until such time as the Company and the lender set an interest rate for any future amounts borrowed under the facility. As of September 30, 2003, the borrowings under the facility bear interest equal to the 30-day LIBOR rate plus 295 to 300 basis points. Properties are eligible within the borrowing base for 150 days, unless extended by the Company and the lender. The facility has a one-year term, which matures on March 21, 2004, and is renewable annually.

(12) The facility provides for a three-year term with interest determined, at our option, at either the Prime rate less 50 basis points or the one-month, two-month or three-month LIBOR rate plus 200 basis points. As of September 30, 2003, the borrowings under the facility

bear interest equal to the one-month LIBOR plus 200 basis points. Properties are eligible within the borrowing base for 12 months, unless extended by the Company and the lender. The facility matures on March 29, 2005.

(13) This construction credit facility provides for a one-year term. Amounts borrowed under this facility bear interest at a spread over LIBOR as determined at the time of each draw. Proceeds will be used to fund construction and improvement financing for existing tenants. As of September 30, 2003, no amounts had been borrowed on this facility. The facility matures on June 22, 2004, and is renewable annually.

As of September 30, 2003, we were in compliance with all of the debt covenants related to our mortgage debt and credit facilities.

Aggregate annual principal amortization and payments due at maturity of our mortgage debt as of September 30, 2003 are as follows (in thousands):

For the Year Ended December 31,	Principal Amortization	Maturities	Total
2003	$ 9,943	$	$ 9,943
2004	36,544		36,544
2005	37,305		37,305
2006	38,632		38,632
2007	40,931		40,931
Thereafter	438,027	416,234	854,261
Total	$601,382	$416,234	$1,017,616

Interest Rate Swaps

To minimize interest rate risk, during 2002 and 2001, we entered into three interest rate swap arrangements with third parties to fix the interest rate on the underlying variable rate debt, totaling approximately $141 million. These swaps were designed to mirror the underlying variable rate debt in terms of index, spread, reset, amortization, compounding and maturity. Due to the identical nature of the terms of the swap arrangements and the underlying terms of the debt, these swaps were documented as cash flow hedges and designated as highly effective at inception of the swap arrangements. Therefore, in accordance with GAAP, the unrealized gain or loss upon measuring the swaps at their fair value is recorded as a component of accumulated other comprehensive income (loss) within shareholders equity on our consolidated balance sheets. The fair value of the swaps is recorded as either a derivative instrument asset or a derivative instrument liability on our consolidated balance sheets. In addition, we are required to post collateral, generally in the amount of the swap valuations at any point in time, to protect the lenders in case of an early termination by us. The collateral posted by us, totaling approximately $13.9 million and $15.0 million as of September 30, 2003 and December 31, 2002, respectively, is included in other assets on our consolidated balance sheets. Total comprehensive income for the three months ended September 30, 2003 and 2002 was $16.8 million and $1.9 million, respectively. Total comprehensive income for the nine months ended September 30, 2003 and 2002 was $37.6 million and $18.6 million, respectively. The unrealized loss as of September 30, 2003 and December 31, 2002 was as follows (in thousands):

	September 30, 2003	December 31, 2002
Derivative instrument liability	$16,436	$16,274

7. MINORITY INTEREST

Assets and liabilities allocated to the limited partners (other than the Company), which we describe as the Minority Interest, are based on their ownership percentage of the Partnership at the end of the period. The ownership percentage is determined by dividing the number of Units held by the Minority Interest at the end of the period by the total Units outstanding at the end of the period, excluding derivative securities. The Minority Interest ownership percentage in assets and liabilities of the Partnership was 20.4% and 23.4% as of September 30, 2003 and December 31, 2002, respectively.

Income before minority interest is allocated to the limited partners based on their weighted average ownership during the period. The ownership percentage is determined by dividing the weighted average number of Units held by the Minority Interest by the total weighted average number of Units outstanding during the period, excluding derivative securities. The Minority Interest ownership percentage in income of the Partnership was 20.6% and 23.6% for the three months ended September 30, 2003 and 2002, respectively. The Minority Interest ownership percentage in income of the Partnership was 21.6% and 23.7% for the nine months ended September 30, 2003 and 2002, respectively.

Holders of Units, which we refer to as Unitholders, are entitled to quarterly distributions which are equivalent to the quarterly dividend distributions received by holders of common shares. There were approximately 8.3 million and 8.6 million limited partnership units in the Partnership, as of September 30, 2003 and December 31, 2002, respectively, not held by the Company, which were outstanding and could be exchanged for common shares of the Company on a one-for-one basis in specified circumstances. When a Unitholder converts Units to shares of common stock, an adjustment is recorded to equity to reflect the change in the Minority Interest ownership in the Partnership.

8. EARNINGS PER SHARE

Basic earnings per share is computed as net income divided by the weighted average common shares, excluding restricted shares, outstanding for the period. Diluted earnings per share is computed as net income, adjusted to reflect the change in the income allocated to minority interest calculated as if the derivative securities were outstanding, divided by the weighted average common shares outstanding for the period plus the effect of dilutive securities outstanding for the period, based on the treasury stock method. Dilutive securities include options, warrants, phantom shares and restricted shares.

A reconciliation of net income and weighted average common shares used to calculate basic and diluted earnings per share for the three months and nine months ended September 30, 2003 and 2002 is as follows (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
Income from continuing operations	$13,071	$10,662	$37,489	$32,290
Adjustments	67	91	237	315
Income from continuing operations used to calculate diluted earnings per share	$13,138	$10,753	$37,726	$32,605
Basic earnings per share	$ 0.41	$ 0.38	$ 1.24	$ 1.18
Diluted earnings per share	$ 0.40	$ 0.37	$ 1.21	$ 1.15
Net income	$13,071	$10,924	$37,718	$32,692
Adjustments	67	93	239	320
Net income used to calculate diluted earnings per share	$13,138	$11,017	$37,957	$33,012
Basic earnings per share	$ 0.41	$ 0.39	$ 1.24	$ 1.20
Diluted earnings per share	$ 0.40	$ 0.38	$ 1.22	$ 1.16
Weighted average shares:				
Common shares outstanding used to compute basic earnings per share	31,919	27,917	30,303	27,291
Adjustments	812	1,039	895	1,163
Common shares outstanding used to compute diluted earnings per share	32,731	28,956	31,198	28,454

9. DIVIDENDS DECLARED PER SHARE

Dividends are generally declared a quarter in arrears. Dividends declared per share for the three months ended September 30, 2003 and 2002 represent the second quarter dividend for 2003 and 2002, respectively. Dividends declared per share for the nine months ended September 30, 2003 include the first and second quarter dividends for 2003 and the fourth quarter dividend for 2002. Dividends declared per share for the nine months ended September 30, 2002 includes the first and second quarter dividends for 2002 and the fourth quarter dividend for 2001.

10. SUBSEQUENT EVENTS

Declaration of Dividend. On October 14, 2003, our Board of Trustees declared a cash dividend of $0.4140 per share, which will be paid on November 20, 2003 to shareholders of record as of November 10, 2003.

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

The following discussion should be read in conjunction with the accompanying unaudited consolidated financial statements and notes thereto.

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Also, documents that we subsequently file with the SEC will contain forward-looking statements. When we refer to forward-looking statements or information, sometimes we use words such as may, will, could, should, plans, intends, expects, believes, estimates, anticipates and continues. In particular, Item II and Item III of Part I o Form 10-Q describe forward-looking information. The statements made herein are not all inclusive, particularly with respect to possible future events, and should be read together with other filings made by the Company under the Securities Act and the Exchange Act, including the risks and other risk factors contained in the Company s Form 8-K/A filed on February 12, 2003. Other parts of this Form 10-Q may also describe forward-looking information. Many things can happen that can cause our actual results to be different than those described. These factors include, but are not limited to:

- risks that our tenants will not pay rent;
- risk related to our reliance on a small number of tenants for a significant portion of our revenue;
- risks of financing, such as our ability to meet existing financial covenants and to consummate planned and additional financings on terms that are acceptable to us;
- risks that our growth will be limited if we cannot obtain additional capital;
- risks that planned and additional acquisitions may not be consummated;
- risks related to the automotive industry, such as the ability of our tenants to compete effectively in the automotive retail industry and the ability of our tenants to perform their lease obligations as a result of changes in any manufacturer s production, supply, vehicle financing, marketing or other practices or changes in the economy generally;
- risks generally incident to the ownership of real property, including adverse changes in economic conditions, changes in the investment climate for real estate, changes in real estate taxes and other operating expenses, adverse changes in governmental rules and fiscal policies and the relative illiquidity of real estate;
- environmental and other risks associated with the acquisition and leasing of automotive properties; and
- risks related to our status as a REIT for federal income tax purposes, such as the existence of complex regulations relating to our status as a REIT, the effect of future changes in REIT requirements as a result of new legislation and the adverse consequences of the failure to qualify as a REIT.

Given these uncertainties, readers are cautioned not to place undue reliance on these forward-looking statements. We also make no promise to update any of the forward-looking statements, or to publicly release the results if we revise any of them.

OVERVIEW

Our primary business strategy is to purchase real estate (land, buildings and other improvements), which we simultaneously lease to operators of franchised automobile dealerships and motor vehicle service, repair or parts businesses, used vehicle businesses and other related businesses under long-term, triple-net leases. We focus on leasing properties to dealer groups that have a long history of operating multi-site, multi-franchised dealerships, generally targeting the largest dealer groups in terms of revenues in the largest metropolitan areas in the U.S. in terms of population. In addition, we provide facility improvement and expansion funding, construction financing and takeout commitments in certain circumstances. As of September 30, 2003, we had invested more than $1.7 billion in 313 properties located in 30 states, consisting of approximately 2,234 acres of land and containing approximately 12.8 million square feet of buildings and improvements. Our tenants operate 436 motor vehicle franchises on our properties, representing 43 brands of motor vehicles, which include all of the top selling brands in the U.S.

Substantially all of our properties are leased pursuant to long-term, triple-net leases, under which the tenants typically pay all operating expenses of a property, including, but not limited to, all real estate taxes, assessments and other government charges, insurance, utilities, repairs and maintenance. The initial lease terms generally range from 10 to 20 years (with a weighted average initial lease term for leases entered into during the quarter ended September 30, 2003 of approximately 17.7 years), with our entire portfolio having a weighted average initial lease term of approximately 14.4 years. As of September 30, 2003, our portfolio had a weighted average remaining lease term of approximately 11.2 years. The leases typically have options to renew upon generally the same terms and conditions for one or more additional periods of five to 10 years each, exercisable at the option of the tenants (with renewal options typically ranging from a total of five to 40 years).

Substantially all of our revenues are derived from (1) rents received or accrued under long-term, triple-net leases; (2) interest earned from the temporary investment of funds in short-term investments; and (3) other fee income.

We incur general and administrative expenses including, principally, compensation expense for our executive officers and other employees, professional fees, office administration expenses (including rent), business taxes and insurance and various other expenses incurred in managing our business. We are a self-administered and self-managed real estate company operating as a real estate investment trust, or a REIT, for federal income tax purposes. Our primary non-cash expense is the depreciation of our properties. We depreciate buildings and improvements on our properties over a nine-year to 40-year period for tax purposes and a 20-year to 45-year period for financial reporting purposes. We do not own or lease any significant personal property, furniture or equipment at any property we currently own.

THIRD QUARTER ACQUISITIONS

During the three months ended September 30, 2003, we completed approximately $24.4 million of property acquisitions, bringing total acquisitions for the nine-month period ended September 30, 2003 to $130.8 million. The third quarter acquisitions included one auto mall, four other auto retail properties and construction and improvement fundings. These acquisitions contain nine automotive franchises and added approximately 224,000 square feet of buildings and improvements on approximately 28 acres of land. The leases have initial lease terms ranging from 15 to 20 years, with a weighted average initial lease term of 17.7 years. The leases have renewal options exercisable at the option of the tenants ranging from a total of 20 to 40 years. The acquisitions were funded with cash on hand and borrowings on our short-term revolving credit facilities. A summary of the third quarter acquisitions is as follows:

Two properties totaling approximately $8.7 million leased to affiliates of Sonic Automotive, Inc. (Sonic) located in Alabama. Included in the acquisition is a collision center and an auto mall that currently has three franchises (Audi, Land Rover and Porsche). Three additional franchises (BMW, Cadillac and Lexus) will be constructed on the auto mall during the next six months. We have committed to fund approximately $18 million for the construction of these new dealerships upon satisfactory completion of each facility subject to due diligence and customary closing conditions. As of September 30, 2003, we leased 86 properties to affiliates of Sonic, representing approximately 23% of the Company s total annualized rental revenue.

One property totaling approximately $7.5 million leased to a subsidiary of UnitedAuto Group, Inc. (UnitedAuto) located in Arizona. A Ford franchise is operated on the property. As of September 30, 2003, we leased 17 properties to subsidiaries of UnitedAuto, representing approximately 11% of the Company s total annualized rental revenue.

Two properties totaling approximately $5.5 million leased to subsidiaries of Asbury Automotive Group, Inc. (Asbury) located in Georgia and Mississippi. Five franchises (Buick, Cadillac, Chevrolet, GMC and Pontiac) and a collision center are operated on these properties. As of September 30, 2003, we leased 11 properties to subsidiaries of Asbury, representing approximately 3% of the Company s total annualized rental revenue.

Construction and improvement fundings, totaling approximately $2.7 million, all of which were transacted with existing tenants.

RESULTS OF OPERATIONS

Revenue

Rental. Rental revenue for the three months ended September 30, 2003 increased 19% to $43.0 million from $36.1 million for the same quarter in 2002. Rental revenue for the nine months ended September 30, 2003 increased 23% to $125.3 million from $102.2 million for the same period in 2002. The increase was primarily attributable to:

the growth of our real estate portfolio from which we generate our rental income. This increase will vary depending on the timing of our property acquisitions and whether or not our leases have fixed minimum escalators. We owned 313 properties as of September 30, 2003 versus 287 properties as of September 30, 2002, although one of the properties owned as of September 30, 2002 was sold subsequent to September 30, 2002 and reclassified from rental revenue to discontinued operations as discussed under Discontinued Operations below;

an increase from rent escalations above the fixed minimum escalators, which are recorded as revenue in the period they are due from the tenants.

In addition to the above, during the quarter and nine months ended September 30, 2003, the investment spreads on our variable rate leases have increased as compared to the same period in the prior year. As of September 30, 2003 our variable rate leases totaled $413 million, as compared to $367 million as of September 30, 2002. Under these leases, base rent changes monthly, generally based upon a spread over LIBOR. The vast majority of these variable rate leases contain minimum lease rates, generally ranging from 8% to 9%, which has allowed us to realize additional investment spread during the current low short-term interest rate environment. During the past year, the average one-month LIBOR rate has decreased from 1.82% during the third quarter of 2002 to 1.11% during the third quarter of 2003. This has resulted in a decrease in interest expense on our variable rate debt, as discussed in *Expenses* below. However, the revenue generated from the vast majority of our variable rate leases has remained constant during this same time period, since the minimum lease rates were in effect at these LIBOR levels.

Interest and Other. Interest and other income for the three months ended September 30, 2003 decreased 40% to $144,000 from $241,000 for the same quarter in 2002. Interest and other income for the nine months ended September 30, 2003 increased 55% to $783,000 from $505,000 for the same period in 2002. Differences in interest and other income are primarily due to fluctuations in the cash collateral balances held by our lenders at any point in time and changes in the interest rates earned on these balances. The purpose of the cash collateral accounts is to hold funds, generally in the amount of the swap valuations at any point in time, to protect the lenders in case of an early termination by us. The cash collateral accounts are controlled by the lenders, however, we earn interest on the funds held. Our cash collateral accounts totaled $13.9 million and $14.0 million as of September 30, 2003 and 2002.

Expenses

Depreciation and Amortization. Depreciation and amortization for the three months ended September 30, 2003 increased 16% to $7.8 million from $6.8 million for the same quarter in 2002. Depreciation and amortization for the nine months ended September 30, 2003 increased 21% to $22.9 million from $18.9 million for the same period in 2002. Depreciation and amortization consisted primarily of depreciation on buildings and improvements owned during those periods. The increase is attributable to the growth of our real estate portfolio, resulting in an increase in our depreciable assets.

General and Administrative. General and administrative expenses for the three months ended September 30, 2003 increased 26% to $2.5 million from $2.0 million for the same quarter in 2002. General and administrative expenses for the nine months ended September 30, 2003 increased 17% to $7.2 million from $6.1 million for the same period in 2002. The increase in operating expenses is due primarily to:

- an increase in payroll and related expenses primarily attributable to an increase in base compensation and bonus targets, expenses related to stock based compensation plans, and an increase in the number of employees;

- an increase in directors and officers insurance due to an increase in market rates;

- an increase in professional fees associated with the implementation of Section 404 of the Sarbanes-Oxley Act of 2002, which requires companies to assess the effectiveness of their internal controls over financial reporting, effective for our fiscal year ended 2004;

- an increase in business taxes and state registration fees due to the growth in our real estate portfolio during 2002 and 2003 as well as changes in state tax laws;

- an increase in rent and occupancy costs due to the relocation of our office during the fourth quarter of 2002; and

- an increase in fees paid to our Board of Trustees.

The increase in operating expenses from the nine months ended September 30, 2002 was partially offset by the decrease in information technology costs due to projects initiated and completed during the first quarter of 2002.

Interest. Interest expense for the three months ended September 30, 2003 increased 20% to $16.3 million from $13.6 million for the same quarter in 2002. Interest expense for the nine months ended September 30, 2003 increased 36% to $48.2 million from $35.4 million for the same period in 2002. The increase in interest expense is primarily due to an increase in our overall debt during the past twelve months, which was primarily obtained to directly or indirectly finance the acquisition of properties during that time period.

In addition, the effective interest rate on our debt, which includes deferred loan fees amortized over the life of the loans, was 6.39% for the quarter ended September 30, 2003 as compared to 6.37% for the quarter ended September 30, 2002. For the nine months ended September 30, 2003, the effective interest rate on our debt was 6.36% as compared to 6.41% for the nine months ended September 30, 2002. The change in the effective interest rate for the nine months ended September 30, 2003 is due to the decrease in interest rates during the past twelve months. This was partially offset by the issuance of long-term fixed rate debt during the same period to lock in rates during this low interest rate environment, resulting in a reduction of our borrowings on our short-term revolving credit facilities, and $80 million of debt that was swapped from variable rate to fixed rate effective during the fourth quarter of 2002.

Discontinued Operations. In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (effective for the Company on January 1, 2002). SFAS No. 144 requires that gains and losses from dispositions of properties and all operating earnings from these properties be reported as discontinued operations. This also requires that all past earnings applicable to a property disposed of subsequent to January 1, 2002 be reported as discontinued operations. As a result, previously reported income from continuing operations will be updated each time a property is sold. This requirement is for presentation only and has no impact on net income.

The following table is a summary of revenue from properties sold subsequent to January 1, 2002 (not including the gain on the sale of the properties) and total discontinued operations for the three months and nine months ended September 30, 2003 and 2002:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	**2002**	**2003**	**2002**
Revenue	$	$105,000	$226,000	$536,000
Total discontinued operations	$	$262,000	$229,000	$402,000
Number of properties included in discontinued operations		4	1	4

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents were $18.1 million and $16.6 million at September 30, 2003 and September 30, 2002, respectively. The changes in cash and cash equivalents during the nine months ended September 30, 2003 and 2002 were attributable to operating, investing and financing activities, as described below.

Operating Activities

Cash provided by operating activities for the nine months ended September 30, 2003 and 2002 was $72.4 million and $59.6 million, respectively, and represents, in each year, cash received primarily from rents under long-term, triple-net leases, plus interest and other fee income, less normal recurring general and administrative expenses and interest payments on debt outstanding.

Investing Activities

Cash used in investing activities for the nine months ended September 30, 2003 and 2002 was $129.0 million and $272.9 million, respectively, and primarily reflects the acquisition of dealership properties, facility improvements and construction financings, net of sales, during those periods.

Financing Activities

Cash provided by financing activities for the nine months ended September 30, 2003 and 2002 was $67.4

million and $220.5 million, respectively. Cash provided by financing activities for the nine months ended September 30, 2003 primarily reflects:

- $234.5 million of proceeds received from mortgage debt incurred during the period;
- $66.4 million of proceeds received from our follow-on common share offering, net of costs;
- $58.0 million of proceeds received from borrowings on our revolving credit facilities;
- $12.5 million of proceeds received from the issuance of common shares through our Dividend Reinvestment and Share Purchase Plan, which we refer to as the DRIP, and equity incentive plans, net of costs; and
- the decrease of restricted cash totaling $1.2 million.

The cash provided by financing activities was partially offset by:

- the repayment of borrowings on our revolving credit facilities totaling $139.1 million;
- the repayment of mortgage debt totaling $91.6 million;
- distributions made to shareholders and minority partners during the period totaling $43.9 million;
- payments of principal on outstanding mortgage debt totaling $24.0 million; and
- payments for debt issuance costs totaling $6.6 million.

Cash provided by financing activities for the nine months ended September 30, 2002 primarily reflects:

- $251.7 million of proceeds received from borrowings on our revolving credit facilities;
- $205.4 million of proceeds received from mortgage debt incurred during the period; and
- $17.1 million of proceeds received from the issuance of common shares through our DRIP and equity incentive plans, net of costs.

The cash provided by financing activities was partially offset by:

- the repayment of borrowings on our revolving credit facilities totaling $169.2 million;
- distributions made to shareholders and minority partners during the period totaling $42.3 million;
- payments of principal on outstanding mortgage debt totaling $16.1 million;
- the increase of restricted cash totaling $12.4 million;
- payments for debt issuance costs totaling $7.3 million;
- payments made during the first quarter of 2002 totaling $6.0 million and $293,000 to purchase outstanding warrants to purchase common shares during the fourth quarter of 2001 and first quarter of 2002, respectively; and

the redemption of Units totaling $153,000.

Debt Financing Strategy

We typically fund our short-term liquidity requirements through available cash or one of our three revolving credit facilities. These facilities provide short-term borrowing capacity of $260 million of which approximately $230 million was available as of September 30, 2003. Periodically, in order to more closely match the term of our debt with that of our leases, we replace our short-term debt using the proceeds of long-term mortgage debt.

To minimize interest rate risk, we typically match the average term of our long-term debt with the average remaining term of our leases as well as the type of debt with the type of leases (fixed or variable rate) in order to maintain an investment spread over the lease term. We describe this process as match-funding. We currently intend to match-fund at least 70% of our total outstanding debt with leases. We may change the 70% guideline at any time without shareholder approval. As of September 30, 2003, approximately 91% of our debt outstanding was substantially match-funded debt. As of September 30, 2003, our long-term debt had a weighted average remaining term of 10.9 years and our leases had a weighted average remaining term of 11.2 years.

We have adopted a policy to limit debt to approximately 65% of our assets (calculated as total assets plus accumulated depreciation). This policy may be changed by our Board of Trustees at any time without notice or shareholder approval. As of September 30, 2003, our debt to assets ratio was approximately 59% and our debt to total market capitalization was approximately 46%.

In light of our current financial position, we believe that we will be able to obtain additional financing for our short-term and long-term liquidity requirements as discussed in *Liquidity Requirements* below. We have used and may continue to use interest rate swap arrangements to minimize interest rate risk and to match-fund our long-term debt with our long-term leases. However, there can be no assurance that additional financing or capital will be available, or that the terms will be acceptable or advantageous to us.

Variable Rate Lease Program

We may offer our current and prospective tenants the option of utilizing our variable rate lease program. Under this program, base rent changes monthly based upon a spread over an applicable index, typically LIBOR. In addition, our leases typically provide for upward periodic adjustments in base rent, usually based on a factor of the change in the consumer price index, commonly referred to as CPI. The vast majority of our variable rate lease agreements contain minimum lease rates, generally between 8% and 9%, and fixed rate conversion features generally with minimum rates of 10.0% to 10.25%, and none of these leases contains a maximum rate. Upon conversion, the fixed base rent typically continues to be adjusted upward periodically based on a factor of the change in the CPI or other escalation provisions set forth in the lease.

As of September 30, 2003, approximately $413 million of our more than $1.7 billion real estate portfolio, or 24%, was subject to variable rate leases. The execution of these variable rate leases has enabled us to utilize variable rate debt, which totaled $255 million as of September 30, 2003. Of the $255 million, approximately $200 million is matched with variable rate leases. The investment spreads on our variable rate lease portfolio will change under certain interest rate conditions. Our strategy of including minimum lease rates in our variable rate leases allows us to realize additional investment spread during the current low interest rate environment. During the past year, as LIBOR has decreased, the interest expense on our variable rate debt has also decreased. However, the revenue generated from the vast majority of our variable rate leases has remained constant during this same time period, since the minimum lease rates were in effect at these LIBOR levels. Because many of our leases are subject to minimum lease rates, as LIBOR rises, our investment spreads will contract from current levels until the one-month LIBOR reaches 3.0% to 3.5%. At that time, our variable lease rates and variable debt rates will rise equally with LIBOR.

Mortgage Debt and Revolving Credit Facilities

As of September 30, 2003, we had total mortgage debt outstanding of approximately $1.02 billion (consisting of approximately $792.9 million of fixed rate and approximately $224.7 million of variable rate debt), which was secured by approximately 266 of our properties. In addition, we had approximately $30.0 million outstanding on our revolving credit facilities.

The following is a summary of our total debt outstanding as of September 30, 2003 and December 31, 2002 (dollars in thousands):

Description of Debt	Original Debt Issued	Principal Balance as of September 30, 2003	Principal Balance as of December 31, 2002	Effective Interest Rate*	Term/ Amortization Schedule
7.50% fixed rate debt due 4/20/03 (1)	$ 12,000	$	$ 10,771		(1)
7.59% fixed rate debt due 12/1/08 (2)	38,050	33,415	34,572	7.95%	10 yr/17 yr
7.54% fixed rate debt due 7/6/11 (3)	100,000	92,994	94,413	7.69%	12 yr/25 yr
7.565% fixed rate debt due 11/12/12 (4)	28,500	25,650	26,220	7.62%	12 yr/25 yr
7.5975% fixed rate debt due 12/18/12 (4)	32,054	29,212	29,781	7.59%	12 yr/30 yr
7.50% fixed rate debt due 8/10/13 (5)	82,600	77,093	79,158	7.62%	12 yr/30 yr
Triple Net Lease Mortgage Notes, Series 2002 (6)	325,000	309,535	318,995	7.70%	(6)
Triple Net Lease Mortgage Notes, Series 2003-1 (7)	228,000	225,002		5.86%	(7)
Total Mortgage Fixed Rate Debt		$ 792,901	$ 593,910	7.17%	
Variable rate debt due 9/29/11 (8)	150,000	139,642	143,907	3.40%	12 yr/25 yr
Various variable rate debt (9)	90,030	85,073	80,049	4.12%	10 to 12 yr/25 to 30 yr
Short-term variable rate debt (10)	80,867		80,867		(10)
Total Mortgage Variable Rate Debt		$ 224,715	$ 304,823	3.67%	
TOTAL MORTGAGE DEBT		$1,017,616	$ 898,733	6.40%	
$100 million revolving secured facility (11)		22,002	65,096	4.26%	(11)
$60 million revolving unsecured facility (12)		8,000	46,000	4.21%	(12)
$100 million revolving secured facility (13)					(13)
TOTAL CREDIT FACILITIES		$ 30,002	$ 111,096	4.26%	
TOTAL DEBT OUTSTANDING		**$1,047,618**	**$1,009,829**	**6.39%**	

* For the quarter ended September 30, 2003. Includes deferred loan fees amortized over the life of the loans.

(1) This loan was paid off on March 26, 2003 with the net proceeds from the issuance of the Triple Net Lease Mortgage Notes, Series 2003-1 as discussed in footnote (7) below.

(2) The loan requires monthly payments of principal and interest with a final payment at maturity of approximately $24.2 million. The Partnership has provided a guaranty of collection limited to approximately $8.9 million of this loan, contingent upon the lender first making written demand upon and proceeding against the borrower, including obtaining judgment and foreclosing upon all collateral. All amounts recovered from the borrower or collateral following a default reduce such guarantee.

(3) The loan requires quarterly payments of principal and interest with a final payment at maturity of approximately $72.4 million.

(4) These loans require quarterly interest and level principal payments until maturity, at which time the loans require final payments totaling approximately $33.5 million. These loans bear interest equal to the A1/P1 Commercial Paper Rate plus 215 basis points. We have entered into interest rate swap arrangements with a third party to fix the interest rates

on these loans.

(5) This loan requires quarterly interest and level principal payments with a final payment at maturity of approximately $49.6 million. This loan bears interest equal to the 30-day LIBOR rate plus 175 basis points. We have entered into an interest rate swap arrangement with a third party to fix the interest rate on this loan.

(6) During 2002, we issued $325 million in four classes of Triple Net Lease Mortgage Notes, Series 2002. The notes have a weighted average effective interest rate (including deferred fees amortized over the life of the notes) of approximately 7.7%. CARS Loan Servicer L.L.C., one of our subsidiaries, is servicer of the notes on behalf of the noteholders. The following is a breakdown of the Triple Net Lease Mortgage Notes, Series 2002 by class:

Class	Original Principal Balance	Current Principal Balance	Maturity Date
A-1a	164,136	153,494	8/15/14
A-1b	9,064	9,064	7/15/15
A-2	75,900	71,077	7/15/15
A-3	75,900	75,900	6/15/22

Classes A-1a and A-1b are fully-amortizing in succession over their respective terms and Classes A-2 and A-3 are fully-amortizing in succession over 20 years. The Partnership has provided a guaranty of collection limited to approximately $35 million of this loan, contingent upon the trustee first making written demand upon and proceeding against the borrower, including obtaining judgment and foreclosing upon all collateral. All amounts recovered from the borrower or collateral following a default reduce such guarantee. In connection with the issuance of this debt, in certain situations, the Company guarantees payments of principal and interest and any unpaid debt. The term of the guaranty is the same as the term of the debt.

(7) On March 26, 2003, we issued $228 million in two classes of Triple Net Lease Mortgage Notes, Series 2003-1. CARS Loan Servicer L.L.C. is servicer of the notes on behalf of the noteholders. The following is a breakdown of the Triple Net Lease Mortgage Notes, Series 2003-1 by class:

Class	Original Principal Balance	Current Principal Balance	Maturity Date
A-1	109,000	106,002	9/25/15
A-2	119,000	119,000	3/25/19

The Class A-1 and Class A-2 notes have weighted average effective interest rates (including deferred fees amortized over the life of the notes) of approximately 5.4% and 6.3%, respectively. The notes amortize in succession over a 20-year amortization schedule with the Class A-1 notes fully-amortizing and the Class A-2 notes requiring a final payment at maturity of approximately $70.8 million. In connection with the issuance of this debt, in certain situations, the Company guarantees payments of principal and interest and any unpaid debt. The term of the guaranty is the same as the term of the debt.

(8) The loan bears interest equal to the 30-day LIBOR rate plus 227 basis points and requires monthly level payments of principal and interest with a final payment at maturity of approximately $100.2 million.

(9) These loans bear interest at variable rates ranging from 200 to 357 basis points above the A1/P1 Commercial Paper Rate, the 30-day LIBOR rate, or the 3-month LIBOR rate and have maturity dates ranging from December 22, 2009 to June 2, 2015. The terms of the various loans require either quarterly interest and level principal payments or monthly level payments of principal and interest until maturity, at which time the loans require final payments totaling approximately $65.5 million.

(10) This short-term loan was paid off on March 26, 2003 with the net proceeds from the issuance of the Triple Net Lease Mortgage Notes, Series 2003-1 as discussed in footnote (7) above.

(11) Amounts borrowed under this facility bear interest at market rates determined at the time of each draw until such time as the Company and the lender set an interest rate for any future amounts borrowed under the facility. As of September 30, 2003, the borrowings under the facility bear interest equal to the 30-day LIBOR rate plus 295 to 300 basis points. Properties are eligible within the borrowing base for 150 days, unless extended by the Company and the lender. The facility has a one-year term, which matures on March 21, 2004, and is renewable annually.

(12) The facility provides for a three-year term with interest determined, at our option, at either the Prime rate less 50 basis points or the one-month, two-month or three-month LIBOR rate plus 200 basis points. As of September 30, 2003, the borrowings under the facility

bear interest equal to the one-month LIBOR plus 200 basis points. Properties are eligible within the borrowing base for 12 months, unless extended by the Company and the lender. The facility matures on March 29, 2005.

(13) This construction credit facility provides for a one-year term. Amounts borrowed under this facility bear interest at a spread over LIBOR as determined at the time of each draw. Proceeds will be used to fund construction and improvement financing for existing tenants. As of September 30, 2003, no amounts had been borrowed on this facility. The facility matures on June 22, 2004, and is renewable annually.

For the quarter and trailing 12 months ended September 30, 2003, our interest coverage and debt service coverage ratios were 2.5 and 1.6, respectively. We consider the interest coverage and debt service coverage ratios meaningful financial performance measures of liquidity as they provide our investors with information pertaining to our ability to satisfy our debt service requirements. These measures are typically used by our lenders in assessing our compliance with certain debt covenants. These ratios are considered non-GAAP financial measures because they are calculated using Earnings Before Interest, Taxes, Depreciation and Amortization, commonly referred to as EBITDA. The ratios should not be considered an alternative measure of operating results or cash flow from operations as determined in accordance with GAAP.

The following is a calculation of our interest coverage ratio and our debt service coverage ratio for the three months and twelve months ended September 30, 2003 (dollars in thousands). The calculation includes a reconciliation of EBITDA to its most directly comparable GAAP measure, net income.

	Three months ended September 30, 2003	**Twelve months ended September 30, 2003**
Interest Coverage Ratio:		
Net Income before minority interest (Earnings)	$ 16,454	$ 62,645
Interest expense	16,323	63,449
Depreciation and amortization	7,834	30,311
EBITDA	$ 40,611	$ 156,405
Interest Coverage Ratio (EBITDA divided by interest expense)	2.5	2.5
Debt Service Coverage Ratio (DSCR):		
Interest expense	$ 16,323	$ 63,449
Principal amortization for the period	9,077	32,669
	$ 25,400	$ 96,118
DSCR (EBITDA divided by interest expense + principal amortization for the period)	1.6	1.6

As of September 30, 2003, we were in compliance with all of the debt covenants related to our mortgage debt and revolving credit facilities.

Interest Rate Swaps

To minimize interest rate risk, during 2002 and 2001, we entered into three interest rate swap arrangements with third parties to fix the interest rate on the underlying variable rate debt, totaling approximately $141 million. These swaps were designed to mirror the underlying variable rate debt in terms of index, spread, reset, amortization, compounding and maturity. Due to the identical nature of the terms of the swap arrangements and the underlying terms of the debt, these swaps were documented as cash flow hedges and designated as highly effective at inception of the swap arrangements. Therefore, in accordance with GAAP, the unrealized gain or loss upon measuring the swaps at their fair value is recorded as a component of accumulated other comprehensive income (loss) within shareholders equity on our consolidated balance sheets. The fair value of the swaps is recorded as either a derivative instrument asset or a derivative instrument liability on our consolidated balance sheets. In addition, we are required to post collateral, generally in the amount of the swap valuations at any point in time, to protect the lenders in case of an early termination by us. The collateral posted by us, totaling approximately $13.9 million and $15.0 million as of September 30, 2003 and December 31, 2002, respectively, is included in other assets on our consolidated balance sheets. Total comprehensive income for the three months ended September 30, 2003 and 2002 was $16.8 million and $1.9 million, respectively. Total comprehensive income for the nine months ended September 30, 2003 and 2002 was $37.6 million and $18.6 million, respectively. The unrealized loss as of September 30, 2003 and December 31, 2002 was as follows (in thousands):

	September 30, 2003	December 31, 2002
Derivative instrument liability	$16,436	$16,274

Liquidity Requirements

Short-term liquidity requirements consist primarily of normal recurring operating expenses and capital expenditures, debt service requirements (including debt service relating to additional and replacement debt), distributions to shareholders and holders of Units, who we refer to as Unitholders, and amounts required for additional property acquisitions, facility improvement and expansion fundings and construction financings. We expect to meet these requirements (other than amounts required for additional property acquisitions, facility improvement and expansion fundings and construction financings) through cash provided from operations and our existing revolving credit facilities. We anticipate that any additional acquisitions of properties, facility improvement and expansion fundings and construction financings during the next 12 months will be funded with amounts available under our existing commitments for long-term financing, future long-term secured and unsecured debt and the issuance of common or preferred equity or Units, each of which may be initially funded with our existing revolving credit facilities. Acquisitions of properties, facility improvement and expansion fundings and construction financings will be made subject to our investment objectives and policies with the intention of maximizing both current and long-term growth and income.

As of September 30, 2003, long-term liquidity requirements consisted primarily of maturities under our long-term debt. We anticipate that long-term liquidity requirements will also include amounts required for acquisitions of properties, facility improvement and expansion fundings and construction financings. We expect to meet long-term liquidity requirements through long-term secured and unsecured borrowings and other debt and equity financing alternatives. The availability and terms of any such financing will depend upon market and other conditions.

Aggregate annual principal amortization and payments due at maturity of our mortgage debt as of September 30, 2003 are as follows (in thousands):

For the Year Ended December 31,	Principal Amortization	Maturities	Total
2003	$ 9,943	$	$ 9,943
2004	36,544		36,544
2005	37,305		37,305
2006	38,632		38,632
2007	40,931		40,931
Thereafter	438,027	416,234	854,261
Total	$601,382	$416,234	$1,017,616

Commitments for Long-Term Financing

During the second quarter of 2001, we received a commitment for $150.0 million of secured long-term variable rate financing from Toyota Financial Services. The commitment can be drawn down in multiple fundings under one or more debt instruments, and each funding is subject to customary conditions precedent and the lender s satisfaction with the loan documentation. The terms of the commitment provide for a 12-year term with interest at a spread over the one-month or three-month LIBOR rate. As of September 30, 2003, we had approximately $60.9 million available under this commitment.

During the second quarter of 2003, we signed a commitment for $40 million of secured mortgage financing from Bank of America. The commitment can be drawn down in multiple fundings under one or more debt instruments, and each funding is subject to customary conditions and the lender s satisfaction with the loan documentation. The commitment provides financing for up to five years at a spread over LIBOR. As of September 30, 2003, there were no borrowings under this commitment.

Equity Transactions

On April 25, 2003, we sold 2,350,000 common shares in an underwritten public offering at an initial price to the public of $26.00 per share under our shelf registration statement filed with the SEC on March 2, 1999, which we refer to as the Shelf Registration Statement. In addition, on May 2, 2003, 352,500 common shares subject to the underwriters over-allotment option were issued at an initial price to the public of $26.00 per share. Net proceeds to the Company, after deducting the discounts and commissions to the underwriters and other expenses of this offering, totaled approximately $66.4 million. After the offering, $64.2 million remains available under the Shelf Registration Statement for the issuance of securities. The Company contributed the net proceeds of the offering to the Operating Partnership in exchange for Units in the Operating Partnership and used them to fund acquisitions, repay borrowings under our short-term credit facilities and for general corporate purposes.

On June 25, 2003, we filed a shelf registration statement, which we refer to as the 2003 Shelf Registration Statement, with the SEC relating to the future offering of up to an aggregate of $500 million of common shares, preferred shares, depositary shares, debt securities and warrants exercisable for common or preferred shares. We believe the 2003 Shelf Registration Statement will provide us with more efficient and immediate access to capital markets when considered appropriate. As of June 30, 2003, we had not issued any securities pursuant to the 2003 Shelf Registration Statement and, thus, $500 million was available under the 2003 Shelf Registration Statement for the issuance of securities.

Dividend Reinvestment and Share Purchase Plan

During April 2000, we implemented a DRIP Plan, which was subsequently amended in March 2001. Under the DRIP, current shareholders and Unitholders are permitted to elect to reinvest all, a portion or none of their cash dividends or distributions to purchase common shares. The DRIP also allows both new investors and existing shareholders and Unitholders to make optional cash payments to purchase common shares.

The DRIP permits current shareholders, Unitholders and new investors to invest a minimum of $500 up to a maximum of $10,000 in common shares per month. The DRIP also allows us to raise additional capital by waiving the limitations on the $10,000 maximum per month, as more fully described in the Prospectus relating to the DRIP. Shares purchased under the DRIP through reinvestment of dividends are purchased at a discount (currently 3%) to the market price. Shares purchased under the DRIP through optional cash payments of $10,000 or less are purchased at market price.

Common shares may be purchased directly from us or in open market or privately negotiated transactions, as we determine from time to time, to fulfill the requirements for the DRIP. For the three months ended September 30, 2003, we issued approximately 63,600 common shares under the DRIP, totaling approximately $1.8 million. For the nine months ended September 30, 2003, we issued approximately 167,300 common shares under the DRIP, totaling approximately $4.3 million.

Common Share Repurchase Program

During 1998, we announced that our Board of Trustees had authorized the repurchase of up to 6.0 million common shares. Purchases have been and will be made from time to time in open market transactions at prevailing prices or in negotiated private transactions at the discretion of management. During the nine months ended September 30, 2003, no common shares were repurchased. From the inception of the common share repurchase program through September 30, 2003, a total of 4,094,700 common shares have been repurchased at an average price of $10.62 per common share. In conjunction with the common share repurchases, the Partnership redeemed an equivalent number of Units from the Company for equivalent purchase prices.

FUNDS FROM OPERATIONS (FFO)

The National Association of Real Estate Investment Trusts (NAREIT) developed FFO as a relative non-GAAP financial measure of performance and liquidity of an equity REIT in order to recognize that income-producing real estate historically has not depreciated on the basis determined under GAAP. FFO, as defined under the revised definition adopted in April 2002 by NAREIT and as presented by us, is net income, computed in accordance with GAAP, plus depreciation and amortization of assets unique to the real estate industry, plus minority interest related to income from continuing operations and income from discontinued operations, and excluding gains from the sales of property, and after adjustments for unconsolidated partnerships and joint ventures. FFO does not represent cash flows from operating activities in accordance with GAAP (which, unlike FFO, generally reflects all cash effects of transactions and other events in the determination of net income) and should not be considered an alternative to net income as an indication of our performance or to cash flow as a measure of liquidity or ability to make distributions. We consider FFO a meaningful, additional measure of operating performance because it primarily excludes the assumption that the value of the real estate assets diminishes predictably over time, and because industry analysts have accepted it as a performance measure. Comparison of our presentation of FFO, using the NAREIT definition, to similarly titled measures for other REITs may not necessarily be meaningful due to possible differences in the application of the NAREIT definition used by such REITs.

The following table reconciles FFO and FFO per share for the three months and nine months ended September 30, 2003 and 2002 to their most directly comparable GAAP measures, net income and net income per share (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
Net income	$13,071	$10,924	$37,718	$32,692
Real estate depreciation and amortization	7,817	6,777	22,882	18,992
Minority interest related to income from continuing operations and income from discontinued operations	3,383	3,298	10,384	10,070
Gain on sale of real estate		(222)	(58)	(222)
FFO	$24,271	$20,777	$70,926	$61,532
Weighted average number of common shares used to compute basic net income per share	31,919	27,917	30,303	27,291
Weighted average number of common shares used to compute fully diluted net income per share	32,731	28,956	31,198	28,454
Weighted average number of common shares and units used to compute basic FFO per share	40,185	36,526	38,652	35,774
Weighted average number of common shares and units used to compute fully diluted FFO per share	40,997	37,565	39,547	36,937
Basic net income per share	$ 0.41	$ 0.39	$ 1.24	$ 1.20
Diluted net income per share	$ 0.40	$ 0.38	$ 1.22	$ 1.16
Basic FFO per share	$ 0.60	$ 0.57	$ 1.83	$ 1.72
Diluted FFO per share	$ 0.59	$ 0.55	$ 1.79	$ 1.67

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to certain financial market risks, the most predominant being fluctuations in interest rates. Interest rate fluctuations are monitored by our management as an integral part of our overall risk management program, which recognizes the unpredictability of financial markets and seeks to reduce the potentially adverse effect on our results of operations. In general, our policy of substantially match-funding at least 70% of our total outstanding debt with leases reduces our exposure to interest rate fluctuations. As of September 30, 2003, approximately 91% of our debt outstanding was substantially match-funded debt. We have used and may continue to use interest rate swap arrangements to minimize interest rate risk and to match-fund our long-term debt with our long-term leases. We do not enter into interest rate swap arrangements for trading purposes.

During the nine months ended September 30, 2003, our fixed rate debt increased from $593.9 million as of December 31, 2002 to $792.9 million as of September 30, 2003. Interest rate fluctuations may affect the fair value of our fixed rate debt instruments. If interest rates on our fixed rate debt instruments at September 30, 2003 had been one percentage point higher or lower, the fair value of those debt instruments on that date would have decreased or increased, respectively, by approximately $52.7 million.

As of September 30, 2003, approximately $413 million, or 24% of our total real estate portfolio, was leased to tenants utilizing our variable rate lease program, as compared to $418 million as of December 31, 2002. Under these leases, base rent changes monthly using a spread over an applicable index, typically LIBOR. The vast majority of our variable rate lease agreements contain minimum lease rates, generally between 8% and 9%, and fixed rate conversion features generally with minimum rates of 10.0% to 10.25% , and none of these leases contains a maximum rate. The execution of these variable rate leases has enabled us to utilize variable rate debt, which totaled $255 million as of September 30, 2003, as compared to $416 million as of December 31, 2002. The investment spreads on our variable rate lease portfolio will change under certain interest rate conditions. Our strategy of including minimum lease rates in our variable rate leases allows us to realize additional investment spread during the current low short-term interest rate environment. During the past year, as LIBOR has declined, the interest expense on our variable rate debt has also declined. However, the revenue generated from the vast majority of our variable rate leases has remained constant during this same time period, since the minimum lease rates were in effect at these LIBOR levels. Because many of our leases are subject to minimum lease rates, as LIBOR rises, our investment spreads will contract from current levels until the one-month LIBOR reaches 3.0% to 3.5%. At that time, our variable lease rates and variable debt rates will rise equally with LIBOR.

If interest rates on our variable rate debt instruments outstanding at September 30, 2003 had been 1% higher or lower, our annual interest expense relating to those debt instruments would have increased or decreased, respectively, by approximately $2.5 million, based on balances at September 30, 2003. This impact on net income as a result of an increase or decrease in interest rates by 1% is partially reduced by the structure of our variable rate leases as noted above. Because of the minimum lease rates built into the majority of our leases, if the underlying index on our variable rate lease agreements outstanding at September 30, 2003 had been 1% higher or lower, our annual rental revenue relating to those lease agreements would have increased by approximately $438,000 or decreased by approximately $380,000 respectively. Assuming the underlying index increased to a level where none of our minimum lease rates were triggered, a 1% increase or decrease in the underlying index would increase or decrease our rental revenue by approximately $3.2 to $4.1 million because of certain investment spread variations at various LIBOR levels.

Item 4. Controls and Procedures

Quarterly Evaluation. We carried out an evaluation as of September 30, 2003 of the effectiveness of the design and operation of our disclosure controls and procedures, which we refer to as our disclosure controls, and our internal controls and procedures for financial reporting, which we refer to as our internal controls. This evaluation was done under the supervision and with the participation of management, including our President and Chief Executive Officer and our Senior Vice President, Chief Financial Officer and Treasurer. Rules adopted by the SEC require that we present the conclusions of the President and Chief Executive Officer and our Senior Vice President, Chief Financial Officer and Treasurer about the effectiveness of our disclosure controls and internal controls as of the end of the period covered by this quarterly report.

CEO and CFO Certifications. Included as Exhibits 31.1 and 31.2 to this Quarterly Report on Form 10-Q are forms of Certification of our President and Chief Executive Officer and our Senior Vice President, Chief Financial Officer and Treasurer. The forms of Certification are required in accordance with Section 302 of the Sarbanes-Oxley Act of 2002. This section of the Quarterly Report on Form 10-Q which you are currently reading is the information concerning the evaluation referred to in the Section 302 certifications and this information should be read in conjunction with the Section 302 certifications for a more complete understanding of the topics presented.

Disclosure Controls and Procedures and Internal Control over Financial Reporting. Disclosure controls and procedures are designed with the objective of ensuring that information required to be disclosed in our reports filed or submitted under the Exchange Act, such as this Quarterly Report on Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures are also designed with the objective of ensuring that such information is accumulated and communicated to our management, including our President and Chief Executive Officer and our Senior Vice President, Chief Financial Officer and Treasurer, as appropriate to allow timely decisions regarding required disclosure.

Internal control over financial reporting is a process designed by, or under the supervision of our President and Chief Executive Officer and our Senior Vice President, Chief Financial Officer and Treasurer, and effected by our Board of Directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;

- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that our receipts and expenditures are being made only in accordance with authorizations of management or our Board; and

- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material adverse effect on our financial statements.

Limitations on the Effectiveness of Controls. Management, including our President and Chief Executive Officer and our Senior Vice President, Chief Financial Officer and Treasurer, do not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management s override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Scope of the Evaluation. The evaluation by our President and Chief Executive Officer and our Senior Vice President, Chief Financial Officer and Treasurer of our disclosure controls and procedures and our internal control over financial reporting included a review of procedures and discussions with our Disclosure Control Monitor and others in our organization. In the course of the evaluation, we sought to identify data errors, control problems or acts of fraud and to confirm that appropriate corrective action, including process improvements, were being undertaken. This type of evaluation is done on a quarterly basis so that the conclusions concerning controls effectiveness can be reported in our Quarterly Reports on Form 10-Q and Annual Report on Form 10-K.

Our internal control over financial reporting is also evaluated on an ongoing basis by personnel in our Accounting department and by our independent auditors in connection with their audit and review activities. The overall goals of these various evaluation activities are to monitor our disclosure controls and procedures and our internal control over financial reporting and to make modifications as necessary. Our intent in this regard is that the disclosure controls and procedures and the internal control over financial reporting will be maintained as systems that change (including with improvements and corrections) as conditions warrant. Among other matters, we sought in our evaluation to determine whether there were any significant deficiencies or material weaknesses in our internal control over financial reporting, or whether we had identified any acts of fraud involving personnel who have a significant role in our internal control over financial reporting. This information was important both for the evaluation generally and because the Section 302 certifications require that our President and Chief Executive Officer and our Senior Vice President, Chief Financial Officer and Treasurer disclose that information to the Audit Committee of our Board of Trustees and to our independent auditors and to report on related matters in this section of the Quarterly Report on Form 10-Q. In the professional auditing literature, significant deficiencies are referred to as reportable conditions ; these are control issues that could have a significant adverse effect on the ability to record, process, summarize and report financial data in the financial statements. A material weakness is defined in the auditing literature as a particularly serious reportable condition where the internal control does not reduce to a relatively low level the risk that misstatements caused by error or fraud may occur in amounts that would be material in relation to the financial statements and not be detected within a timely period by employees in the normal course of performing their assigned functions. We also sought to deal with other control matters in the evaluation, and in each case if a problem was identified, we considered what revision, improvement and/or correction was necessary to be made in accordance with our on-going procedures.

Conclusions. Based upon the evaluation, our President and Chief Executive Officer and our Senior Vice President, Chief Financial Officer and Treasurer have concluded that, as of September 30, 2003 and subject to the limitations noted above, our disclosure controls and procedures were effective at the reasonable assurance level to ensure that material information relating to us and our consolidated subsidiaries is made known to management, including our President and Chief Executive Officer and our Senior Vice President, Chief Financial Officer and Treasurer.

During the three months ended September 30, 2003, there were no significant changes in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect our internal control for financial reporting.

CAPITAL AUTOMOTIVE REIT
PART II-OTHER INFORMATION

Item 1. Legal Proceedings

Not applicable.

Item 2. Changes in Securities

Not applicable.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Submission of Matters to Vote of Security Holders

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

10.20	Employment Agreement dated as of October 15, 2003 by and between Capital Automotive L.P. and Lisa M. Clements (filed herewith)
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer (filed herewith)
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer (filed herewith)
32.1	Section 1350 Certification of Chief Executive Officer (filed herewith)
32.2	Section 1350 Certification of Chief Financial Officer (filed herewith)

(b) Reports on Form 8-K

A Form 8-K was dated and furnished to the SEC on July 22, 2003 in response to Items 7 and 12 to file a press release announcing our financial results for the quarter ended June 30, 2003.

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.

CAPITAL AUTOMOTIVE REIT
(Registrant)

BY: /s/ Thomas D. Eckert

Thomas D. Eckert
President and Chief Executive Officer
(principal executive officer)

BY: /s/ David S. Kay

David S. Kay
Senior Vice President, Chief Financial Officer and Treasurer
(principal financial officer)

Dated: November 13, 2003

LIGN="bottom"> 30.765 02/09/25 82,673 41,337 31.670 02/08/26 26,567 53,133 50.160 02/13/27 0 77

John J. Kita																	
29,130	0	0	30.765	02/09/25	8,230	351,421	0	0	22,067	11,033	31.670	02/08/26	5,525	235,918	7,085	14,	
James F. Stern																	
21,260	0	0	30.765	02/09/25	5,730	244,671	0	0	15,360	7,680	31.670	02/08/26	3,945	168,452	5,060	10,1	
Mark A. Petrarca																	
16,020	0	0	30.765	02/09/25	4,320	184,464	11,593	5,797	31.670	02/08/26	2,860	122,122	3,669	7,336	5		
Wei Ding																	
0	6,143	0	31.670	02/08/26	4,580	195,566	0	0	3,712	7,423	50.160	02/13/27	2,895	123,617	0	10,660	61

[1] All references to shares mean shares of the company s Common Stock. Mr. Wheeler will have the right to exercise an option for 7,400 shares at the exercise price of $31.670 on February 8, 2019; 4,891 shares at the exercise price of $50.160 on February 13, 2019; 4,892 shares at the exercise price of $50.160 on February 13, 2020; 8,145 shares at the exercise price of $61.760 on February 12, 2019; 8,145 shares at the exercise price of $61.760 on February 12, 2020; 8,145 shares at the exercise price of $61.760 on February 12, 2021; 5,585 shares at the exercise

price of $57.465 on September 1, 2019; 5,585 shares at the exercise price of $57.465 on September 1, 2020; and 5,585 shares at the exercise price of $57.465 on September 1, 2021. Mr. Rajendra will have the right to exercise an option for 41,337 shares at the exercise price of $31.670 on February 8, 2019; 26,566 shares at the exercise price of $50.160 on February 13, 2019; 26,567 shares at the exercise price of $50.160 on February 13, 2020; 25,914 shares at the exercise price of $61.760 on February 12, 2019; 25,913 shares at the exercise price of $61.760 on February 12, 2020; and 25,913 shares at the exercise price of $61.760 on February 12, 2021. Mr. Kita will have the right to

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exercise an option for 11,033 shares at the exercise price of $31.670 on February 8, 2019; 7,085 shares at the exercise price of $50.160 on February 13, 2019; 7,085 shares at the exercise price of $50.160 on February 13, 2020; 6,664 shares at the exercise price of $61.760 on February 12, 2019; 6,663 shares at the exercise price of $61.760 on February 12, 2020; and 6,663 shares at the exercise price of $61.760 on February 12, 2021. Mr. Stern will have the right to exercise an option for 7,680 shares at the exercise price of $31.670 on February 8, 2019; 5,060 shares at the exercise price of $50.160 on February 13, 2019; 5,060 shares at the exercise price of $50.160 on February 13, 2020; 5,184 shares at the exercise price of $61.760 on February 12, 2019; 5,183 shares at the exercise price of $61.760 on February 12, 2020; and 5,183 shares at the exercise price of $61.760 on February 12, 2021. Mr. Petrarca will have the right to exercise an option for 5,797 shares at the exercise price of $31.670 on February 8, 2019; 3,668 shares at the exercise price of $50.160 on February 13, 2019; 3,668 shares at the exercise price of $50.160 on February 13, 2020; 3,405 shares at the exercise price of $61.760 on February 12, 2019; 3,405 shares at the exercise price of $61.760 on February 12, 2020; and 3,405 shares at the exercise price of $61.760 on February 12, 2021. Mr. Ding will have the right to exercise an option for 6,143 shares at the exercise price of $31.670 on February 8, 2019; 3,711 shares at the exercise price of $50.160 on February 13, 2019; 3,712 shares at the exercise price of $50.160 on February 13, 2020; 3,554 shares at the exercise price of $61.760 on February 12, 2019; 3,553 shares at the exercise price of $61.760 on February 12, 2020; and 3,553 shares at the exercise price of $61.760 on February 12, 2021.

[2] Mr. Wheeler will vest in 5,520 restricted stock units on February 8, 2019; 3,815 restricted stock units on February 13, 2020; and 5,880 restricted stock units on February 12, 2021. Mr. Rajendra will vest in 30,840 restricted stock units on February 8, 2019; 20,725 restricted stock units on February 13, 2020; and 18,700 restricted stock units on February 12, 2021. Mr. Kita will vest in 8,230 restricted stock units on February 8, 2019; 5,525 restricted stock units on February 13, 2020; and 4,810 restricted stock units on February 12, 2021. Mr. Stern will vest in 5,730 restricted stock units on February 8, 2019; 3,945 restricted stock units on February 13, 2020; and 3,740 restricted stock units on February 12, 2021. Mr. Petrarca will vest in 4,320 restricted stock units on February 8, 2019; 2,860 restricted stock units on February 13, 2020; and 2,460 restricted stock units on February 12, 2021. Mr. Ding will vest in 4,580 restricted stock units on February 8, 2019; 2,895 restricted stock units on February 13, 2020; and 2,565 restricted stock units on February 12, 2021.

[3] Market value determined by the NYSE closing market price of $42.70 on December 31, 2018, the last trading day of the fiscal year.

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OPTION EXERCISES AND STOCK VESTED

The following table provides information related to options exercised and stock vested for each of the named executive officers during fiscal year 2018.

Name	Option Awards: Number of Shares Acquired on Exercise (#)	Option Awards: Value Realized on Exercise ($)	Stock Awards: Number of Shares Acquired on Vesting (#)	Stock Awards: Value Realized on Vesting ($)[1]
Kevin J. Wheeler	0	$ 0	5,360	$ 322,190
Ajita G. Rajendra	0	0	29,500	1,773,245
John J. Kita	0	0	8,130	488,694
James F. Stern	0	0	5,930	356,452
Mark A. Petrarca	0	0	4,470	268,692
Wei Ding	11,773	400,921	4,710	283,118

1 Based on NYSE closing price of the Common Stock on the vesting date.

PENSION BENEFITS

Name	Plan Name	Number of Years Credited Service (#)	Present Value of Accumulated Benefit ($)	Payments During Last Fiscal Year ($)
Kevin J. Wheeler	A. O. Smith Retirement Plan	20.12	$ 754,957	0
Ajita G. Rajendra	A. O. Smith Retirement Plan	9.92	434,018	0
		13.92	8,236,852	
	Executive Supplemental Pension Plan Special Pension		1,119,450	

	Arrangement			
John J. Kita	A. O. Smith Retirement Plan	26.28 30.28		0
	Executive Supplemental Pension Plan		1,195,260 7,422,003	
James F. Stern	A. O. Smith Retirement Plan			0
	Executive Supplemental Pension Plan	7.59 11.59	253,401 1,863,631	
Mark A. Petrarca	A. O. Smith Retirement Plan			0
	Executive Supplemental Pension Plan	15.57 19.57	507,502 2,298,711	
Wei Ding	A. O. Smith Retirement Plan	17.83	612,626	0

We maintained a qualified defined benefit pension plan, the A. O. Smith Retirement Plan, for all eligible salaried employees that was closed to new entrants in 2010. Credited service was determined as of December 31, 2014, when the Plan was frozen. The plan provides a monthly retirement benefit at normal retirement age equal to 1.1% of five-year final average pay, plus 0.5% of five-year final average pay in excess of social security compensation multiplied by credited service up to a 40-year maximum. Average annual pay includes base salary and 50% of annual bonus. Benefit accruals under the A. O. Smith Retirement Plan ceased as of December 31, 2014. In its place, we provide a nonelective company contribution under the A. O. Smith Retirement Security Plan, which is our 401(k) plan.

We also maintain the A. O. Smith Corporation Executive Supplemental Pension Plan to provide benefits to an executive whose benefits in the A. O. Smith Retirement Plan are subject to limitations under the Internal Revenue Code and to take into account 100% of an executive s annual incentive bonus. The Executive Supplemental Pension Plan provides a benefit equivalent to 1.65% of the executive s five-year final average pay times years of credited service up to a 40-year maximum, less the benefit provided from the A. O. Smith Retirement Plan. In July 2010, the PCC decided to continue the existing Executive Supplemental Pension Plan for all executive officers participating at that time, which includes Messrs. Rajendra, Kita, Stern and Petrarca. Its decision, however, reduces the final retirement benefit for affected executives by the amount of the monthly benefit that was lost when the A. O. Smith Retirement Plan stopped accruing benefits on December 31, 2014. Executives hired or promoted to a qualifying position after July 2010 do not participate in the existing defined benefit Executive Supplemental Pension Plan. Instead, they participate in a defined contribution restoration plan that will provide a 3% contribution under the A. O. Smith Non-qualified Deferred Compensation Plan per year of pay (base salary plus annual bonus) based on compensation above the Internal Revenue Service limit. All named executive officers participate in the Executive Supplemental Pension Plan except Mr. Wheeler and Mr. Ding. Mr. Wheeler and Mr. Ding participate in the defined contribution restoration plan.

The normal retirement age under the A. O. Smith Retirement Plan and the Executive Supplemental Pension Plan for Mr. Rajendra is 66; for Messrs. Kita, Wheeler, Stern, Petrarca and Ding, the normal retirement age is 67. Each plan provides for early retirement as early as age 57 and 10 years of service but with reductions in the normal retirement benefit. The reductions for benefits provided by the A. O. Smith Retirement Plan are equal to 6.67% per year between the age at retirement and the executive s normal retirement age less three years (also called the unreduced retirement age). Mr. Rajendra is retirement eligible, and Mr. Kita and Mr. Wheeler are currently eligible for early retirement. If an executive retires early, the single lump-sum amount to be paid from the Executive Supplemental Pension Plan is calculated based upon the unreduced benefit commencing at the unreduced retirement age discounted for interest between the unreduced retirement age and executive s age at early retirement using the after-tax yield on the Bloomberg Barclays Capital U.S. Corporate Index. Executives terminating before age 57 and 10 years of service with a vested benefit receive a single lump-sum amount from the Executive Supplemental Pension Plan calculated in the same manner as for early retirement, except the benefit is based upon the unreduced benefit commencing at the executive s normal retirement age, discounted for interest between the executive s normal retirement age and the executive s age at termination.

The Present Value of Accumulated Benefit set forth in the table above is based on assumptions and valuation dates that are the same as those used for the valuation of pension liabilities in the company s most recent Annual Report. Retirement age under the A. O. Smith Retirement Plan and the Supplemental Executive Retirement Plan is assumed to be the earliest age that an executive can retire with an unreduced benefit, which is age 64 for Mr. Kita, Mr. Wheeler, Mr. Stern, Mr. Petrarca and Mr. Ding, and 63 for Mr. Rajendra. Post-retirement mortality rates are based on the RP2014 Healthy Annuitant Mortality Table (white-collar variant), including generational improvements using scale MP2018. The assumption is made that there is no probability of pre-retirement death or termination by any other cause.

The A. O. Smith Retirement Plan pays benefits in the form of a single life retirement annuity. Optional forms of annuity payment are available on an actuarially equivalent basis. The retirement benefit under the Executive Supplemental Pension Plan is paid as a single lump-sum to the executive upon retirement. The lump-sum amount is calculated by determining the amount necessary (on an after tax basis to the executive) to purchase a commercial annuity that will provide a monthly amount equivalent to the after-tax amount the executive would receive if the monthly pension would be paid directly by us. To calculate the Present Value of Accumulated Benefits for the benefit under the Executive Supplemental Pension Plan, assumptions are made regarding the executive s tax rate at retirement and post-retirement tax rate and a lump-sum interest rate obtained by surveying various annuity companies (currently

3.25%). As an offset to a portion of the lump-sum payment obligation to the executive, we may transfer life insurance policies to the executive valued at the cash surrender value of the life insurance policies.

We do not have a policy to grant extra years of service. One named executive has a special arrangement negotiated upon his employment with us. Having completed 10 years of service, Mr. Rajendra will be eligible for a payment of $85,000 per year. Under this arrangement, the company will provide semimonthly payments of $3,541.67 to Mr. Rajendra for the balance of his life, with the first payment commencing six months following his separation, as required by law. Payments are treated as taxable wages for FICA purposes. Mr. Rajendra s benefit is in addition to the benefits provided by the A. O. Smith Retirement Plan and the Executive Supplemental Pension Plan. This agreement was granted in order to compensate Mr. Rajendra for benefits forfeited from his prior employer upon termination.

NON-QUALIFIED DEFERRED COMPENSATION

Name	Executive Contributions in 2018 ($)	Registrant Contributions in 2018 ($)[1]	Aggregate Earnings in 2018 ($)	Aggregate Withdrawals/ Distributions ($)	Aggregate Balance at December 31, 2018 ($)
Kevin J. Wheeler	$ 212,000	$ 78,146	$ (68,552)	$ 0	$ 1,239,986
Ajita G. Rajendra	1,177,333	63,337	(117,093)	0	2,258,466
John J. Kita	0	24,892	8,859	0	493,194
James F. Stern	408,000	19,410	(191,963)	0	2,204,811
Mark A. Petrarca	0	14,023	(16,396)	0	267,151
Wei Ding	0	46,937	1,229	0	107,742

1 All registrant contributions under the A. O. Smith Non-qualified Deferred Compensation Plan in 2018 are also reported in the Summary Compensation Table.

Each executive has an account in the A. O. Smith Non-qualified Deferred Compensation Plan, which each year is credited with supplemental company contributions and notional dividend equivalents on restricted stock and restricted stock units. The executive s account is a bookkeeping entry only. Amounts credited to the executive s account are credited with gains and losses each month based on the executive s crediting election. The crediting election is used to designate the investment fund(s) as the basis for calculating the rate of return equivalent for the executive s account. The current funds available for a crediting election are: Fidelity VIP Money Market Division, PIMCO VIT Total Return Division, Principal LifeTime 2010 Division, Principal LifeTime 2020 Division, Principal LifeTime 2030 Division, Principal LifeTime 2040 Division, Principal LifeTime 2050 Division, Principal LifeTime 2060 Division, Principal LifeTime Strategic Income Division, Principal Global Investors Equity Income Division, Vanguard VIF Balanced Division, MFS Growth Division, Vanguard VIF Equity Index Division, Vanguard VIF Mid Cap Index Division, American Century VP Mid Cap Value Division, American Funds Ins Series International Fund Division, Mellon Capital Mgmt Bond Index Division, Janus Henderson Enterprise Division, Goldman Sachs VIT Small Cap

Equity Insights Division, Calvert VP Russell 2000 Small Cap Index Division and A. O. Smith Stable Value Fund.

The Non-qualified Deferred Compensation Plan also allows executives to defer payment of all or a part of their base salary, annual incentive bonus or restricted stock units to a future date. Deferred amounts are credited to the executive s account in the Non-qualified Deferred Compensation Plan, and gains and losses on the deferred amounts are credited in the same manner as described above for supplemental company contributions and notional dividend equivalents, except that deferrals of restricted stock units are deemed invested in shares of our Common Stock for purposes of determining gains and losses, and dividend equivalents on such restricted stock units are credited in the form of additional restricted stock units.

Executives are eligible to receive payment of amounts in their accounts under the Non-qualified Deferred Compensation Plan beginning upon termination of employment (six months after termination in the case of the amounts credited to accounts on or after January 1, 2005).

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EMPLOYMENT CONTRACTS, TERMINATION OF EMPLOYMENT

AND CHANGE IN CONTROL ARRANGEMENTS

We have a Senior Leadership Severance Plan, in which all of the named executive officers participate. The Board implemented the Senior Leadership Severance Plan to establish financial protection for our executives upon various employment termination scenarios, including a change in control of our company. We believe the Senior Leadership Severance Plan assists in retention of executives and provides a more attractive compensation package when recruiting key talent. Furthermore, instead of negotiating individual separation arrangements upon a termination, the Board can ensure consistent and equitable treatment for all executives through the Senior Leadership Severance Plan.

The Senior Leadership Severance Plan provides that each named executive officer will receive severance benefits upon a Qualifying Termination and provides for vesting of certain equity awards upon a Change in Control. Under the Senior Leadership Severance Plan:

A Qualifying Termination is an involuntary termination of employment without Cause or a voluntary termination of employment with Good Reason.

Cause means any of the following: conviction or plea of nolo contendere to a felony or crime involving moral turpitude; the executive s willful and continuing refusal to substantially perform his duties; the executive engages in conduct that constitutes willful gross neglect or willful gross misconduct, or any other material breach of the Confidentiality and Loyalty Agreement by the executive.

Good Reason means any of the following, without the executive s consent: our company materially reduces the executive s base salary; our company requires the executive to be based at a location in excess of 50 miles from his principal job location; material diminution in the executive s title, authority, duties or responsibilities; the failure of our company or its business unit, as applicable, to obtain the written commitment of a purchaser of substantially all assets of our company or the business unit, to be bound to the terms of the Senior Leadership Severance Plan; or any action or inaction by our company that constitutes a material breach of the Senior Leadership Severance Plan.

A Change in Control is deemed to have occurred upon: the acquisition of 50% or more of our company s or relevant business unit s capital stock entitled to vote in the election of directors (other than acquisitions by certain members of the Smith family); a majority of the members of the Board of Directors of our company as of August 1, 2009, (or succeeding directors elected or nominated by 2/3 of the existing directors) ceasing to be continuing directors at any time; or the consummation of a reorganization, merger, or consolidation resulting in a change in ownership with respect to 50% or more of the relevant entity s voting securities, or a sale or other disposition of more than 40% of our company s or the relevant business unit s assets.

In order to be covered by the Senior Leadership Severance Plan, named executive officers must sign a noncompete, non-solicitation, assignment of inventions and confidentiality agreement. In order to receive severance benefits, the named executive officers must sign a release of all claims against our company and its affiliates.

The Senior Leadership Severance Plan had an irrevocable term through July 31, 2013, and automatically renews for successive one-year periods. The Plan will automatically renew for two years upon a Change in Control.

In the event of a Qualifying Termination, Messrs. Wheeler and Rajendra will receive 24 months of continuation of pay. Messrs. Kita, Stern, Petrarca and Ding will receive continuation of pay for 18 months. The continuation of pay will be equal to the executive s annual salary and target bonus during the year of termination. Each named executive officer will also receive within 2-1/2 months after the end of the year in which the termination occurred a lump-sum payment of the actual bonus based on performance that would have been payable for the year of termination adjusted on a pro rata basis based on days employed during the bonus plan year. Each named executive officer will also receive medical benefit continuation and outplacement (capped at 25% of the executive s annual base salary) through the Severance Period (the period during which the executive receives salary continuation).

Upon a Qualifying Termination without a Change in Control, long-term incentive awards are treated as follows: (i) any unvested or unearned long-term incentive awards that were granted during the calendar year of the termination date will be forfeited; (ii) unvested stock options become vested on a pro rata basis; (iii) unvested shares of restricted stock and unvested restricted stock units that vest solely on the passage of time that were granted in any calendar year before the termination become vested on a pro rata basis; and (iv) unearned performance shares and performance units, and unearned shares of restricted stock and restricted stock units that vest based on the achievement of performance goals will be paid at the end of the actual performance period on a pro rata basis based on actual performance.

Upon a Qualifying Termination within two years following a Change in Control, the named executive officers will be eligible for an enhanced benefit. The named executive officers, other than Messrs. Wheeler and Rajendra, will receive a lump-sum severance payment equal to 15 months of base salary and target bonus, and a lump-sum payment equal to 9 months of base pay and target bonus in consideration for the noncompete provisions. Messrs. Wheeler and Rajendra will receive a lump-sum payment equal to 24 months of base salary and target bonus, and a lump-sum payment equal to 12 months of base pay and target bonus in consideration for the noncompete provisions. Each named executive officer will also receive a lump-sum payment of the target bonus that would have been payable for the year of termination adjusted on a pro rata basis based on days employed during the bonus plan year. The named executive officers also will be eligible to receive continued medical and outplacement benefits during the Severance Period.

Furthermore, upon a Change in Control, long-term incentive awards are treated as follows: (i) unvested stock options become fully vested; (ii) unvested shares of restricted stock and unvested restricted stock units that vest solely on the passage of time become fully vested; and (iii) unearned performance shares and performance units, and unearned shares of restricted stock and restricted stock units that vest based on the achievement of performance goals are paid out at the target amount, adjusted on a pro rata basis based on the time the executive was employed during the relevant performance period. However, if the Change in Control is the result of a sale of our company s or a relevant business unit s assets, then the executive will only receive such treatment with respect to his long-term incentive awards if the executive experiences a Qualifying Termination within 24 months of such Change in Control.

The company will reimburse the named executive officer for excise tax liability resulting from payments received in connection with his or her termination following a Change in Control if the executive s Parachute Payments (as defined under Internal Revenue Code Section 280G) exceed the officer s safe harbor (as defined under Internal Revenue Code Section 280G) by more than 10 percent. The company will cap the executive s total payment if his or her total net benefit is less than 110 percent of the executive s respective safe harbor amount, which we refer to as Effect of Modified Gross-up Provision in the table below.

Set forth below are tables showing payments and benefits to each named executive officer upon a Qualifying Termination or a Change in Control and a Qualifying Termination under the Senior Leadership Severance Plan.

We list the estimated amount of compensation payable to each of our named executive officers in each situation in the tables below assuming that a Qualifying Termination or Change in Control and Qualifying Termination occurred at December 31, 2018, and that our Common Stock had a value of $42.70, which was the closing market price for our Common Stock on December 31, 2018. The actual amount of payments and benefits can only be determined at the time of such a Qualifying Termination or Change in Control, and therefore the actual amounts would vary from the estimated amounts in the tables below.

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Payments Resulting From A Qualifying Termination

December 31, 2018

Name	Severance	Pro rata Bonus[1]	Stock Options	Restricted Stock Units	Performance Units[2]	Medical Coverage[3]	Outplacement[4]	Total
Kevin J. Wheeler	$ 3,960,000	$ 774,000	$ 81,622	$ 816,852	$ 606,000	$ 26,472	$ 225,000	$ 6,489,946
Ajita G. Rajendra	3,960,000	1,336,000	455,943	3,000,316	3,059,000	26,472	225,000	12,062,731
John J. Kita	1,485,750	470,000	121,698	792,726	813,000	21,135	141,500	3,845,809
James F. Stern	1,320,135	391,000	70,592	334,021	467,000	21,135	131,750	2,735,633
Mark A. Petrarca	1,094,400	303,000	53,281	248,846	349,000	15,219	114,000	2,177,746
Wei Ding[5]	1,129,755	231,000	45,634	260,244	366,000	30,252	112,750	2,175,635

1 Upon a Qualifying Termination or retirement, pro rata bonus is based upon actual performance. The amounts in the table are based on the actual bonus for 2018.

2 Upon a Qualifying Termination, payout is based upon actual performance. The amounts in the table assume the 2016-2018 award will pay out at 193.5% of target and awards for other performance periods will pay out at target.

3 Calculated based on the employer-paid portion of medical and dental insurance for the Severance Period.

4 Calculated at the maximum under the Senior Leadership Severance Plan, 25% of the named executive officer s base salary.

5 Excludes amounts Mr. Ding would receive under his June 1, 2017 Special Retention Agreement, discussed below, with our company in the event of a Qualifying Termination.

Payments Resulting From A Change In Control

And Qualifying Termination Of Employment

December 31, 2018

Name	Severance	Pro rata Bonus	Stock Options	Restricted Stock Units	Performance Units	Medical Coverage[1]	Outplace-ment[2]	Effect of Modified Gross-up Provision[3]	Excise Tax Gross-up	Total
Kevin J. Wheeler	$ 5,940,000	$ 1,080,000	$ 81,622	$ 816,852	$ 436,000	$ 39,708	$ 225,000	$ 0	$ 3,132,242	$ 11,751,424
Ajita G. Rajendra	5,940,000	1,080,000	455,947	3,000,316	2,118,000	39,708	225,000	0	0	12,858,971
John J. Kita	1,981,000	424,500	121,694	792,726	562,000	28,179	141,500	0	0	4,051,599
James F. Stern	1,760,180	353,090	84,710	388,570	403,000	28,179	131,750	0	0	3,149,479
Mark A. Petrarca	1,459,200	273,600	63,941	285,364	293,000	20,292	114,000	0	0	2,509,397
Wei Ding[4]	1,506,340	302,170	67,757	298,346	305,000	40,336	112,750	0	0	2,632,699

1 Calculated based on the employer paid portion of medical and dental insurance for the Severance Period.

2 Calculated at the maximum under the Senior Leadership Severance Plan, 25% of the named executive officer s base salary.

3 Reflects the amount by which payments to an executive will be reduced so that the executive is not required to pay excise tax.

4 Excludes amounts Mr. Ding would receive under his June 1, 2017, Special Retention Agreement, discussed below, with our company in the event of a Change in Control.

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The A. O. Smith Combined Incentive Compensation Plan allows executives who retire to continue to vest stock options, restricted stock units and performance awards on their original vesting schedule. Upon an executive s retirement, outstanding stock options receive an accelerated expiration of the earlier of the original expiration date or five years from the date of retirement. A retiring executive is entitled to receive a pro rata portion of performance units based on the period of his employment during the three-year performance period based on achievement of the performance goals. A retiring executive is also entitled to receive a pro rata portion of annual incentive compensation, based on his period of employment during the performance period and actual performance achieved.

Please refer to the Pension Benefits and Non-qualified Deferred Compensation Tables above and related narrative for additional information on the present value of accumulated benefits for our named executive officers.

Mr. Ding entered into a Special Retention Agreement with our company on June 1, 2017, which provides him with a retention award if he remains employed with our company and we reach certain financial thresholds. Specifically, the award provides for a $500,000 bonus payment to Mr. Ding on June 1, 2022 and an additional $1,000,000 bonus payment on June 1, 2027. To qualify for the bonus, certain corporate Return on Equity performance criteria must be met each year. In the event of a Qualifying Termination by Mr. Ding, as defined in the Agreement, then the award will be paid on a pro rata basis as of the Qualifying Termination, with the payment made on the dates set forth above. Further, in the event of a Change in Control, as defined in the Agreement, the award will fully vest and be paid out in full.

In addition, each of our named executive officers is provided life insurance as discussed in the section, Executive Life Insurance. The death benefits payable as of December 31, 2018, are: $2,700,000 for Mr. Wheeler; $2,700,000 for Mr. Rajendra; $1,698,000 for Mr. Kita; $1,581,000 for Mr. Stern; $1,368,000 for Mr. Petrarca; and $1,353,000 for Mr. Ding. The death benefits payable after retirement are: $900,000 for Mr. Wheeler; $900,000 for Mr. Rajendra; $566,000 for Mr. Kita; $527,000 for Mr. Stern; $456,000 for Mr. Petrarca; and $451,000 for Mr. Ding.

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REPORT OF THE PERSONNEL AND COMPENSATION COMMITTEE

The Committee has reviewed and discussed the foregoing Compensation Discussion and Analysis with management. Based on the Committee s review and discussion with management, the Committee has recommended to the Board of Directors that the Compensation Discussion and Analysis be included in this Proxy Statement and incorporated by reference in our Annual Report on Form 10-K for the year ended December 31, 2018.

Ronald D. Brown, Chairperson

William P. Greubel, Committee Member

Paul W. Jones, Committee Member

Bruce M. Smith, Committee Member

PAY RATIO DISCLOSURE

Our philosophy is to pay our employees competitively with similar positions in the applicable labor market. We follow this approach worldwide, whether it be an executive level position or hourly job at a foreign plant. As such, we typically benchmark by position to the applicable labor market every year, and adjust compensation to match the applicable market. By doing so, we believe we maintain a high-quality, more stable workforce. The compensation we paid to the median employee identified below was benchmarked in accordance with this process to verify competitive compensation.

As a result of rules the SEC adopted under the Dodd-Frank Act, we are providing the following disclosure about the ratio of the annual total compensation of our chief executive officer to the median annual total compensation of our employees. For the year ended December 31, 2018:

- the median of the annual total compensation of all employees of our company was reasonably estimated to be $19,316.81;
- the annual total compensation of our chief executive officer was 3,872,974; and
- based on this information, the ratio of the annual total compensation is estimated to be 200:1.

Mr. Wheeler was appointed president and chief executive officer on September 1, 2018. To calculate the total compensation of our chief executive officer for the pay ratio calculation above, we annualized Mr. Wheeler s compensation relative to the period that he was chief executive officer. In annualizing Mr. Wheeler s compensation, we used his annual base salary and annual incentive bonus for the time period in which he served as chief executive officer, but we used his actual long-term incentive compensation and all other compensation.

We identified our median employee using a multistep process that is permitted under the SEC rules. We first examined the annual cash compensation paid to each of our employees during 2018, which we gathered from payroll data. Then, we excluded approximately 415 employees in India and approximately 37 employees in Vietnam, as allowed under the deminimis exception to the SEC rules. The total numbers of U.S. employees and non-U.S.

employees were 4,366 and 11,960, respectively, before taking into account such exclusions and for purposes of calculating such exclusions. We annualized the total cash compensation paid to those employees who commenced work with us during 2018 and therefore did not work for us the entire calendar year. Using this annual cash compensation data, we identified 10 employees whose total cash compensation was closest to the median annual cash compensation, as we believed that our median employee was likely within such group since cash compensation reasonably reflects the total compensation for most of our employee population. We then examined the total compensation of each of the employees within such group, calculated the same way as we calculate total compensation for our named executive officers in the Summary Compensation Table, to select our median employee whose total compensation is disclosed above. The median employee is an hourly-paid factory worker at our Nanjing, China plant who in 2018 earned the U.S. dollar equivalent of $19,316.81, which is competitive pay for this position in China.

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ADVISORY VOTE TO APPROVE COMPENSATION OF OUR NAMED EXECUTIVE OFFICERS

As required by Section 14A of the Securities Exchange Act of 1934, we are asking our stockholders to vote, on a nonbinding advisory basis, on a resolution approving the compensation of our named executive officers, as disclosed pursuant to the executive compensation disclosure rules of the SEC, including in the Compensation Discussion and Analysis section and the accompanying compensation tables and narrative discussion contained in this Proxy Statement.

As we describe in detail in the Compensation Discussion and Analysis section and the accompanying compensation tables and narrative discussion contained in this Proxy Statement, we have designed our executive compensation programs to drive our long-term success and increase stockholder value. We utilize our executive compensation programs to provide competitive compensation that will attract and retain our named executive officers, encourage our named executive officers to perform at their highest levels by linking compensation with financial and performance milestones and directly align our executive compensation with stockholders interests through the use of equity-based incentive awards.

The Personnel and Compensation Committee has overseen the development and implementation of our executive compensation programs in line with these core compensation principles. The Personnel and Compensation Committee also continuously reviews, evaluates and updates our executive compensation programs to help ensure that we provide competitive compensation that motivates our named executive officers to perform at their highest levels, while increasing long-term value to our stockholders. With these core compensation principles in mind, the Personnel and Compensation Committee took the following compensation actions in 2018 to align our programs with stockholder interests:

- maintained the structure of our compensation programs and incentive awards generally to provide compensation at targeted levels based on benchmark studies;
- conducted an annual risk assessment with respect to our executive compensation program; and
- maintained the maximum cap in our annual incentive compensation plan at 200% of target, which aligns with market practices and rewards management for building extraordinary value for stockholders.

We believe the Personnel and Compensation Committee s compensation actions, like those described above, demonstrate our continued commitment to align our executive compensation with stockholders interests, while providing competitive compensation to attract, motivate and retain our named executive officers and other key talent. We will continue to review and adjust our executive compensation programs with these goals in mind to help ensure the long-term success of our company and generate increased long-term value to our stockholders.

The Board of Directors requests the support of our stockholders for the compensation of our named executive officers as disclosed in the Compensation Discussion and Analysis section and the accompanying compensation tables and narrative discussion in this Proxy Statement. This advisory vote on the compensation of our named executive officers gives our stockholders another means to make their opinions known on our executive compensation programs. For the reasons we discuss above, the Board recommends that stockholders vote in favor of the following resolution:

RESOLVED, that the stockholders approve, on an advisory basis, the compensation of the named executive officers, as disclosed pursuant to Item 402 of Regulation S-K, including in the Compensation Discussion and Analysis section and compensation tables and narrative discussion contained in this Proxy Statement.

This vote on the compensation of our named executive officers is advisory and not binding on us, our Board of Directors or the Personnel and Compensation Committee. Although the outcome of this advisory vote on the compensation of our named executive officers is nonbinding, the Personnel and Compensation Committee and the Board of Directors will review and consider the outcome of this vote when making future compensation decisions for our named executive officers.

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REPORT OF THE AUDIT COMMITTEE

The primary responsibility of the Audit Committee is to oversee our financial reporting process on behalf of the Board, to oversee the activities of our internal audit function, to appoint the independent registered public accounting firm and to report the results of the Committee s activities to the Board. Management has the primary responsibility for the financial statements and reporting process, including the systems of internal control, and Ernst & Young LLP (the independent registered public accounting firm) is responsible for auditing and reporting on those financial statements and our internal control structure. The Committee reviewed and discussed with management and the independent registered public accounting firm our audited financial statements as of and for the year ended December 31, 2018.

During 2018, the Audit Committee conducted eleven meetings, four of which were in person and seven of which were telephonic. The Committee chairperson and other members of the Committee each quarter reviewed and commented on the earnings news release and SEC Form 10-Qs, including the interim statements included therein, and met and discussed our draft Annual Report on SEC Form 10-K with the chief financial officer, general counsel, controller and independent registered public accounting firm prior to filing and public release. In addition, the Committee reviewed and ratified its Charter.

The Committee discussed with the independent registered public accounting firm the matters required to be discussed by Auditing Standard No. 1301 and Rule 2-07 of SEC Regulation S-X. Both the director of internal audit and the independent registered public accounting firm have direct access to the Audit Committee at any time on any issue of their choosing, and the Committee has the same direct access to the director of internal audit and the independent registered public accounting firm. The Committee met with the director of internal audit and the independent registered public accounting firm, with and without management present, to discuss the results of their examinations, their evaluations of our internal controls, and the overall quality of our financial reporting. The Committee met separately with the company s chief financial officer and controller regarding financial reporting, and met separately with the company s general counsel on compliance matters. The Committee discussed with management the status of pending litigation, taxation and other areas of oversight relating to financial reporting and audit processes as the Committee determined to be appropriate. The Committee also reviewed with the Board and management the company s Enterprise Risk Management (ERM) program, including specific risk topics that are addressed in presentations to the Board, including information security risk and privacy compliance.

The Committee received and reviewed the written disclosures and the letter from the independent registered public accounting firm required by applicable requirements of the Public Company Accounting Oversight Board for independent auditor communications with Audit Committees concerning independence. In addition, the Committee considered the compatibility of non-audit services with the independent registered public accounting firm s independence. The Audit Committee has procedures for pre-approving all audit and non-audit services provided by the independent registered public accounting firm. These procedures include reviewing and approving a budget for audit and permitted non-audit services. Audit Committee approval is required to exceed the amount of the budget for a particular category of non-audit services. The Audit Committee may delegate pre-approval authority to one or more members of the Audit Committee, which is later ratified by the full Committee. The Audit Committee concluded the provision of the non-audit services is compatible with maintaining the independent registered public accounting firm s independence.

During the fiscal year ended December 31, 2018, Ernst & Young LLP was employed principally to perform the annual audit and to render tax services. Fees paid to Ernst & Young LLP for each of the last two fiscal years are listed in the following table:

	Year Ended December 31	
	2018	2017
Audit Service Fees	$ 1,366,000	$ 1,484,500
Audit Related Fees	0	42,500
Tax Fees	108,685	53,000
Total Fees	$ 1,474,685	$ 1,580,000

Audit fees consist of fees for the annual audit of our company s financial statements and internal controls over financial reporting, reviews of financial statements included in our Form 10-Q and 10-K filings, statutory audits for certain of our company s foreign locations and other services related to regulatory filings.

In reliance on the reviews and discussions referred to above, the Committee recommended to the Board of Directors that the audited financial statements be included in our Annual Report on Form 10-K for the year ended December 31, 2018, filed with the SEC. The Committee appointed Ernst & Young LLP as our independent registered public accounting firm for fiscal 2019, subject to stockholder ratification, and preliminarily approved its estimated fees for first and second quarter reviews, audit related and tax services.

Gene C. Wulf, Chairperson

Dr. Ilham Kadri, Committee Member

Mark D. Smith, Committee Member

Idelle K. Wolf, Committee Member

RATIFICATION OF APPOINTMENT OF INDEPENDENT REGISTERED

PUBLIC ACCOUNTING FIRM

The Audit Committee of the Board of Directors of our company has appointed Ernst & Young LLP as our company s independent registered public accounting firm for 2019. Representatives of Ernst & Young LLP have been invited to be present at the 2019 Annual Meeting of Stockholders to provide a statement and respond to stockholder questions. Although not required to be submitted to a vote of the stockholders, the Board of Directors believes it appropriate to obtain stockholder ratification of the Audit Committee s action in appointing Ernst & Young LLP as our independent registered public accounting firm. The Board of Directors has itself ratified the Audit Committee s action. Should such appointment not be ratified by the stockholders, the Audit Committee will reconsider the matter. Even if the appointment is ratified, the Audit Committee, in its discretion, may select a different independent registered public accounting firm at any time during the fiscal year if it determines that such a change would be in the best interest of our company and our stockholders.

REPORT OF THE NOMINATING AND GOVERNANCE COMMITTEE

The Nominating and Governance Committee met three times during the year. The Committee monitored the status of legislation and related SEC regulations impacting corporate governance. The Committee also reviewed the process implemented by the Board and each Board Committee to review best practices and how they addressed risk oversight. In addition, the Committee reviewed a governance best practice or SEC topic at each of its meetings. In 2018, the Committee oversaw the engagement of an outside consultant to lead the Board through an in-depth reflection on existing corporate governance practices and best practices for Board consideration. This review is scheduled to take place in 2019. Further, the Committee reviewed and ratified its Charter, which provides that the Committee is responsible for the nomination of directors, review of director independence and compensation committee consultant independence, review of compensation to be paid to directors and our company s corporate governance practices, especially in light of SEC and NYSE rules. The Charter is posted on our website; the address of the website is www.aosmith.com.

As part of its responsibilities, the Committee monitored our corporate governance. It recommended to the Board of Directors updates to the Corporate Governance Guidelines, which the Board adopted. The Committee verified that all Committees Charters were in place and were reviewed by the Committees. It reviewed our code of business conduct, called the Guiding Principles, as well as our financial code of ethics, officers outside board memberships, minimum qualifications for directors, the process and procedure for stockholder recommendation of director candidates and stockholder communications with the Board, which the Board previously adopted. These and other corporate governance documents, including Committees Charters, are available via our website. No waivers were sought or granted from our code of conduct. The Committee also recommended strategic programs available to directors, monitored director education programs in which directors participated and reviewed best practices for ongoing director education.

The Committee also is responsible for reviewing director compensation. In 2018, the Committee implemented previously approved changes in director compensation that eliminated all meeting fees and implemented a streamlined annual retainer program for the Board and Committees, which were then adjusted to reflect annual director compensation benchmarking provided by Willis Towers Watson, as approved by the Board.

The Committee reviewed Board Committee member qualifications and independence and made recommendations to the Board on member appointments to Committees. The Committee reviewed the Board s Committee structure and operations and reported to the Board regarding them. Further, the Committee reviewed the independence of compensation consultants and made recommendations to the Personnel and Compensation Committee as to their independence.

The Committee also conducted an evaluation of its performance and oversaw the evaluation process to ensure that the Board and each of the other Committees performed its own self-evaluation and reported on it to the Board of Directors. The directors also evaluated the performance of each of their fellow directors.

William P. Greubel, Chairperson

Ronald D. Brown, Committee Member

Paul W. Jones, Committee Member

Bruce M. Smith, Committee Member

DATE FOR STOCKHOLDER PROPOSALS

Proposals of stockholders pursuant to Rule 14a-8 under the Securities Exchange Act of 1934 intended to be presented at the 2020 Annual Meeting of Stockholders must be received by us no later than October 31, 2019, to be considered for inclusion in our proxy materials for the 2020 meeting. If a stockholder who otherwise desires to bring a proposal before the 2020 meeting does not notify us of its intent to do so on or before January 14, 2020, then the proposal will be untimely, and the proxies will be able to vote on the proposal in their discretion.

February 28, 2019

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Shareowner Services

P.O. Box 64945

St. Paul, MN 55164-0945

A. O. SMITH CORPORATION

ANNUAL MEETING OF STOCKHOLDERS

Tuesday, April 9, 2019

8:00 a.m. Central Daylight Time

(Meeting location and directions on back page.)

Important Notice Regarding the Availability of Proxy Materials for the

Stockholders Meeting to be Held on April 9, 2019.

Notice is hereby given that the Annual Meeting of Stockholders of A. O. Smith Corporation will be held at the Lloyd R. Smith Corporate Technology Center, 11100 West Park Place, Milwaukee, Wisconsin on Tuesday, April 9, 2019, at 8:00 a.m. Central Daylight Time.

This communication presents only an overview of the more complete proxy materials that are available to you on the Internet. We encourage you to access and review all of the important information contained in the proxy materials before voting.

The Proxy Statement and Annual Report are available at www.proxydocs.com/aos

If you want to receive a paper copy or an email with links to the electronic materials, you must request one. There is no charge to you for requesting a copy. Please make your request for a copy as instructed on the reverse side of this notice on or before March 26, 2019, to facilitate timely delivery.

Admission

All stockholders must pre-register in order to attend the Annual Meeting of Stockholders of A. O. Smith Corporation. Please contact us by e-mail at 2019stockholdersmeeting@aosmith.com or by telephone at 414-359-4000 and provide your name, address, telephone number and your request to attend. We will respond to all pre-registration requests and will maintain a list of verified stockholders at the admission desk for the meeting. In addition to ownership confirmation, you must also present government-issued photo identification showing your name, address and signature for admission. Annual meeting pre-registration requests must be received by the end of business on Friday, April 5, 2019. Seating and parking are limited and admission is on a first-come basis.

Matters intended to be acted upon at the meeting are listed below.

The Board of Directors recommends that you vote FOR proposals 1, 2 and 3:

1. Election of our Directors;
2. Approval, by nonbinding advisory vote, of compensation for our named executive officers;
3. Ratification of the appointment of Ernst & Young LLP as our independent registered public accounting firm.

THIS IS NOT A FORM FOR VOTING

You may immediately vote your proxy on the Internet at:

www.proxypush.com/aos

Use the Internet to vote your proxy 24 hours a day, 7 days a week, until 11:59 p.m. (CDT) on April 5, 2019.

Please have this Notice and the last four digits of your Social Security Number or Tax Identification Number available. Follow the instructions to vote your proxy.

Your Internet vote authorizes the Named Proxies to vote your shares in the same manner as if you marked, signed and returned your Proxy Card.

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To request paper copies of the proxy materials, which include the Proxy Card,

Proxy Statement and Annual Report, please contact us via:

Internet/Mobile - Access the Internet and go to www.investorelections.com/aos. Follow the instructions to log in, and order copies.

Telephone - Call us free of charge at 866-870-3684 in the U.S. or Canada, using a touch-tone phone, and follow the instructions to log in and order copies.

Email - Send us an email at paper@investorelections.com with aos Materials Request in the subject line. The email must include:

The 11-digit control # located in the box in the upper right-hand corner on the front of this Notice.

Your preference to receive printed materials via mail ***-or-*** to receive an email with links to the electronic materials.

If you choose email delivery, you must include the email address.

If you would like this election to apply to delivery of material for all future meetings, write the word Permanent and include the last 4 digits of your Social Security or Tax Identification Number in the email.

Important Information about the Notice of Proxy Materials

This Notice Regarding the Online Availability of Proxy Materials (Notice) is provided to stockholders in place of the printed materials for the upcoming Stockholders Meeting.

Information about the Notice:

The Securities and Exchange Commission has adopted a voluntary rule permitting Internet-based delivery of proxy materials. Companies can now send Notices, rather than printed proxy materials to stockholders. This may help lower mailing, printing and storage costs for the company, while minimizing environmental impact. This Notice contains specific information regarding the meeting, proposals and the Internet site where the proxy materials may be found.

To view the proxy materials online:

Please refer to the instructions in this Notice on how to access and view the proxy materials online, including the Proxy Card, Annual Report and Proxy Statement.

To receive paper copies of the proxy materials:

Please refer to the instructions in this Notice on how to request hard copies of proxy materials via phone, email or Internet.

Directions to Annual Meeting of Stockholders on April 9, 2019:

Location:	Lloyd R. Smith Corporate Technology Center 11100 West Park Place Milwaukee, Wisconsin 53224
Directions:	From Milwaukee General Mitchell Airport: Exit Airport and take ramp on right to I-41 North/I-894 West/I-43 South. Continue straight onto I-41 North. At Exit 47B, take Good Hope Road. Keep right and take ramp to Park Place. At stop sign, turn right and arrive at Lloyd R. Smith Corporate Technology Center.

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Shareowner Services
P.O. Box 64945

St. Paul, MN 55164-0945

Vote by Internet, Telephone or Mail

24 Hours a Day, 7 Days a Week
Please have available the Control Number located at the top of this page, along with the last four digits of your Social Security Number or Tax Identification Number.

Your phone or Internet vote authorizes the named proxies to vote your shares in the same manner as if you marked, signed and returned your Proxy Card.

INTERNET/MOBILE www.proxypush.com/aos

Use the Internet to vote your proxy until 11:59 p.m. (CDT) on April 7, 2019.

PHONE 1-866-883-3382

Use a touch-tone telephone to vote your proxy until 11:59 p.m. (CDT) on April 7, 2019.

MAIL Mark, sign and date your Proxy Card and return it in the postage-paid envelope provided or return it to A. O. SMITH CORPORATION, c/o Shareowner Services, P.O. Box 64873, St. Paul, MN 55164-0873. Your proxy must be received by April 8, 2019.

IF YOU VOTE BY INTERNET OR TELEPHONE, PLEASE DO NOT MAIL YOUR PROXY CARD.

ò *Detach here* ò

A. O. SMITH CORPORATION 2019 ANNUAL MEETING

PROXY - COMMON STOCK

This proxy when properly executed will be voted in the manner directed herein by the undersigned. If no direction is made, this proxy will be voted FOR proposals 1, 2 and 3.

1.	Election of directors:	01	William P. Greubel	03	Idelle K. Wolf	Vote FOR	Vote WITHHOLD
		02	Dr. Ilham Kadri	04	Gene C. Wulf	all nominees (except as marked)	from all nominees

(Instructions: To withhold authority to vote for any indicated nominee, write the number(s) of the nominee(s) in the box provided to the right.)

2.	Proposal to approve, by nonbinding advisory vote, the compensation of our named executive officers:	For	Against	Abstain
3.	Proposal to ratify the appointment of Ernst & Young LLP as the independent registered public accounting firm of the corporation:	For	Against	Abstain

Directors recommend a vote FOR proposals 1, 2 and 3.

Date ____________________

____

I plan to attend meeting.

Address Change? Mark box, sign, and indicate changes below:

Signature(s) in Box

Please sign exactly as your name appears hereon. When shares are held by joint tenants, both should sign. When signing as attorney, executor, administrator, trustee or guardian, please give full title as such. If a corporation, please sign in full corporate name by President or other authorized officer. If a partnership, please sign in partnership name by authorized person.

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ANNUAL MEETING OF STOCKHOLDERS

Tuesday, April 9, 2019

8:00 a.m. Central Daylight Time

Lloyd R. Smith Corporate Technology Center

11100 West Park Place

Milwaukee, Wisconsin

A. O. SMITH CORPORATION

PROXY - COMMON STOCK

This Proxy is Solicited on Behalf of the Board of Directors

The undersigned hereby appoints KEVIN J. WHEELER, JOHN J. KITA and JAMES F. STERN, or any one of them, with full power of substitution, as proxy or proxies of the undersigned to attend the Annual Meeting of Stockholders of A. O. Smith Corporation to be held on April 9, 2019, at 8:00 a.m. Central Daylight Time, at the Lloyd R. Smith Corporate Technology Center, 11100 West Park Place, Milwaukee, Wisconsin, or at any adjournment thereof, and there to vote all shares of Common Stock which the undersigned would be entitled to vote if personally present as specified upon the following matters and in their discretion upon such other matters as may properly come before the meeting.

This proxy when properly executed will be voted in the manner directed herein by the undersigned.

If no direction is made, this proxy will be voted FOR proposals 1, 2 and 3.

PLEASE VOTE BY INTERNET OR TELEPHONE OR MARK, SIGN, DATE

AND RETURN THE PROXY CARD PROMPTLY USING THE ENCLOSED ENVELOPE.

See reverse for voting instructions.

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Shareowner Services
P.O. Box 64945

St. Paul, MN 55164-0945

Vote by Internet, Telephone or Mail

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Please have available the

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along with the last four digits of your Social Security

Number or Tax Identification Number.

Your phone or Internet vote authorizes the named

proxies to vote your shares in the same manner as if

you marked, signed and returned your Proxy Card.

INTERNET/MOBILE www.proxypush.com/aos

Use the Internet to vote your proxy until 11:59 p.m. (CDT) on April 7, 2019.

PHONE 1-866-883-3382

Use a touch-tone telephone to vote your proxy until 11:59 p.m. (CDT) on April 7, 2019.

MAIL Mark, sign and date your Proxy Card and return it in the postage-paid envelope provided or return it to

A. O. SMITH CORPORATION, c/o Shareowner Services, P.O. Box 64873, St. Paul, MN 55164-0873. Your proxy must be received by April 8, 2019.

IF YOU VOTE BY INTERNET OR TELEPHONE, PLEASE DO NOT MAIL YOUR PROXY CARD.

ò ***Detach here*** ò

A. O. SMITH CORPORATION 2019 ANNUAL MEETING

PROXY - CLASS A COMMON STOCK

This proxy when properly executed will be voted in the manner directed herein by the undersigned. If no direction is made, this proxy will be voted FOR proposals 1, 2 and 3.

1.	Election of directors:	01	Ronald D. Brown	04	Bruce M. Smith	Vote FOR	Vote WITHHOLD
		02	Paul W. Jones	05	Mark D. Smith	all nominees	from all nominees
		03	Ajita G. Rajendra	06	Kevin J. Wheeler	(except as marked)	

(Instructions: To withhold authority to vote for any indicated nominee, write the number(s) of the nominee(s) in the box provided to the right.)

2.	Proposal to approve, by nonbinding advisory vote, the compensation of our named executive officers:	For	Against	Abstain
3.	Proposal to ratify the appointment of Ernst & Young LLP as the independent registered public accounting firm of the corporation:	For	Against	Abstain

Directors recommend a vote FOR proposals 1, 2, and 3.

Date ______________________

I plan to attend meeting.

Address Change? Mark box, sign, and indicate changes below:

Signature(s) in Box

Please sign exactly as your name appears hereon. When shares are held by joint tenants, both should sign. When signing as attorney, executor, administrator, trustee or guardian, please give full title as such. If a corporation, please sign in full corporate name by President or other authorized officer. If a partnership, please sign in partnership name by authorized person.

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ANNUAL MEETING OF STOCKHOLDERS

Tuesday, April 9, 2019

8:00 a.m. Central Daylight Time

Lloyd R. Smith Corporate Technology Center

11100 West Park Place

Milwaukee, Wisconsin

A. O. SMITH CORPORATION

PROXY CLASS A COMMON STOCK

This Proxy is Solicited on Behalf of the Board of Directors

The undersigned hereby appoints KEVIN J. WHEELER, JOHN J. KITA and JAMES F. STERN, or any one of them, with full power of substitution, as proxy or proxies of the undersigned to attend the Annual Meeting of Stockholders of A. O. Smith Corporation to be held on April 9, 2019, at 8:00 a.m. Central Daylight Time, at the Lloyd R. Smith Corporate Technology Center, 11100 West Park Place, Milwaukee, Wisconsin, or at any adjournment thereof, and there to vote all shares of Class A Common Stock which the undersigned would be entitled to vote if personally present as specified upon the following matters and in their discretion upon such other matters as may properly come before the meeting.

This proxy when properly executed will be voted in the manner directed herein by the undersigned.

If no direction is made, this proxy will be voted FOR proposals 1, 2 and 3.

PLEASE VOTE BY INTERNET OR TELEPHONE OR MARK, SIGN, DATE

AND RETURN THE PROXY CARD PROMPTLY USING THE ENCLOSED ENVELOPE.

See reverse for voting instructions.