

ARDEN REALTY INC  
Form 10-Q  
August 09, 2004

**Table of Contents**

---

---

**Securities and Exchange Commission**

**Washington, D.C. 20549**

**FORM 10-Q**

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

For the quarter ended June 30, 2004

Commission file number 1-12193

**ARDEN REALTY, INC.**

(Exact name of registrant as specified in its charter)

**Maryland**

(State or other jurisdiction of incorporation or  
organization)

**95-4578533**

(I.R.S. Employer Identification No.)

**11601 Wilshire Boulevard,  
4th Floor**

**Los Angeles, California 90025-1740**

(Address and zip code of principal executive offices)

Registrant's telephone number, including area code: (310) 966-2600

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

Yes  No

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

Yes  No

As of August 6, 2004 there were 65,508,421 shares of the registrant's common stock, \$.01 par value, issued and outstanding.

---

---

**ARDEN REALTY, INC.  
FORM 10-Q  
TABLE OF CONTENTS**

**PART I. FINANCIAL INFORMATION**

|  |    |
|--|----|
| <u>Item 1. Financial Statements</u>  |    |
| <u>Consolidated Balance Sheets as of June 30, 2004 (unaudited) and December 31, 2003</u>                       | 3  |
| <u>Consolidated Statements of Income for the three and six months ended June 30, 2004 and 2003 (unaudited)</u> | 4  |
| <u>Consolidated Statements of Cash Flows for the six months ended June 30, 2004 and 2003 (unaudited)</u>       | 5  |
| <u>Notes to Consolidated Financial Statements</u>  | 6  |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>           | 11 |
| <u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>                                      | 28 |
| <u>Item 4. Controls and Procedures</u>   | 29 |
| <b><u>PART II. OTHER INFORMATION</u></b>   |    |
| <u>Item 1. Legal Proceedings</u>   | 30 |
| <u>Item 2. Changes in Securities</u>   | 30 |
| <u>Item 3. Defaults Upon Senior Securities</u>   | 30 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u>   | 30 |
| <u>Item 5. Other Information</u>   | 30 |
| <u>Item 6. Exhibits and Reports on Form 8-K</u>  | 30 |
| <b><u>SIGNATURES</u></b>   | 31 |

Exhibit 31.1Exhibit 32.1

**Table of Contents****Part I. FINANCIAL INFORMATION****Item 1. Financial Statements****Arden Realty, Inc.****Consolidated Balance Sheets  
(in thousands, except share amounts)**

|   | <b>June 30,<br/>2004</b> | <b>December 31,<br/>2003</b> |
|---|--------------------------|------------------------------|
|   | <b>(unaudited)</b>       |                              |
| <b>Assets</b>   |                          |                              |
| Investment in real estate:  |                          |                              |
| Land  | \$ 467,325               | \$ 467,216                   |
| Buildings and improvements  | 2,184,023                | 2,122,216                    |
| Tenant improvements and leasing commissions   | 363,583                  | 345,604                      |
|   | <hr/>                    | <hr/>                        |
|   | 3,014,931                | 2,935,036                    |
| Less: accumulated depreciation and amortization   | (483,022)                | (455,261)                    |
|   | <hr/>                    | <hr/>                        |
|   | 2,531,909                | 2,479,775                    |
| Properties under development  | 8,769                    | 75,627                       |
| Land available for development  | 23,749                   | 23,723                       |
| Properties held for disposition, net  | 8,053                    | 67,574                       |
|   | <hr/>                    | <hr/>                        |
| Net investment in real estate   | 2,572,480                | 2,646,699                    |
| Cash and cash equivalents   | 9,924                    | 4,707                        |
| Restricted cash   | 13,655                   | 19,694                       |
| Rent and other receivables, net of allowance of \$3,310 and \$4,041 at June 30, 2004 and December 31, 2003, respectively  | 5,522                    | 3,688                        |
| Deferred rent, net of allowance of \$1,782 and \$2,216 at June 30, 2004 and December 31, 2003, respectively   | 43,853                   | 44,203                       |
| Prepaid financing costs, expenses and other assets, net of accumulated amortization of \$11,811 and \$13,781 at June 30, 2004 and December 31, 2003, respectively | 22,201                   | 22,442                       |
|   | <hr/>                    | <hr/>                        |
| Total assets  | <b>\$2,667,635</b>       | <b>\$2,741,433</b>           |
|   | <hr/>                    | <hr/>                        |
| <b>Liabilities</b>  |                          |                              |
| Mortgage loans payable  | \$ 386,632               | \$ 564,829                   |
| Unsecured lines of credit   | 282,000                  | 161,000                      |

Edgar Filing: ARDEN REALTY INC - Form 10-Q

|   |             |             |
|---|-------------|-------------|
| Unsecured term loan   | 125,000     | 125,000     |
| Unsecured senior notes, net of discount   | 497,349     | 498,952     |
| Accounts payable and accrued expenses   | 48,457      | 54,317      |
| Security deposits   | 23,089      | 22,321      |
| Dividends payable   | 33,083      | 32,535      |
|   | <hr/>       | <hr/>       |
| Total liabilities   | 1,395,610   | 1,458,954   |
| Minority interest   | 70,933      | 72,194      |
| <b>Stockholders Equity</b>  |             |             |
| Preferred stock, \$.01 par value, 20,000,000 shares authorized, none issued.  |             |             |
| Common stock, \$.01 par value, 100,000,000 shares authorized, 65,508,421 and 64,425,450 issued and outstanding at June 30, 2004 and December 31, 2003, respectively | 656         | 646         |
| Additional paid-in capital  | 1,211,082   | 1,225,192   |
| Deferred compensation   | (14,448)    | (14,952)    |
| Accumulated other comprehensive loss  | 3,802       | (601)       |
|   | <hr/>       | <hr/>       |
| Total stockholders equity   | 1,201,092   | 1,210,285   |
|   | <hr/>       | <hr/>       |
| Total liabilities and stockholders equity   | \$2,667,635 | \$2,741,433 |
|   | <hr/>       | <hr/>       |

*See accompanying notes to consolidated financial statements.*

Table of Contents**Arden Realty, Inc.****Consolidated Statements of Income**  
**(in thousands, except per share data)**  
**(unaudited)**

|   | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|---|--|-------------|--------------------------------------|-------------|
|   | <b>2004</b>                            | <b>2003</b> | <b>2004</b>                          | <b>2003</b> |
| Property revenues   | \$105,398                              | \$102,308   | \$209,877                            | \$203,284   |
| Property operating expenses   | 34,163                                 | 32,631      | 68,260                               | 63,974      |
|   | 71,235                                 | 69,677      | 141,617                              | 139,310     |
| General and administrative expenses   | 4,665                                  | 3,981       | 9,149                                | 7,571       |
| Interest expense  | 21,184                                 | 23,254      | 44,497                               | 46,289      |
| Depreciation and amortization   | 31,936                                 | 29,487      | 62,212                               | 57,895      |
| Interest and other loss (income)  | 435                                    | (149)       | (331)                                | (253)       |
| Income from continuing operations before<br>impairment on investment in securities and<br>minority interest | 13,015                                 | 13,104      | 26,090                               | 27,808      |
| Impairment on investment in securities  | (2,700)                                |             | (2,700)                              |             |
| Minority interest   | (1,307)                                | (1,399)     | (2,689)                              | (2,837)     |
| Income from continuing operations   | 9,008                                  | 11,705      | 20,701                               | 24,971      |
| Discontinued operations, net of minority<br>interest.   | (281)                                  | 1,177       | 458                                  | 3,988       |
| Gain on sale of discontinued properties   | 400                                    | 6,021       | 6,829                                | 5,382       |
| Net income  | \$ 9,127                               | \$ 18,903   | \$ 27,988                            | \$ 34,341   |
| Basic net income per common share:  |  |             |                                      |             |
| Income from continuing operations   | \$ 0.14                                | \$ 0.19     | \$ 0.32                              | \$ 0.39     |
| Income from discontinued operations   | 0.00                                   | 0.11        | 0.11                                 | 0.15        |
| Net income per common share basic   | \$ 0.14                                | \$ 0.30     | \$ 0.43                              | \$ 0.54     |
| Weighted average number of common shares<br>basic   | 65,464                                 | 63,207      | 65,139                               | 63,124      |

Edgar Filing: ARDEN REALTY INC - Form 10-Q

|  |                   |                   |                   |                   |
|--|-------------------|-------------------|-------------------|-------------------|
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Diluted net income per common share:             |                   |                   |                   |                   |
| Income from continuing operations                | \$ 0.14           | \$ 0.19           | \$ 0.32           | \$ 0.39           |
| Income from discontinued operations              | 0.00              | 0.11              | 0.11              | 0.15              |
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Net income per common share diluted              | \$ 0.14           | \$ 0.30           | \$ 0.43           | \$ 0.54           |
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Weighted average number of common shares diluted | 65,759            | 63,436            | 65,496            | 63,268            |
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

*See accompanying notes to consolidated financial statements.*

**Table of Contents****Arden Realty, Inc.**

**Consolidated Statements of Cash Flows**  
**(in thousands)**  
**(unaudited)**

|   | <b>Six Months Ended<br/>June 30,</b> |             |
|---|--------------------------------------|-------------|
|   | <b>2004</b>                          | <b>2003</b> |
| <b>Operating Activities:</b>  |                                      |             |
| Net income  | \$ 27,988                            | \$ 34,341   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                      |             |
| Minority interest, including discontinued operations                              | 2,877                                | 3,087       |
| Gain on sale of discontinued properties   | (6,829)                              | (5,382)     |
| Impairment on investment in securities  | 2,700                                |             |
| Depreciation and amortization, including discontinued operations                  | 62,319                               | 59,670      |
| Amortization of loan costs  | 2,083                                | 1,924       |
| Non-cash compensation expense   | 1,531                                | 837         |
| Changes in operating assets and liabilities:                                      |                                      |             |
| Rent and other receivables  | (1,834)                              | 913         |
| Deferred rent   | (1,982)                              | 89          |
| Prepaid financing costs, expenses and other assets                                | (2,205)                              | (3,662)     |
| Accounts payable and accrued expenses   | (4,989)                              | (3,682)     |
| Security deposits   | 876                                  | 512         |
|   | <hr/>                                | <hr/>       |
| Net cash provided by operating activities   | 82,535                               | 88,647      |
|   | <hr/>                                | <hr/>       |
| <b>Investing Activities:</b>  |                                      |             |
| Improvements to commercial properties   | (47,367)                             | (40,729)    |
| Proceeds from sale of properties  | 68,284                               | 78,719      |
|   | <hr/>                                | <hr/>       |
| Net cash provided by investing activities   | 20,917                               | 37,990      |
|   | <hr/>                                | <hr/>       |
| <b>Financing Activities:</b>  |                                      |             |
| Repayments of mortgage loans  | (178,197)                            | (2,090)     |
| Proceeds from unsecured lines of credit   | 244,000                              | 41,500      |
| Repayments of unsecured lines of credit   | (123,000)                            | (92,087)    |
| Proceeds from issuance of common stock  | 22,391                               | 5,298       |
| Distributions to preferred operating partnership unit holders                     | (2,156)                              | (2,156)     |
| Decrease (increase) in restricted cash  | 6,039                                | (211)       |
| Distributions to minority interests   | (1,697)                              | (1,735)     |
| Dividends paid  | (65,615)                             | (63,654)    |



Edgar Filing: ARDEN REALTY INC - Form 10-Q

|  |           |           |
|--|-----------|-----------|
| Net cash used in financing activities                                | (98,235)  | (115,135) |
| Net increase in cash and cash equivalents                            | 5,217     | 11,502    |
| Cash and cash equivalents at beginning of period                     | 4,707     | 4,063     |
| Cash and cash equivalents at end of period                           | \$ 9,924  | \$ 15,565 |
| <b>Supplemental Disclosure of Cash Flow Information:</b>             |           |           |
| Cash paid during the period for interest, net of amounts capitalized | \$ 44,069 | \$ 47,214 |

*See accompanying notes to consolidated financial statements.*

**Table of Contents**

**Arden Realty, Inc.**

**Notes to Consolidated Condensed Financial Statements  
June 30, 2004  
(unaudited)**

**1. Description of Business**

The terms Arden Realty, us, we and our as used in this report refer to Arden Realty, Inc. Through our controlling interest in Arden Realty Limited Partnership, or the Operating Partnership, and our other subsidiaries, we own, manage, lease, develop, renovate and acquire commercial office properties located in Southern California. As of June 30, 2004, our portfolio was comprised of 128 primarily suburban office properties, consisting of 210 buildings with approximately 18.8 million net rentable square feet. As of June 30, 2004, our operating portfolio was 89.6% occupied.

The minority interests at June 30, 2004 consist of limited partnership interests in the Operating Partnership of approximately 2.5%, exclusive of ownership interests of the Operating Partnership's preferred unit holders.

**2. Summary of Significant Accounting Policies**

*Basis of Presentation*

The accompanying consolidated financial statements include the accounts of Arden Realty, Inc., the Operating Partnership, and our subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

We consolidate all entities for which we have controlling financial interest as measured by a majority of the voting interest. For entities in which the controlling financial interest is not clearly indicated by ownership of a majority of the voting interest, we would consolidate those entities that we control by agreement. We would also consolidate all variable interest entities for which we were the primary beneficiary.

Except for minority interests in the Operating Partnership, Arden Realty and the Operating Partnership currently own 100% of all of our consolidated subsidiaries and we do not have any unconsolidated investments other than a \$2.7 million investment in the securities of a non-publicly traded company (see Note 4). Because we do not control this company contractually nor exert significant influence over its operating and financial policies, we account for this investment under the cost method of accounting.

*Interim Financial Data*

The accompanying consolidated condensed financial statements should be read in conjunction with our 2003 Annual Report on Form 10-K as filed with the Securities and Exchange Commission. The accompanying financial information reflects all adjustments, which are, in our opinion, of a normal recurring nature and necessary for a fair presentation of our financial position, results of operations and cash flows for the interim periods. Interim results of operations are not necessarily indicative of the results to be expected for the full year.

*Reclassifications*

Certain prior year amounts have been reclassified to conform with the current period presentation.

### **3. Property Dispositions**

We recovered a \$400,000 environmental reserve during the second quarter of 2004 relating to the approximate 133,000 square foot retail property located in Riverside County which was sold in the first quarter of 2004. This amount has been included in the gain on sale of discontinued properties line item in our consolidated statements of income.

### **4. Non-Real Estate Investments**

During the three months ended June 30, 2004, an impairment of \$2.7 million was recognized in conjunction with our investment in the securities of a non-publicly traded company that provides distributed energy generation to commercial property owners. This impairment represents our entire investment in this company.

We recorded this impairment after analyzing information received from this company over the past several months regarding their current business and financial strategies which indicated to us that the recoverability of our investment is doubtful.

**Table of Contents****5. Outstanding Indebtedness**

A summary of our outstanding indebtedness as of June 30, 2004 and December 31, 2003 is as follows:

| Type of Debt                                | June 30,<br>2004 | December 31,<br>2003 | Stated<br>Annual<br>Interest<br>Rate at<br>June 30,<br>2004 | Rate<br>Fixed/Floating          | Number<br>of<br>Properties<br>Securing<br>Loan | Maturity |
|---|------------------|----------------------|---|---------------------------------|--|----------|
| (in thousands)                              |                  |                      |   |                                 |  |          |
| <b>Mortgage Loans Payable:</b>              |                  |                      |   |                                 |  |          |
| <i>Fixed Rate</i>                           |                  |                      |   |                                 |  |          |
| Mortgage Financing I <sup>(1)</sup>         | \$               | \$ 175,000           | %   |                                 |  |          |
| Mortgage Financing III <sup>(2)</sup>       | 133,624          | 134,544              | 6.74%   | Fixed                           | 22   | 4/08     |
| Mortgage Financing IV <sup>(2)</sup>        | 109,229          | 109,960              | 6.61%   | Fixed                           | 12   | 4/08     |
| Mortgage Financing V <sup>(2)</sup>         | 104,723          | 105,899              | 6.94%   | Fixed                           | 12   | 4/09     |
| Mortgage Financing VI <sup>(2)</sup>        | 21,472           | 21,578               | 7.54%   | Fixed                           | 3  | 4/09     |
| Activity Business Center <sup>(2)</sup>     | 7,317            | 7,394                | 8.85%   | Fixed                           | 1  | 5/06     |
| 145 South Fairfax <sup>(2)</sup>            | 3,891            | 3,912                | 8.93%   | Fixed                           | 1  | 1/27     |
| Marin Corporate Center <sup>(2)</sup>       | 2,656            | 2,724                | 9.00%   | Fixed                           | 1  | 7/15     |
| Conejo Business Center <sup>(2)</sup>       | 2,602            | 2,669                | 8.75%   | Fixed                           | (Note 3)                                       | 7/15     |
| Conejo Business Center <sup>(2)</sup>       | 1,118            | 1,149                | 7.88%   | Fixed                           | (Note 3)                                       | 7/15     |
|   | 386,632          | 564,829              |   |                                 |  |          |
| <b>Unsecured Lines of Credit:</b>           |                  |                      |   |                                 |  |          |
| <i>Floating Rate</i>                        |                  |                      |   |                                 |  |          |
| Wells Fargo - \$310 mm <sup>(4)</sup>       | 272,000          | 158,000              | 2.54%   | LIBOR +<br>0.90% (Notes<br>5,6) |  | 4/06     |
| City National Bank - \$20 mm <sup>(4)</sup> | 10,000           | 3,000                | 2.13%   | (Note 7)                        |  | 8/04     |

Edgar Filing: ARDEN REALTY INC - Form 10-Q

|                                       |                 |                 |       |                |       |
|---------------------------------------|-----------------|-----------------|-------|----------------|-------|
|                                       | 282,000         | 161,000         |       |                |       |
| <b>Unsecured Term Loan:</b>           |                 |                 |       |                |       |
| <i>Fixed Rate</i>                     |                 |                 |       |                |       |
| Wells Fargo - \$125 mm <sup>(4)</sup> | 125,000         | 125,000         | 4.14% | Fixed (Note 8) | 6/06  |
| <b>Unsecured Senior Notes:</b>        |                 |                 |       |                |       |
| <i>Fixed Rate</i>                     |                 |                 |       |                |       |
| 2005 Notes <sup>(9)</sup>             | 199,923         | 199,872         | 8.88% | Fixed          | 3/05  |
| 2007 Notes <sup>(9)</sup>             | 148,190         | 149,907         | 7.00% | (Note 10)      | 11/07 |
| 2010 Notes <sup>(9)</sup>             | 49,765          | 49,744          | 9.15% | Fixed          | 3/10  |
| 2010 Notes <sup>(9)</sup>             | 99,471          | 99,429          | 8.50% | Fixed          | 11/10 |
|                                       | <hr/>           | <hr/>           |       |                |       |
|                                       | 497,349         | 498,952         |       |                |       |
|                                       | <hr/>           | <hr/>           |       |                |       |
| <br>Total Debt                        | <br>\$1,290,981 | <br>\$1,349,781 |       |                |       |
|                                       | <hr/>           | <hr/>           |       |                |       |

- 
- (1) This mortgage financing was repaid in full on April 9, 2004 with proceeds from recent asset dispositions and funds from our unsecured lines of credit.
  - (2) Requires monthly payments of principal and interest.
  - (3) Both mortgage loans are secured by the Conejo Business Center property.
  - (4) Requires monthly payments of interest only, with outstanding principal balance due upon maturity.
  - (5) This line of credit also has an annual 20 basis point facility fee on the entire \$310 million commitment amount. In June 2004, we amended this line of credit to reduce the interest rate from LIBOR + 1.00% to LIBOR + 0.90%.
  - (6) We have entered into interest rate swap agreements that fixed the interest rate on \$50 million of the outstanding balance on this line of credit at 3.95% through April of 2006.
  - (7) In December 2003, we expanded this line of credit to \$20 million at an interest rate of LIBOR + 1.00% or Prime Rate 1.875%.
  - (8) In 2002, we entered into interest rate swap agreements that fixed the interest rate on the entire balance of this loan. In June 2004, we amended this loan to reduce its effective interest rate by 20 basis points. After this amendment and after taking into effect the interest rate swap agreements for this loan, it will have an effective interest rate of approximately 4.14% for the remainder of 2004, 4.55% in 2005 and 4.70% in 2006.
  - (9) Requires semi-annual interest payments only, with principal balance due upon maturity.

- (10) During the fourth quarter of 2003, we entered into interest rate swap agreements to float the interest rate on \$100 million of the outstanding balance of these notes at a rate of LIBOR + 3.1% through November of 2007. Including these swap agreements, the effective interest rate on these notes was approximately 6.20% as of June 30, 2004.

**Table of Contents**

**6. Interest Rate Swap Agreements**

We have entered into interest rate swap agreements to effectively convert floating rate debt into fixed rate debt, to convert fixed rate debt to floating rate debt and to lock the current Treasury rate in anticipation of future debt issuances. Net amounts received or paid under these agreements are recognized as an adjustment to interest expense when such amounts are incurred or earned. Our objective in using interest rate swap agreements is to manage our exposure to interest rate movements.

During 2002, such agreements were used to fix the floating interest rate associated with \$50 million of the Wells Fargo unsecured line of credit and the entire \$125 million balance of the unsecured term loan. Since June of 2003, we have also entered into \$150 million of forward-starting swaps that effectively fixed the 10-year Treasury rate at an average rate of approximately 4.1% for borrowings that are anticipated to occur in 2004 to refinance some of our scheduled debt maturities. The forward-starting interest rate swaps were entered into at current market rates and, therefore, had no initial cost.

In October and November of 2003, we also entered into reverse interest rate swap agreements to float \$100 million of the fixed interest rate associated with the 7.00% senior unsecured notes due in November of 2007. Under these reverse swaps, we will receive interest at a fixed rate of 7.00% and pay interest at a variable rate averaging six-month LIBOR in arrears plus 3.10%. The interest rate swaps mature at the same time the notes are due. These swaps qualify as fair value hedges for accounting purposes. Net semi-annual interest payments will be recognized as increases or decreases in interest expense. The fair value of the interest rate swaps will be recognized on our balance sheet and the carrying value of the senior unsecured notes will be increased or decreased by an offsetting amount.

Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133), as amended and interpreted, establishes accounting and reporting standards for derivative instruments and for hedging activities. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives used to hedge the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, are considered fair value hedges. Derivatives used to hedge the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges.

For derivatives designated as fair value hedges, changes in the fair value of the derivative and the hedged item related to the hedged risk are recognized in earnings. For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of the derivative is initially reported in other comprehensive income (loss), outside of earnings and subsequently recognized to earnings when the hedged transaction affects earnings.

Under SFAS 133, our \$175 million in floating-to-fixed swaps and our \$150 million in forward-starting swaps outstanding as of June 30, 2004 are classified as cash flow hedges with their fair value of approximately \$3.8 million reported in accumulated other comprehensive income on our balance sheet. The estimated fair value of these interest rate swap agreements are dependent on changes in market interest rates and other market factors that affect the value of such agreements. Consequently, the estimated current fair value may significantly change during the term of the agreements. Any estimated gain or loss from these agreements will be amortized into earnings as we recognize the interest expense for the underlying floating-rate loans at the fixed interest rate provided under our agreements in the case of the fixed-to-floating swaps or as part of interest expense for future borrowings in the case of the forward starting swaps. If the underlying debt related to these swaps were to be repaid prior to maturity, we would recognize into interest expense any unamortized gain or loss at the time of such early repayment.

Under SFAS 133, our \$100 million in fixed-to-floating hedges are classified as fair value hedges with their fair value of approximately \$1.3 million reported in both the unsecured senior notes and accounts payable and accrued

expenses line items on our balance sheet. The estimated fair value of these interest rate hedge agreements are dependent on changes in market interest rates and other market factors that affect the value of such agreements. Consequently, the estimated current fair value may significantly change during the term of the agreements. Any estimated gain or loss from these agreements will be amortized into earnings as we recognize the interest expense for the underlying fixed-rate loan at the floating interest rate provided under our agreements in the case of the floating-to-fixed hedges. If the underlying debt related to these hedges were to be repaid prior to maturity, we would recognize into interest expense any unamortized gain or loss at the time of such early repayment.

## **7. Stockholders Equity and Minority Interests**

A common Operating Partnership unit, or common OP Unit, and a share of our common stock have essentially the same economic characteristics as they share equally in the total net income or loss and distributions of the Operating Partnership. A common OP Unit may be redeemed for cash or, at the election of the Operating Partnership, for shares of our common stock on a one-for-one basis.

Our minority interest balance includes \$50 million of 8.625% Series B Cumulative Redeemable Preferred Operating Partnership Units, or Preferred OP Units. These Preferred OP Units were issued in September of 1999, are callable by us after September 2004 and are exchangeable after ten years by the holder into our 8.625% Series B Cumulative Redeemable Preferred Stock, on a one-for-one basis. The Preferred OP Units and Series B Cumulative Redeemable Preferred Stock have no stated maturity or mandatory redemption and are subordinate to all debt.

On June 14, 2004, we declared a quarterly dividend of \$0.505 per share to stockholders of record on June 30, 2004. For the three months ended June 30, 2003, we declared a quarterly dividend of \$0.505 per share.



**Table of Contents****8. Revenue from Rental Operations and Property Expenses**

Revenue from rental operations and property expenses for properties held for use are summarized as follows (in thousands):

|  | <b>Three Months Ended<br/>June 30,</b> |                   | <b>Six Months Ended<br/>June 30,</b> |                   |
|--|--|-------------------|--------------------------------------|-------------------|
|  | <b>2004</b>                            | <b>2003</b>       | <b>2004</b>                          | <b>2003</b>       |
| <b>Revenue from Rental Operations:</b> |  |                   |                                      |                   |
| Scheduled cash rents                   | \$ 90,962                              | \$ 88,776         | \$ 181,494                           | \$ 176,946        |
| Straight-line rents                    | 448                                    | 114               | 1,340                                | 493               |
| Tenant reimbursements                  | 4,850                                  | 5,138             | 9,603                                | 11,175            |
| Parking, net of expenses               | 6,121                                  | 5,525             | 11,821                               | 10,648            |
| Other rental operations                | 3,017                                  | 2,755             | 5,619                                | 4,022             |
|  | <u>          </u>                      | <u>          </u> | <u>          </u>                    | <u>          </u> |
|  | \$ 105,398                             | \$ 102,308        | \$ 209,877                           | \$ 203,284        |
|  | <u>          </u>                      | <u>          </u> | <u>          </u>                    | <u>          </u> |
| <b>Property Expenses:</b>              |  |                   |                                      |                   |
| Repairs and maintenance                | 11,529                                 | 10,671            | 22,870                               | 20,709            |
| Utilities                              | 8,083                                  | 7,934             | 15,650                               | 15,817            |
| Real estate taxes                      | 7,875                                  | 7,041             | 15,896                               | 14,317            |
| Insurance                              | 1,994                                  | 2,030             | 4,055                                | 4,104             |
| Ground rent                            | 207                                    | 322               | 332                                  | 364               |
| Administrative                         | 4,475                                  | 4,633             | 9,457                                | 8,663             |
|  | <u>          </u>                      | <u>          </u> | <u>          </u>                    | <u>          </u> |
|  | 34,163                                 | 32,631            | 68,260                               | 63,974            |
|  | <u>          </u>                      | <u>          </u> | <u>          </u>                    | <u>          </u> |
|  | \$ 71,235                              | \$ 69,677         | \$ 141,617                           | \$ 139,310        |
|  | <u>          </u>                      | <u>          </u> | <u>          </u>                    | <u>          </u> |

**9. Income (Loss) from Taxable REIT Subsidiary**

Beginning in the first quarter of 2004, we have reclassified for financial presentation purposes the operating results of Nextedge, our taxable REIT subsidiary, or TRS, from general and administrative expenses to interest and other income (loss) in our consolidated statements of income. Nextedge provides energy consulting services to commercial real estate owners. The following is a breakdown of the components of interest and other income (loss) for each of the periods presented (in thousands):

|                            | <b>Three Months<br/>Ended<br/>June 30,</b> |               | <b>Six Months<br/>Ended<br/>June 30,</b> |               |
|----------------------------|--|---------------|--|---------------|
|                            | <b>2004</b>                                | <b>2003</b>   | <b>2004</b>                              | <b>2003</b>   |
| Net income (loss) from TRS | \$ (517)                                   | \$ (229)      | \$ 121                                   | \$ (257)      |
| Interest and other income  | 82   | 378           | 210                                      | 510           |
|                            | <u>\$ (435)</u>                            | <u>\$ 149</u> | <u>\$ 331</u>                            | <u>\$ 253</u> |

## 10. Stock Option Plan

Beginning on January 1, 2003, we adopted the provisions of SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure under which we began expensing the costs of new stock options granted to employees in 2003 in accordance with SFAS No. 123, Accounting for Stock-Based Compensation. We used the Black-Scholes option valuation model to estimate the fair value of the stock options granted. During the three months ended June 30, 2004 and June 30, 2003, we expensed approximately \$8,000 of stock option based employee compensation costs.

The following table reflects pro forma net income and earnings per share had we elected to expense all options granted prior to 2003 assuming the fair value method and using the Black-Scholes option valuation model (in thousands, except per share amounts):

|  | <b>Three Months Ended<br/>June 30,</b> |                  | <b>Six Months Ended<br/>June 30,</b> |                  |
|--|--|------------------|--------------------------------------|------------------|
|  | <b>2004</b>                            | <b>2003</b>      | <b>2004</b>                          | <b>2003</b>      |
| Net income available to common stockholders, as reported   | \$ 9,127                               | \$ 18,903        | \$ 27,988                            | \$ 34,341        |
| Stock based employee compensation costs for options granted prior to 2003 assuming fair value method | <u>(77)</u>                            | <u>(259)</u>     | <u>(154)</u>                         | <u>(523)</u>     |
| Net income available to common stockholders, as adjusted   | <u>\$ 9,050</u>                        | <u>\$ 18,644</u> | <u>\$ 27,834</u>                     | <u>\$ 33,818</u> |
| Earnings per share:  |  |                  |                                      |                  |
| Basic as reported  | <u>\$ 0.14</u>                         | <u>\$ 0.30</u>   | <u>\$ 0.43</u>                       | <u>\$ 0.54</u>   |
| Basic as adjusted  | <u>\$ 0.14</u>                         | <u>\$ 0.30</u>   | <u>\$ 0.43</u>                       | <u>\$ 0.54</u>   |

Edgar Filing: ARDEN REALTY INC - Form 10-Q

|                     |                   |                   |                   |                   |
|---------------------|-------------------|-------------------|-------------------|-------------------|
| Diluted as reported | \$ 0.14           | \$ 0.30           | \$ 0.43           | \$ 0.54           |
|                     | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Diluted as adjusted | \$ 0.14           | \$ 0.29           | \$ 0.42           | \$ 0.53           |
|                     | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

**Table of Contents****11. Comprehensive Income**

Comprehensive income represents net income, plus the results of certain non-shareholders' equity changes not reflected in the Consolidated Statements of Income. The components of comprehensive income are as follows (in thousands):

|   | <b>Three Months Ended<br/>June 30,</b> |                  | <b>Six Months Ended<br/>June 30,</b> |                  |
|---|--|------------------|--------------------------------------|------------------|
|   | <b>2004</b>                            | <b>2003</b>      | <b>2004</b>                          | <b>2003</b>      |
| Net income  | \$ 9,127                               | \$ 18,903        | \$ 27,988                            | \$ 34,341        |
| Other comprehensive income (loss):                    |  |                  |                                      |                  |
| Unrealized derivative gain (loss) on cash flow hedges | <u>12,451</u>                          | <u>(1,812)</u>   | <u>4,403</u>                         | <u>(2,909)</u>   |
| Comprehensive income                                  | <u>\$ 21,578</u>                       | <u>\$ 17,091</u> | <u>\$ 32,391</u>                     | <u>\$ 31,432</u> |

**12. Commitments and Contingencies**

We are presently subject to various lawsuits, claims and proceedings arising in the ordinary course of business, none of which if determined unfavorably to us is expected to have a material adverse effect on our cash flows, financial condition or results of operations. There were no material changes in our legal proceedings during the three months ended June 30, 2004.

**Table of Contents**

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

**Overview**

*The following discussion relates to our unaudited consolidated financial statements included herein, which should be read in conjunction with the financial statements and related notes thereto included elsewhere in this Form 10-Q and in our 2003 Annual Report on Form 10-K.*

This form 10-Q, including the documents incorporated herein by reference, contains forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act pertaining to, among other things, our future results of operations, cash available for distribution, acquisitions, lease renewals, property development, property renovation, capital requirements and general business, industry and economic conditions applicable to us. Also, documents we subsequently file with the SEC and incorporated herein by reference will contain forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements as a result of the risk factors set forth below and the matters set forth or incorporated in this form 10-Q generally. We caution you, however, that this list of factors may not be exhaustive, particularly with respect to future filings.

We are a self-administered and self-managed real estate investment trust that owns, manages, leases, develops, renovates and acquires commercial properties located in Southern California. We are managed by 7 senior executive officers who have experience in the real estate industry ranging from 13 to 34 years and who collectively have an average of 19 years experience. We perform all property and development management, accounting, finance and acquisition, disposition activities and a majority of our leasing transactions with our staff of approximately 300 employees.

As of June 30, 2004, we were Southern California's largest publicly traded office landlord as measured by total net rentable square feet owned. As of that date, our portfolio was comprised of 128 primarily suburban office properties, consisting of 210 buildings with approximately 18.8 million net rentable square feet. As of June 30, 2004 and December 31, 2003, our operating portfolio was 89.6% and 90.4% occupied, respectively.

**Business Strategy**

Our primary business strategy is to actively manage our portfolio to seek to achieve gains in rental rates and occupancy, control operating expenses and maximize income from ancillary operations and services. When market conditions permit, we may also renovate existing or new properties or selectively develop or acquire new properties that add value and fit strategically into our portfolio. We may also sell existing properties and place the proceeds into investments we believe will generate higher long-term value.

We continue to seek to build a tenant base of smaller, diverse companies that limits our exposure to any single tenant or industry. Smaller tenants typically translate into shorter-term leases. Shorter-term leases provide greater opportunity for renewing a substantial portion of our portfolio at higher rental rates each year during strong markets, but create challenges to maintain occupancy and rates when markets weaken. The average term of our leases is 4 to 5 years, resulting in approximately 15% to 20% of our leases expiring annually.

We closely monitor our operating expenses and capital expenditures to sustain or improve operating margins and dividend coverage. We may defer discretionary operating expenses and capital expenditures until market conditions improve.

**Impact of Economic Climate**

Our short and long-term liquidity, ability to refinance existing indebtedness, ability to issue long-term debt and equity securities at favorable rates and our dividend policy are significantly impacted by the operating results of our properties, all of which are located in Southern California. Our ability to lease available space and increase rates when leases expire is largely dependent on the demand for office space in the markets where our properties are located.

The timing and extent of future changes in the national and local economy and their effects on our properties and results of operations are difficult to accurately predict. It is likely, however, that if national and regional economic conditions deteriorate they would directly affect our operating results in the future, making it more difficult for us to lease and renew available space, to increase or maintain rental rates as leases expire and to collect amounts due from our tenants. For additional information, see Risk Factors Further declines in the economic activity of Southern California will adversely affect our operating results, The financial condition and solvency of our tenants may reduce our cash flow, and Rising energy costs and power outages in California may have an adverse effect on our operations and revenue, in our 2003 Annual Report on Form 10-K.

### **Critical Accounting Policies**

Refer to our 2003 Annual Report on Form 10-K for a discussion of our critical accounting policies, which include, among other things, revenue recognition, allowance for doubtful accounts and depreciation. There have been no material changes to these policies in 2004.

### **Off-Balance Sheet Arrangements**

As of June 30, 2004, there are no off-balance sheet transactions, arrangements or obligations (including contingent obligations) that have, or are reasonably likely to have a current or future material effect on our financial condition, changes in our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

**Table of Contents****RESULTS OF OPERATIONS**

Our financial position and operating results primarily relate to our portfolio of commercial properties and income derived from those properties. Therefore, the comparability of financial data from period to period will be affected by the timing of property developments, acquisitions and dispositions.

*Comparison of the three months ended June 30, 2004 to the three months ended June 30, 2003 (in thousands, except number of properties and percentages):*

|   | <b>Three Months Ended<br/>June 30,</b> |             | <b>Change</b> | <b>Percent<br/>Change</b> |
|---|--|-------------|---------------|---------------------------|
|   | <b>2004</b>                            | <b>2003</b> |               |                           |
| <b>Total Portfolio:</b>   |  |             |               |                           |
| <b>Revenue from rental operations:</b>  |  |             |               |                           |
| Scheduled cash rents  | \$ 90,962                              | \$ 88,776   | \$ 2,186      | 3%                        |
| Straight-line rents   | 448                                    | 114         | 334           | 293                       |
| Tenant reimbursements   | 4,850                                  | 5,138       | (288)         | (6)                       |
| Parking, net of expense   | 6,121                                  | 5,525       | 596           | 11                        |
| Other rental operations   | 3,017                                  | 2,755       | 262           | 10                        |
|   | <hr/>                                  | <hr/>       | <hr/>         | <hr/>                     |
| Total revenue from rental operations  | 105,398                                | 102,308     | 3,090         | 3                         |
|   | <hr/>                                  | <hr/>       | <hr/>         | <hr/>                     |
| <b>Property expenses:</b>   |  |             |               |                           |
| Repairs and maintenance   | 11,529                                 | 10,671      | 858           | 8                         |
| Utilities   | 8,083                                  | 7,934       | 149           | 2                         |
| Real estate taxes   | 7,875                                  | 7,041       | 834           | 12                        |
| Insurance   | 1,994                                  | 2,030       | (36)          | (2)                       |
| Ground rent   | 207                                    | 322         | (115)         | (36)                      |
| Administrative  | 4,475                                  | 4,633       | (158)         | (3)                       |
|   | <hr/>                                  | <hr/>       | <hr/>         | <hr/>                     |
| Total property expenses   | 34,163                                 | 32,631      | 1,532         | 5                         |
|   | <hr/>                                  | <hr/>       | <hr/>         | <hr/>                     |
| <b>Property Operating Results <sup>(1)</sup></b>                                    |  |             |               |                           |
| General and administrative  | 71,235                                 | 69,677      | 1,558         | 2                         |
| Interest expense  | 4,665                                  | 3,981       | 684           | 17                        |
| Depreciation and amortization   | 21,184                                 | 23,254      | (2,070)       | (9)                       |
| Interest and other loss (income)  | 31,936                                 | 29,487      | 2,449         | 8                         |
|   | 435                                    | (149)       | 584           | 392                       |
|   | <hr/>                                  | <hr/>       | <hr/>         | <hr/>                     |
| Income from continuing operations before impairment on investment in securities and | \$ 13,015                              | \$ 13,104   | \$ (89)       | (1)%                      |

minority interest

|   |          |          |           |        |
|---|----------|----------|-----------|--------|
|   | _____    | _____    | _____     | _____  |
| Discontinued operations, net of minority interest | \$ (281) | \$ 1,177 | \$(1,458) | (124)% |
|   | _____    | _____    | _____     | _____  |

**Number of Properties:**

Disposed of during period (5)

Completed and placed in service during period 1

In service at end of period 128 130

**Net Rentable Square Feet:**

Disposed of during period (376)

Completed and placed in service during period 283

In service at end of period 18,785 18,617

**Same Property Portfolio<sup>(2)</sup>:**

Revenue from rental operations \$103,167 \$102,189 \$ 978 1%

Property expenses 33,296 32,426 870 3

|  |           |           |        |       |
|--|-----------|-----------|--------|-------|
|  | _____     | _____     | _____  | _____ |
|  | \$ 69,871 | \$ 69,763 | \$ 108 | %     |
|  | _____     | _____     | _____  | _____ |

Straight-line rents \$ 65 \$ 118 \$ (53) (45)%

Number of non-development properties 126

Number of buildings 207

Average occupancy 89.1% 88.9%

Net rentable square feet 18,299

- (1) Property Operating Results is commonly used by investors to evaluate the performance of REITs, to determine trends in earnings and to compute the fair value of properties as it is not affected by (1) the cost of funds of the property owner or (2) the impact of depreciation and amortization expenses as well as gains or losses from the sale of operating real estate assets that are included in net income computed in accordance with Generally Accepted Accounting Principles, or GAAP. The first factor is commonly eliminated from net income because it is specific to the particular financing capabilities and constraints of the owner. The second factor is commonly eliminated because it may not accurately represent the actual change in value in real estate



**Table of Contents**

properties that results from use or changes in market conditions. We believe that eliminating these costs from net income gives investors an additional measure of operating performance that, when used as an adjunct to net income computed in accordance with GAAP, can be a useful measure of our operating results.

Property Operating Results captures trends in occupancy rates, rental rates and operating costs. However, Property Operating Results excludes general and administrative costs, interest expense, interest income, depreciation and amortization expense and gains or losses from the sale of properties, changes in value in our real estate properties that result from use or permanent impairment to carrying costs as stipulated by GAAP, the level of capital expenditures and leasing costs necessary to maintain the operating performance of our properties, all of which are significant economic costs. Therefore, Property Operating Results may fail to capture significant trends which limits its usefulness.

Property Operating Results is a non-GAAP measure of performance. Property Operating Results is not a substitute for net income as computed in accordance with GAAP. It excludes significant expense components such as depreciation and amortization expense and financing costs. This measure should be analyzed in conjunction with net income and cash flow from operating activities as computed in accordance with GAAP. Other companies may use different methods for calculating Property Operating Results or similarly entitled measures and, accordingly, our Property Operating Results may not be comparable to similarly entitled measures reported by other companies that do not define the measure exactly as we do.

The following is a reconciliation of net income computed in accordance with GAAP to Property Operating Results (in thousands):

|   | <b>Three Months Ended June<br/>30,</b> |                  |
|---|--|------------------|
|   | <b>2004</b>                            | <b>2003</b>      |
| Net income  | \$ 9,127                               | \$ 18,903        |
| Add:  |  |                  |
| General and administrative expense                | 4,665                                  | 3,981            |
| Interest expense                                  | 21,184                                 | 23,254           |
| Depreciation and amortization                     | 31,936                                 | 29,487           |
| Minority interest                                 | 1,307                                  | 1,399            |
| Interest and other loss                           | 435                                    |                  |
| Discontinued operations, net of minority interest | 281                                    |                  |
| Impairment on investment in securities            | 2,700                                  |                  |
| Less:   |  |                  |
| Interest and other income                         |  | (149)            |
| Gain on sale of discontinued properties           | (400)                                  | (6,021)          |
| Discontinued operations, net of minority interest |  | (1,177)          |
| Property Operating Results                        | <u>\$ 71,235</u>                       | <u>\$ 69,677</u> |

(2) Consists of non-development properties classified as part of continuing operations and owned for the entirety of

the periods presented.

## **VARIANCES FOR RESULTS OF OPERATIONS**

Our Property Operating Results for the three months ended June 30, 2004 compared to the same period in 2003 were primarily affected by our acquisitions, dispositions and development activities since January 1, 2003.

As a result of these changes within our portfolio of properties since January 1, 2003, we do not believe the Property Operating Results presented above are comparable from period to period. Therefore, in the table above, we have also presented the Property Operating Results for our same store portfolio.

### **Revenue from Rental Operations**

The increase in revenue from rental operations for the total portfolio was primarily due to the approximate 101,000 square foot acquisition we made in December 2003 consisting of an office property in San Diego County and revenues from our 6100 Center Drive development property in Los Angeles County which was placed in service during the second quarter of 2004 and from scheduled rent increases in our existing leases.

The increase in revenue from rental operations for the same property portfolio was primarily due to an approximate \$600,000 increase in cash rents, an approximate \$450,000 increase in parking income and an approximate \$350,000 increase in other rental operations, all of which were partially offset by an approximate \$400,000 decrease in tenant reimbursements. The increase in cash rents was primarily related to scheduled rent increases in existing leases and by the 0.2% increase in average occupancy for these properties. The increase in parking income is primarily due to higher average occupancy in 2004 and special event parking in 2004 in some of our buildings. The increase in other rental operations was primarily related to higher lease termination fees and higher after-hour utility recoveries in 2004. The decrease in tenant reimbursements was primarily due to higher prior year reimbursement reconciliation billings in 2003.

### **Property Expenses**

The increase in property expenses for the total portfolio was partially due to the property acquired in December 2003 and the placement in service of our 6100 Center Drive property in the second quarter of 2004.

The increase in property expenses for the same property portfolio was primarily due to an approximate \$600,000 increase in repairs and maintenance and an approximate \$600,000 increase in real estate taxes, all of which were partially offset by an approximate \$200,000 decrease in property administrative expense and an approximate \$100,000 decrease in ground rent expense. Repairs and maintenance increased primarily due to higher costs for contracted services and the timing of certain projects. Real estate taxes increased

**Table of Contents**

primarily due to refunds received on final reassessments in 2003 for certain properties. Property administrative expenses primarily decreased due to start-up costs associated with employee training programs implemented in 2003 and lower legal expenses relating to unlawful detainers and tenant rent disputes in 2004. Ground rent expense decreased primarily due to higher contingent ground rent recorded in 2003 relating to one of our properties.

**General and Administrative**

General and administrative expenses as a percentage of total revenues were approximately 4.4% for the three months ended June 30, 2004 compared to approximately 3.8% for the same period in 2003. The approximate \$700,000 increase in general and administrative expenses was primarily related to higher personnel costs associated with annual merit increases and non-cash compensation expense associated with restricted stock grants issued in 2004 and 2003 as well as higher corporate governance costs in 2004.

**Interest Expense**

Interest expense decreased approximately \$2.1 million, or 9%, for the three months ended June 30, 2004 compared to the same period in 2003. This decrease was primarily due to the paydown in the second quarter of 2004 of a \$175 million, 7.52% mortgage financing loan with disposition proceeds and funds from our unsecured line of credit and the fixed to floating swaps entered into on our unsecured senior notes in 2003, all of which were partially offset by lower capitalized interest in 2004. Capitalized interest was lower in 2004 as we stopped capitalizing interest on our 6100 Center Drive property in May 2003.

**Depreciation and Amortization**

Depreciation and amortization expense increased by approximately \$2.4 million, or 8%, for the three months ended June 30, 2004 compared to the same period in 2003, primarily due to depreciation related to a property acquired in December 2003 and depreciation related to capital expenditures, tenant improvements and leasing commissions placed in service subsequent to the first quarter of 2003.

**Interest and Other Income (Loss)**

Beginning January 1, 2004, we reclassified the operating results of Nextedge, our taxable REIT subsidiary, or TRS, that provides energy consulting services to commercial real estate owners from general and administrative expenses into the interest and other income (loss) line item to more clearly present our general and administrative costs as well as the operating results of Nextedge. We also reclassified the operating results of our TRS in the second quarter of 2003 to conform to the 2004 presentation.

Interest and other income (loss) decreased by approximately \$600,000 for the three months ended June 30, 2004 compared to the same period in 2003, primarily due to operating losses from Nextedge.

**Table of Contents**

*Comparison of the six months ended June 30, 2004 to the six months ended June 30, 2003  
(in thousands, except number of properties and percentages):*

|   | <b>Six Months Ended<br/>June 30,</b> |             | <b>Change</b> | <b>Percent<br/>Change</b> |
|---|--------------------------------------|-------------|---------------|---------------------------|
|   | <b>2004</b>                          | <b>2003</b> |               |                           |
| <b>Total Portfolio:</b>   |                                      |             |               |                           |
| <b>Revenue from rental operations:</b>  |                                      |             |               |                           |
| Scheduled cash rents  | \$181,494                            | \$176,946   | \$ 4,548      | 3%                        |
| Straight-line rents   | 1,340                                | 493         | 847           | 172                       |
| Tenant reimbursements   | 9,603                                | 11,175      | (1,572)       | (14)                      |
| Parking, net of expense   | 11,821                               | 10,648      | 1,173         | 11                        |
| Other rental operations   | 5,619                                | 4,022       | 1,597         | 40                        |
|   | <hr/>                                | <hr/>       | <hr/>         | <hr/>                     |
| Total revenue from rental operations  | 209,877                              | 203,284     | 6,593         | 3                         |
|   | <hr/>                                | <hr/>       | <hr/>         | <hr/>                     |
| <b>Property expenses:</b>   |                                      |             |               |                           |
| Repairs and maintenance   | 22,870                               | 20,709      | 2,161         | 10                        |
| Utilities   | 15,650                               | 15,817      | (167)         | (1)                       |
| Real estate taxes   | 15,896                               | 14,317      | 1,579         | 11                        |
| Insurance   | 4,055                                | 4,104       | (49)          | (1)                       |
| Ground rent   | 332                                  | 364         | (32)          | (9)                       |
| Administrative  | 9,457                                | 8,663       | 794           | 9                         |
|   | <hr/>                                | <hr/>       | <hr/>         | <hr/>                     |
| Total property expenses   | 68,260                               | 63,974      | 4,286         | 7                         |
|   | <hr/>                                | <hr/>       | <hr/>         | <hr/>                     |
| <b>Property Operating Results <sup>(1)</sup></b>  | 141,617                              | 139,310     | 2,307         | 2                         |
| General and administrative  | 9,149                                | 7,571       | 1,578         | 21                        |
| Interest expense  | 44,497                               | 46,289      | (1,792)       | (4)                       |
| Depreciation and amortization   | 62,212                               | 57,895      | 4,317         | 7                         |
| Interest and other income   | (331)                                | (253)       | (78)          | 31                        |
|   | <hr/>                                | <hr/>       | <hr/>         | <hr/>                     |
| Income from continuing operations before<br>impairment on investment in securities and<br>minority interest | \$ 26,090                            | \$ 27,808   | \$(1,718)     | (6)%                      |
|   | <hr/>                                | <hr/>       | <hr/>         | <hr/>                     |
| Discontinued operations, net of minority interest   | \$ 458                               | \$ 3,988    | \$(3,530)     | (89)%                     |
|   | <hr/>                                | <hr/>       | <hr/>         | <hr/>                     |

**Number of Properties:**

|   |     |     |
|---|-----|-----|
| Disposed of during period                     | (2) | (6) |
| Completed and placed in service during period | 1   |     |
| In service at end of period                   | 128 | 130 |

**Net Rentable Square Feet:**

|   |        |        |
|---|--------|--------|
| Disposed of during period                     | (295)  | (515)  |
| Completed and placed in service during period | 283    |        |
| In service at end of period                   | 18,785 | 18,617 |

**Same Property Portfolio<sup>(2)</sup>:**

|                                |                   |                   |                   |                   |
|--------------------------------|-------------------|-------------------|-------------------|-------------------|
| Revenue from rental operations | \$205,230         | \$202,836         | \$ 2,394          | 1%                |
| Property expenses              | 66,525            | 63,587            | 2,938             | 5                 |
|                                | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
|                                | \$138,705         | \$139,249         | \$ (544)          | %                 |
|                                | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Straight-line rents            | \$ 447            | \$ 477            | \$ (30)           | (6)%              |
|                                | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

|                                      |        |       |
|--------------------------------------|--------|-------|
| Number of non-development properties | 126    |       |
| Number of buildings                  | 207    |       |
| Average occupancy                    | 89.6%  | 89.2% |
| Net rentable square feet             | 18,299 |       |

- (1) Property Operating Results is commonly used by investors to evaluate the performance of REITs, to determine trends in earnings and to compute the fair value of properties as it is not affected by (1) the cost of funds of the property owner or (2) the impact of depreciation and amortization expenses as well as gains or losses from the sale of operating real estate assets that are included in net income computed in accordance with Generally Accepted Accounting Principles, or GAAP. The first factor is commonly eliminated from net income because it is specific to the particular financing capabilities and constraints of the owner. The second factor is commonly eliminated because it may not accurately represent the actual change in value in real estate properties that results from use or changes in market conditions. We believe that eliminating these costs from net income gives investors an additional measure of operating performance that, when used as an adjunct to net income computed in accordance with GAAP, can be a useful measure of our operating results.

Property Operating Results captures trends in occupancy rates, rental rates and operating costs. However, Property Operating Results excludes

**Table of Contents**

general and administrative costs, interest expense, interest income, depreciation and amortization expense and gains or losses from the sale of properties, changes in value in our real estate properties that result from use or permanent impairment to carrying costs as stipulated by GAAP, the level of capital expenditures and leasing costs necessary to maintain the operating performance of our properties, all of which are significant economic costs. Therefore, Property Operating Results may fail to capture significant trends which limits its usefulness.

Property Operating Results is a non-GAAP measure of performance. Property Operating Results is not a substitute for net income as computed in accordance with GAAP. It excludes significant expense components such as depreciation and amortization expense and financing costs. This measure should be analyzed in conjunction with net income and cash flow from operating activities as computed in accordance with GAAP. Other companies may use different methods for calculating Property Operating Results or similarly entitled measures and, accordingly, our Property Operating Results may not be comparable to similarly entitled measures reported by other companies that do not define the measure exactly as we do.

The following is a reconciliation of net income computed in accordance with GAAP to Property Operating Results (in thousands):

|   | <b>Six Months Ended June 30,</b> |                   |
|---|----------------------------------|-------------------|
|   | <b>2004</b>                      | <b>2003</b>       |
| Net income  | \$ 27,988                        | \$ 34,341         |
| Add:  |                                  |                   |
| General and administrative expense                | 9,149                            | 7,571             |
| Interest expense                                  | 44,497                           | 46,289            |
| Depreciation and amortization                     | 62,212                           | 57,895            |
| Minority interest                                 | 2,689                            | 2,837             |
| Impairment on investment in securities            | 2,700                            |                   |
| Less:   |                                  |                   |
| Interest and other income                         | (331)                            | (253)             |
| Gain on sale of discontinued properties           | (6,829)                          | (5,382)           |
| Discontinued operations, net of minority interest | (458)                            | (3,988)           |
| Property Operating Results                        | <u>\$ 141,617</u>                | <u>\$ 139,310</u> |

(2) Consists of non-development properties classified as part of continuing operations and owned for the entirety of the periods presented.

**VARIANCES FOR RESULTS OF OPERATIONS**

Our Property Operating Results for the six months ended June 30, 2004 compared to the same period in 2003 were primarily affected by our acquisitions, dispositions and development activities since January 1, 2003.

As a result of these changes within our portfolio of properties since January 1, 2003, we do not believe the Property Operating Results presented above are comparable from period to period. Therefore, in the table above, we have also presented the Property Operating Results for our same property portfolio.

## **Revenue from Rental Operations**

The increase in revenue from rental operations for the total portfolio was primarily due to the approximate 101,000 square foot acquisition we made in December 2003 of an office property in San Diego County and revenues from our 6100 Center Drive development property which was placed in service during the second quarter of 2004 and from scheduled rent increases in our existing leases that were partially offset by the decline in average occupancy.

The increase in revenue from rental operations for the same property portfolio was primarily due to an approximate \$2.0 million increase in other rental operations, a \$1.1 million increase in cash rents and an approximate \$900,000 increase in parking income, all of which were partially offset by an approximate \$1.7 million decrease in tenant reimbursements. The increase in other rental operations was primarily related to higher lease termination fees in 2004 and lower reserves for tenant receivables. The increase in parking income is primarily due to higher average occupancy in 2004 and special event parking in 2004 in some of our buildings. The increase in cash rents was primarily related to scheduled rent increases in existing leases and by the 0.4% increase in average occupancy for these properties. The decrease in tenant reimbursements was primarily due to higher prior year reimbursement reconciliation billings in 2003.

## **Property Expenses**

The increase in property expenses for the total portfolio was partially due to the property acquired in December 2003 and placing our 6100 Center Drive property in service in the second quarter of 2004.

The increase in property expenses for the same property portfolio was primarily due to an approximate \$1.8 million increase in repairs and maintenance, and an approximate \$1.1 million increase in real estate taxes and an approximate \$650,000 increase in property administrative expenses, all of which were partially offset by an approximate \$500,000 decrease in utility expenses. Repairs and maintenance increased primarily due to higher costs for contracted services and the timing of certain projects. Real estate taxes increased primarily due to the timing of final reassessments and property tax refunds received in 2003 for certain properties. Property administrative expenses increased due to higher personnel costs from annual merit increases and other non-recurring separation costs, partially offset by start-up costs associated with employee training programs implemented in 2003 and lower legal expenses relating to unlawful detainers and tenant rent disputes in 2004. Utility expenses decreased primarily due to lower usage in the first quarter of 2004 due primarily to the temporary decline in average occupancy in the first quarter of 2004.

## **Table of Contents**

### **General and Administrative**

General and administrative expenses as a percentage of total revenues were approximately 4.3% for the six months ended June 30, 2004 compared to approximately 3.6% for the same period in 2003. The approximate \$1.6 million increase in general and administrative expenses was primarily related to higher personnel costs associated with annual merit increases and non-cash compensation expense associated with restricted stock grants issued in 2004 and 2003 and higher corporate governance costs in 2004.

### **Interest Expense**

Interest expense decreased approximately \$1.8 million, or 4%, for the six months ended June 30, 2004 compared to the same period in 2003. This decrease was primarily due to the paydown in the second quarter of 2004 of a \$175 million, 7.52% mortgage financing loan with proceeds from our first quarter 2004 dispositions and funds from our unsecured line of credit in 2004 and the fixed to floating swaps entered into on our unsecured senior notes in 2003, all of which were partially offset by lower capitalized interest in 2004. Capitalized interest was lower in 2004 as we stopped capitalizing interest on our 6100 Center Drive property in May 2003.

### **Depreciation and Amortization**

Depreciation and amortization expense increased by approximately \$4.3 million, or 7%, for the six months ended June 30, 2004 compared to the same period in 2003, primarily due to depreciation related to a property acquired in December 2003 and depreciation related to capital expenditures, tenant improvements and leasing commissions placed in service subsequent to the second quarter of 2003.

## **LIQUIDITY AND CAPITAL RESOURCES**

### **Cash Flows**

Cash provided by operating activities decreased by approximately \$6.1 million to \$82.5 million for the six months ended June 30, 2004 compared to \$88.6 million for the same period in 2003. This decrease was primarily due to the loss of operating cash flows from ten properties sold since the beginning of 2003 as part of our capital recycling program, partially offset by the increased cash flows from a property acquired in the fourth quarter of 2003 and our 6100 Center Drive development property, which was placed in service during the second quarter of 2004.

Cash provided by investing activities decreased by approximately \$17.1 million to \$20.9 million for the six months ended June 30, 2004 compared to \$38.0 million for the same period in 2003. This decrease was primarily due to fewer asset sales and lower disposition proceeds in 2004.

Cash used in financing activities decreased by approximately \$16.9 million to \$98.2 million for the six months ended June 30, 2004 compared to \$115.1 million for the same period in 2003. This change was primarily due to higher proceeds from issuances of common stock in 2004.

### **Available Borrowings, Cash Balance and Capital Resources**

Our Operating Partnership has an unsecured line of credit with a total commitment of \$20 million from City National Bank. This line of credit accrues interest at LIBOR + 1.00% or the City National Bank Prime Rate less 0.875% and is scheduled to mature in August 2004. Proceeds from this line of credit are used, among other things, to provide funds for tenant improvements and capital expenditures and provide for working capital and other corporate purposes. As of June 30, 2004, there was \$10 million outstanding on this line of credit and \$10 million was available



for additional borrowings.

Our Operating Partnership also has an unsecured line of credit with a group of banks led by Wells Fargo. In June 2004, this line of credit was amended to reduce the interest rates by approximately 10 to 15 basis points depending on our secured debt rating and revise certain covenants. As a result of this amendment, this line of credit provides for borrowings up to \$310 million with an option to increase the amount to \$350 million and bears interest at a rate ranging between LIBOR + 0.65% and LIBOR + 1.15% (including an annual facility fee ranging from 0.15% to 0.40% based on the aggregate amount of the line of credit) depending on the Operating Partnership's unsecured debt rating. This line of credit matures in April 2006. In addition, as long as the Operating Partnership maintains an unsecured debt rating of BBB-/Baa3 or better, the agreement contains a competitive bid option, whereby the lenders may bid on the interest rate to be charged for up to \$150 million of the unsecured line of credit. The Operating Partnership also has the option to convert the interest rate on this line of credit to the higher of Wells Fargo's prime rate or the Federal Funds rate plus 0.5%. As of June 30, 2004, \$272 million was outstanding on this line of credit and \$38 million was available for additional borrowings.

As of June 30, 2004, we had approximately \$23.6 million in cash and cash equivalents, including \$13.7 million in restricted cash. Restricted cash consisted of \$9.7 million in interest bearing cash deposits required by four of our mortgage loans payable and \$4.0 million in cash impound accounts for real estate taxes and insurance as required by several of our mortgage loans payable.

We entered into \$150 million of forward-starting swaps during 2003 to effectively fix the 10-year Treasury rate at an average rate of approximately 4.1% for borrowings that are anticipated to occur in 2004 to refinance some of our scheduled debt maturities. The forward-starting interest rate swaps were entered into at current market rates and, therefore, had no initial cost.

In October and November of 2003, we also entered into reverse interest rate swap agreements to float \$100 million of the fixed interest rate associated with the 7.00% senior unsecured notes due in November of 2007. Under these reverse swaps, we will receive interest at a fixed rate of 7.00% and pay interest at a variable rate averaging six-month LIBOR in arrears plus 3.10%. These interest rate

**Table of Contents**

swaps mature at the same time the notes are due.

In June 2004, we amended our \$125 million unsecured term loan with Wells Fargo to reduce its effective interest rate by 20 basis points. This loan was scheduled to increase from LIBOR + 1.25% to LIBOR + 1.45% in June 2004. In 2002, we entered into interest rate swap agreements that fixed the interest rate on the entire balance of this loan. As a result of the amendment and taking into effect the interest rate swap agreements for this loan, it will have an effective interest rate of approximately 4.14% for the remainder of 2004, 4.55% in 2005 and 4.70% in 2006.

We expect to continue meeting our short-term liquidity and capital requirements generally through net cash provided by operating activities and proceeds from our unsecured lines of credit. We believe the foregoing sources of liquidity will be sufficient to fund our short-term liquidity needs over the next twelve months, including recurring non-revenue enhancing capital expenditures, tenant improvements and leasing commissions.

We expect to meet our long-term liquidity and capital requirements such as scheduled principal repayments, development costs, property acquisitions, if any, and other non-recurring capital expenditures through net cash provided by operations, refinancing of existing indebtedness and the issuance of long-term debt and equity securities.

**Capital Recycling Program**

No properties were disposed of during the three months ended June 30, 2004.

**Debt Summary**

Following is a summary of scheduled principal payments for our total debt outstanding as of June 30, 2004 (in thousands):

| <u>Year</u> | <u>Amount</u>          |
|-------------|------------------------|
| 2004        | \$ 13,461              |
| 2005        | 207,470                |
| 2006        | 411,859 <sup>(1)</sup> |
| 2007        | 157,166                |
| 2008        | 230,985                |
| 2009        | 112,550                |
| 2010        | 150,565                |
| 2011        | 710                    |
| 2012        | 768                    |
| 2013        | 845                    |
| Thereafter  | 4,602                  |
|             | <hr/>                  |
| Total       | \$ 1,290,981           |
|             | <hr/>                  |

(1) Includes \$272 million outstanding on our Wells Fargo unsecured line of credit.



**Table of Contents**

Following is certain other information related to our outstanding indebtedness as of June 30, 2004:

**Unsecured and Secured Debt:**

|                   | <b>Balance</b>     | <b>Percent</b> | <b>Weighted<br/>Average<br/>Interest<br/>Rate <sup>(1)</sup></b> | <b>Weighted<br/>Average<br/>Maturity<br/>(in<br/>years)</b> |
|-------------------|--------------------|----------------|--|---|
|                   | <b>(000 s)</b>     |                |  |   |
| Unsecured Debt    | \$ 904,349         | 70%            | 6.09%  | 2.5   |
| Secured Debt      | 386,632            | 30             | 7.15   | 4.4   |
| <b>Total Debt</b> | <b>\$1,290,981</b> | <b>100%</b>    | <b>6.40%</b>   | <b>3.1</b>  |

**Floating and Fixed Rate Debt:**

|                                   | <b>Balance</b>     | <b>Percent</b> | <b>Weighted<br/>Average<br/>Interest<br/>Rate <sup>(1)</sup></b> | <b>Weighted<br/>Average<br/>Maturity<br/>(in years)</b> |
|-----------------------------------|--------------------|----------------|--|---|
|                                   | <b>(000 s)</b>     |                |  |   |
| Floating Rate Debt <sup>(2)</sup> | \$ 332,000         | 26%            | 3.72%  | 2.2   |
| Fixed Debt <sup>(3)</sup>         | 958,981            | 74             | 7.33   | 3.4   |
| <b>Total Debt</b>                 | <b>\$1,290,981</b> | <b>100%</b>    | <b>6.40%</b>   | <b>3.1</b>  |

(1) Includes amortization of prepaid financing costs.

(2) Includes \$100 million of fixed rate debt that has been converted to floating rate through interest rate swap agreements.

(3) Includes \$175 million of floating rate debt that has been fixed through interest rate swap agreements. Total interest incurred and the amount capitalized was as follows (in thousands):

|                         | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended June<br/>30,</b> |             |
|-------------------------|--|-------------|--------------------------------------|-------------|
|                         | <b>2004</b>                            | <b>2003</b> | <b>2004</b>                          | <b>2003</b> |
| Total interest incurred | \$21,382                               | \$24,169    | \$44,851                             | \$48,439    |
| Amount capitalized      | (198)                                  | (915)       | (354)                                | (2,150)     |
| Amount expensed         | \$21,184                               | \$23,254    | \$44,497                             | \$46,289    |

### ***Consolidated Income Available for Debt Service and Compliance with Principal Financial Covenants***

Consolidated Income Available for Debt Service is a non-GAAP measurement of our performance and liquidity. Consolidated Income Available for Debt Service is presented below because this data is used by investors and our management as a supplemental measure to (a) evaluate our operating performance and compare it to other real estate companies, (b) determine trends in earnings, (c) determine our ability to service debt and (d) determine our ability to fund future capital expenditure requirements. As discussed more fully below, Consolidated Income Available for Debt Service is also used in several financial covenants we are required to satisfy each quarter under the terms of our principal debt agreements.

Consolidated Income Available for Debt Service permits investors and management to view income from our operations on an unleveraged basis before the effects of non-cash depreciation and amortization expense. By excluding interest expense, Consolidated Income Available for Debt Service measures our operating performance independent of our capital structure and indebtedness and, therefore, allows for a more meaningful comparison of our operating performance between quarters as well as annual periods and to compare our operating performance to that of other companies, and to more readily identify and evaluate trends in earnings.

The usefulness of Consolidated Income Available for Debt Service is limited because it does not reflect interest expense, taxes, gains or losses on sales of property, losses on valuations of derivatives, asset impairment losses, cumulative effect of a change in accounting principle, extraordinary items as defined by GAAP and depreciation and amortization costs. These costs have been or may in the future be incurred by us, each of which affects or could effect our operating performance and ability to finance our investments at competitive borrowing costs, successfully maintain our REIT status, and acquire and dispose of real estate properties at favorable prices to us. Some of these costs also reflect changes in value in our properties that result from use or changes in market conditions and the level of capital expenditures and leasing costs necessary to maintain the operating performance of our properties. Due to the significance of the net income components excluded from Consolidated Income Available for Debt Service, this measure should not be considered an alternative to (and should be considered in conjunction with) net income, cash flow from operations, and other performance or liquidity measures prescribed by GAAP. This measure should also be analyzed in conjunction with discussions elsewhere in Management's Discussion and Analysis of Financial Condition and Results of Operations regarding the items eliminated in the calculation of Consolidated Income Available for Debt Service.

**Table of Contents**

The reader is cautioned that Consolidated Income Available for Debt Service, as calculated by us, may not be comparable to similar measures reported by other companies (under names such as or similar to Consolidated Income Available for Debt Service, EBITDA or adjusted EBITDA) that do not define this measure exactly the same as we do.

The following is a reconciliation of net cash provided by operating activities and net income computed in accordance with GAAP to Consolidated Income Available for Debt Service (in thousands):

|  | Three Months Ended<br>June 30, |                   | Six Months Ended<br>June 30, |                   |
|--|--------------------------------|-------------------|------------------------------|-------------------|
|  | 2004                           | 2003              | 2004                         | 2003              |
| Net cash provided by operating activities          | \$38,693                       | \$39,217          | \$ 82,535                    | \$ 88,647         |
| Add:   |                                |                   |                              |                   |
| Interest expense                                   | 21,184                         | 23,254            | 44,497                       | 46,289            |
| Less:  |                                |                   |                              |                   |
| Amortization of loan costs and fees                | (1,004)                        | (978)             | (2,083)                      | (1,924)           |
| Amortization of deferred compensation              | (785)                          | (448)             | (1,531)                      | (837)             |
| Changes in operating assets and liabilities:       |                                |                   |                              |                   |
| Rent and other receivables                         | (223)                          | (1,555)           | 1,834                        | (913)             |
| Deferred rent                                      | 345                            | (207)             | 1,982                        | (89)              |
| Prepaid financing costs, expenses and other assets | 1,672                          | 2,168             | 2,205                        | 3,662             |
| Accounts payable and accrued expenses              | 6,630                          | 6,962             | 4,989                        | 3,682             |
| Security deposits                                  | (605)                          | (640)             | (876)                        | (512)             |
|  | <u>          </u>              | <u>          </u> | <u>          </u>            | <u>          </u> |
| Consolidated Income Available for Debt Service     | <u>\$65,907</u>                | <u>\$67,773</u>   | <u>\$133,552</u>             | <u>\$138,005</u>  |

|  | Three Months Ended<br>June 30, |                   | Six Months Ended<br>June 30, |                   |
|--|--------------------------------|-------------------|------------------------------|-------------------|
|  | 2004                           | 2003              | 2004                         | 2003              |
| Net Income                                     | \$ 9,127                       | \$18,903          | \$ 27,988                    | \$ 34,341         |
| Add:   |                                |                   |                              |                   |
| Interest expense                               | 21,184                         | 23,254            | 44,497                       | 46,289            |
| Depreciation and amortization                  | 31,936                         | 29,487            | 62,212                       | 57,895            |
| Minority interest                              | 1,307                          | 1,399             | 2,689                        | 2,837             |
| Minority interest from discontinued operations | 2                              | 190               | 188                          | 250               |
| Depreciation from discontinued operations      | 51                             | 561               | 107                          | 1,775             |
| Impairment on investment in securities         | 2,700                          |                   | 2,700                        |                   |
| Less:  |                                |                   |                              |                   |
| Gain on sale of discontinued properties        | (400)                          | (6,021)           | (6,829)                      | (5,382)           |
|  | <u>          </u>              | <u>          </u> | <u>          </u>            | <u>          </u> |

|  |                   |                   |                   |                   |
|--|-------------------|-------------------|-------------------|-------------------|
| Consolidated Income Available for Debt Service | \$65,907          | \$67,773          | \$133,552         | \$138,005         |
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

Consolidated Income Available for Debt Service is also presented because it is used in ratios contained in the principal financial covenants of the Indenture governing our publicly traded senior unsecured notes and our Credit Agreement with a syndicate of banks led by Wells Fargo. As of June 30, 2004, our senior unsecured notes represented approximately 39% of our total outstanding debt and amounts outstanding under our Wells Fargo unsecured line of credit represented approximately 21% of our total outstanding debt. The Consolidated Income Available for Debt Service ratios and the other ratios reported below are part of financial covenants we are required to satisfy each fiscal quarter. We believe information about these ratios is useful to (1) confirm that we are in compliance with the financial covenants of our principal loan agreements, (2) evaluate our ability to service our debt, (3) evaluate our ability to fund future capital expenditures, and (4) compare our ratios to other real estate companies, including other REITs, that present the same ratios.

If we were to fail to satisfy these financial covenants, we would be in default under the terms of the Indenture for the senior unsecured notes and/or the Wells Fargo Credit Agreement. A default under those agreements could accelerate the obligation to repay such debt and could cause us to be in default under our other debt agreements. Depending on the circumstances surrounding such acceleration, we might not be able to repay the debt on terms that are favorable to us, or at all, which could have a material adverse affect on our financial condition and our ability to raise capital in the future.

**Table of Contents**

The reader is cautioned that these ratios, as calculated by us, may not be comparable to similarly entitled ratios reported by other companies that do not calculate these ratios exactly the same as we do. These ratios should not be considered as alternatives to the ratio of earnings to fixed charges.

The following table summarizes the principal ratios contained in the financial covenants of our senior unsecured notes and Wells Fargo unsecured line of credit as of June 30, 2004 (in thousands, except percentage and covenant ratio data):

|   |             |
|---|-------------|
| Net investment in real estate                                 | \$2,572,480 |
| Cash and cash equivalents                                     | 9,924       |
| Restricted cash   | 13,655      |
| Accumulated depreciation and amortization                     | 483,022     |
|   | <hr/>       |
| Total Gross Assets  | \$3,079,081 |
|   | <hr/>       |
| Gross Value of Unencumbered Assets                            | \$2,107,737 |
|   | <hr/>       |
| Mortgage loans payable <sup>(1)</sup>                         | \$ 386,632  |
| Unsecured lines of credit                                     | 282,000     |
| Unsecured term loan   | 125,000     |
| Unsecured senior notes, net of discount                       | 497,349     |
|   | <hr/>       |
| Total Outstanding Debt  | \$1,290,981 |
|   | <hr/>       |
| Consolidated Income Available for Debt Service <sup>(2)</sup> | \$ 268,084  |
|   | <hr/>       |
| Interest incurred <sup>(2)</sup>                              | \$ 92,675   |
| Loan fee amortization <sup>(2)</sup>                          | (3,747)     |
|   | <hr/>       |
| Debt Service <sup>(2)</sup>                                   | \$ 88,928   |
|   | <hr/>       |

| <b>Covenant Ratios</b>   | <b>Test</b>       | <b>Actual</b> |
|--|-------------------|---------------|
| Ratio of Consolidated Income Available for Debt Service to Debt Service                    | Greater than 1.5  | 3.0           |
| Ratio of Consolidated Income Available for Debt Service to interest expense <sup>(3)</sup> | Greater than 2.0  | 3.2           |
| Ratio of Consolidated Income Available for Debt Service to fixed charges <sup>(4)</sup>    | Greater than 1.75 | 2.3           |
| Total Outstanding Debt/Total Gross Assets  | Less than 60%     | 42%           |



|   |                      |      |
|---|----------------------|------|
| Secured Debt/Total Gross Assets                   | Less than 40%        | 13%  |
| Gross Value of Unencumbered Assets/Unsecured Debt | Greater than<br>150% | 233% |

- 
- (1) Represents 9 secured loans that are secured by 53 properties in our portfolio.
  - (2) Represents amounts for the most recent four consecutive quarters. Loan fee amortization excludes discount amortization on senior unsecured notes.
  - (3) Interest expense consists of interest expense plus capitalized interest and less amortization of loan fees and discounts.
  - (4) Fixed charges consist of interest costs, whether expensed or capitalized, principal payments on all debt, an amount equal to \$0.3125 per quarter multiplied by the weighted average gross leaseable square feet of the portfolio at the end of the period and preferred unit distributions.

**Table of Contents****Funds from Operations**

The following table reflects the calculation of our funds from operations for the three and six months ended June 30, 2004 and 2003 (in thousands):

|  | <b>Three Months Ended<br/>June 30,</b> |                   | <b>Six Months Ended June<br/>30,</b> |                   |
|--|--|-------------------|--------------------------------------|-------------------|
|  | <b>2004</b>                            | <b>2003</b>       | <b>2004</b>                          | <b>2003</b>       |
| <b>Funds From Operations:<sup>(1)</sup></b>  |  |                   |                                      |                   |
| Net income   | \$ 9,127                               | \$ 18,903         | \$27,988                             | \$34,341          |
| Depreciation and minority interest from discontinued operations                    | 53                                     | 751               | 295                                  | 2,025             |
| Gain on sale of discontinued properties  | (400)                                  | (6,021)           | (6,829)                              | (5,382)           |
| Depreciation and amortization  | 31,936                                 | 29,487            | 62,212                               | 57,895            |
| Minority interest  | 1,307                                  | 1,399             | 2,689                                | 2,837             |
| Distribution on Preferred Operating Partnership Units                              | (1,078)                                | (1,078)           | (2,156)                              | (2,156)           |
|  | <u>          </u>                      | <u>          </u> | <u>          </u>                    | <u>          </u> |
| Funds From Operations <sup>(2)</sup> .   | \$40,945                               | \$43,441          | \$84,199                             | \$89,560          |
|  | <u>          </u>                      | <u>          </u> | <u>          </u>                    | <u>          </u> |
| Weighted average common shares and Operating Partnership units outstanding Diluted | 67,430                                 | 65,132            | 67,173                               | 64,976            |
|  | <u>          </u>                      | <u>          </u> | <u>          </u>                    | <u>          </u> |

- (1) We believe that funds from operations, or FFO, is a useful supplemental measure of our operating performance. We compute FFO in accordance with standards established by the White Paper on FFO approved by the Board of Governors of the National Association of Real Estate Investment Trusts, or NAREIT, in April 2002. The White Paper defines FFO as net income or loss computed in accordance with generally accepted accounting principles, or GAAP, excluding extraordinary items, as defined by GAAP, and gains and losses from sales of depreciable operating property plus real estate-related depreciation and amortization and after adjustments for unconsolidated partnerships and joint ventures.

We believe that FFO, by excluding depreciation costs, the gains or losses from the sale of operating real estate properties and the extraordinary items as defined by GAAP, provides an additional perspective on our operating results. However, because these excluded items have a real economic effect, FFO is a limited measure of performance.

FFO captures trends in occupancy rates, rental rates and operating costs. FFO excludes depreciation and amortization costs and it does not capture the changes in value in our properties that result from use or changes in market conditions or the level of capital expenditures and leasing costs necessary to maintain the operating performance of our properties, all of which are significant economic costs. Therefore, its ability to measure

performance is limited.

Because FFO excludes significant economic components of net income determined in accordance with GAAP, FFO should be used as an adjunct to net income and not as an alternative to net income. FFO should also not be used as an indicator of our financial performance, or as a substitute for cash flow from operating activities determined in accordance with GAAP or as a measure of our liquidity. FFO is not by itself indicative of funds available to fund our cash needs, including our ability to pay dividends or service our debt.

FFO is used by investors to compare our performance with other REITs. Other REITs may use different methods for calculating FFO and, accordingly, our FFO may not be comparable to other REITs.

- (2) Includes \$785,000 and \$448,000 in non-cash compensation expense for the three months ended June 30, 2004 and 2003, respectively, and approximately \$1.5 million and \$837,000 in non-cash compensation expense for the six months ended June 30, 2004 and 2003, respectively.

Table of Contents**Portfolio and Lease Information**

The following tables set forth certain information regarding our properties as of June 30, 2004.

**PORTFOLIO SUMMARY**

As of June 30, 2004

| Location                           | Number of Properties                   |             | Number of Buildings |             | Approximate Net Rentable (Sq. Ft.) |             | Property Operating Results <sup>(1)</sup>                     |             |   |             |
|------------------------------------|--|-------------|---------------------|-------------|------------------------------------|-------------|---|-------------|---|-------------|
|                                    | Total                                  | % of Total  | Total               | % of Total  | Total                              | % of Total  | Three Months Ended June 30, 2004 (in thousands and unaudited) | % of Total  | Six Months Ended June 30, 2004 (in thousands and unaudited) | % of Total  |
|                                    | Los Angeles County West <sup>(2)</sup> | 30          | 23%                 | 32          | 15%                                | 5,051,880   | 27%   | \$26,313    | 37%   | \$ 53,164   |
| North                              | 27                                     | 21%         | 43                  | 21%         | 3,172,622                          | 17%         | 10,929  | 15%         | 21,260  | 15%         |
| South                              | 16                                     | 13%         | 21                  | 10%         | 3,085,689                          | 16%         | 9,911   | 14%         | 19,415  | 14%         |
| <b>Subtotal</b>                    | <b>73</b>                              | <b>57%</b>  | <b>96</b>           | <b>46%</b>  | <b>11,310,191</b>                  | <b>60%</b>  | <b>47,153</b>   | <b>66%</b>  | <b>93,839</b>   | <b>66%</b>  |
| Orange County                      | 23                                     | 18%         | 55                  | 26%         | 3,609,394                          | 19%         | 11,190  | 16%         | 22,866  | 16%         |
| San Diego County                   | 26                                     | 20%         | 41                  | 19%         | 2,971,482                          | 16%         | 10,400  | 14%         | 19,889  | 14%         |
| Ventura/Kern Counties              | 6                                      | 5%          | 17                  | 8%          | 794,574                            | 4%          | 2,510   | 4%          | 5,018   | 4%          |
| <b>Subtotal</b>                    | <b>128</b>                             | <b>100%</b> | <b>209</b>          | <b>99%</b>  | <b>18,685,641</b>                  | <b>99%</b>  | <b>\$71,253</b>   | <b>100%</b> | <b>\$141,612</b>  | <b>100%</b> |
| Renovation Building <sup>(3)</sup> |  |             | 1                   | 1%          | 99,119                             | 1%          | (18)  |             | 5   |             |
| <b>Total</b>                       | <b>128</b>                             | <b>100%</b> | <b>210</b>          | <b>100%</b> | <b>18,784,760</b>                  | <b>100%</b> | <b>\$71,235</b>   | <b>100%</b> | <b>\$141,617</b>  | <b>100%</b> |

(1) Excludes the operating results of two properties sold during the first quarter of 2004 and one property currently classified as held for disposition. The operating results for these properties are reported as part of discontinued operations in our quarterly and year to date operating results.

(2) Includes a retail property with approximately 37,000 net rentable square feet.

(3) Comprised of one building in a business park containing a total of four buildings. After completion of the renovation, the total square footage of this building will expand to 130,000 square feet.

**PORTFOLIO OCCUPANCY AND IN-PLACE RENTS**

As of June 30, 2004

| <b>Location</b>                  | <b>Percent<br/>Occupied</b> | <b>Percent<br/>Leased</b> | <b>Annualized Base Rent<br/>Per Leased Square<br/>Foot<sup>(1)</sup></b> |  |
|----------------------------------|-----------------------------|---------------------------|--|--|
|                                  |                             |                           | <b>Portfolio<br/>Total</b>   | <b>Full Service<br/>Gross<br/>Leases<sup>(2)</sup></b> |
| Los Angeles County               |                             |                           |  |  |
| West                             | 91.8%                       | 94.3%                     | \$27.89  | \$ 27.90   |
| North                            | 90.1%                       | 91.3%                     | 21.94  | 22.75  |
| South                            | 86.4%                       | 88.7%                     | 19.04  | 20.10  |
| <b>Subtotal/Weighted Average</b> | 89.8%                       | 91.9%                     | \$23.90  | \$ 24.62   |
| Orange County                    | 88.2%                       | 89.7%                     | 18.82  | 22.10  |
| San Diego County                 | 88.8%                       | 90.5%                     | 19.43  | 23.87  |
| Ventura/Kern Counties            | 95.7%                       | 96.5%                     | 18.84  | 19.40  |
| <b>Subtotal/Weighted Average</b> | 89.6%                       | 91.5%                     | \$22.01  | \$ 23.91   |
| Renovation Building              |                             | 100.0%                    | 17.40  |  |
| <b>Total/Weighted Average</b>    | 89.0%                       | 91.5%                     | \$21.97  | \$ 23.91   |

(1) Based on monthly contractual base rent under existing leases as of June 30, 2004, multiplied by 12 and divided by leased net rentable square feet; for those leases where rent has not yet commenced or which are in a free rent period, the first month in which rent is to be received is used to determine annualized base rent.

(2) Excludes 34 properties and approximately 3.7 million square feet under triple net and modified gross leases.

Table of Contents**TEN LARGEST TENANTS**

As of June 30, 2004

| Tenant   | Number<br>of<br>Locations | Lease<br>Term<br>in<br>Months | Percentage                                    | Percentage                   | Net Rentable<br>Square Feet | Annualized<br>Base Rent<br>(in<br>thousands) |
|--|---------------------------|-------------------------------|---|------------------------------|-----------------------------|--|
|  |                           |                               | Weighted<br>Average<br>Remaining<br>Portfolio | of<br>Aggregate<br>Portfolio |                             |  |
| State of California  | 22                        | 44                            | 2.22%   | 2.16%                        | 379,686                     | \$ 8,115                                     |
| Vivendi Universal  | 2                         | 70                            | 1.36%   | 2.12%                        | 231,681                     | 7,980  |
| University of Phoenix                                      | 6                         | 48                            | 0.97%   | 0.99%                        | 166,195                     | 3,719  |
| Ceridian Corporation                                       | 2                         | 70                            | 0.89%   | 0.96%                        | 152,071                     | 3,619  |
| Atlantic Richfield   | 1                         | 27                            | 0.84%   | 0.92%                        | 143,885                     | 3,453  |
| Pepperdine University<br>Haight, Brown &<br>Bonesteel, LLP | 1                         | 173                           | 0.66%   | 0.84%                        | 113,488                     | 3,173  |
| Westfield Corporation                                      | 2                         | 83                            | 0.37%   | 0.73%                        | 63,262                      | 2,737  |
| State Compensation<br>Insurance Fund                       | 1                         | 106                           | 0.57%   | 0.72%                        | 96,876                      | 2,714  |
| Walt Disney Pictures and<br>Television                     | 1                         | 45                            | 0.67%   | 0.71%                        | 113,513                     | 2,656  |
|  | 1                         | 49                            | 0.67%   | 0.69%                        | 114,922                     | 2,588  |
| <b>Total/Weighted<br/>Average<sup>(2)</sup></b>            | <b>39</b>                 | <b>64</b>                     | <b>9.22%</b>                                  | <b>10.84%</b>                | <b>1,575,579</b>            | <b>\$ 40,754</b>                             |

(1) Annualized base rent is calculated as monthly contractual base rent under existing leases as of June 30, 2004 multiplied by 12; for those leases where rent has not yet commenced or which are in a free rent period, the first month in which rent is to be received is used to determine annualized base rent.

(2) The weighted average calculation is based on net rentable square footage leased by each tenant.

Table of Contents**LEASING ACTIVITY**

|  | <b>Three Months<br/>Ended<br/>June 30, 2004</b> | <b>Six Months<br/>Ended<br/>June 30, 2004</b> |
|--|---|---|
| Net Absorption (square feet)                       | 262,247   | (7,948)                                       |
| Gross New Leasing Activity (square feet)           | 422,126   | 1,019,356                                     |
| Gross Renewal Leasing Activity (square feet)       | 600,948   | 1,458,393                                     |
| Retention Rate                                     | 65.7%   | 59.1%   |
| Cash Rent Growth <sup>(1)</sup> :<br>Expiring Rate | \$ 22.81  | \$ 22.97                                      |
| New / Renewed Rate                                 | \$ 21.03  | \$ 20.77                                      |
| Decrease   | (8)%  | (10)%   |
| GAAP Rent Growth <sup>(2)</sup> :<br>Expiring Rate | \$ 21.98  | \$ 22.14                                      |
| New / Renewed Rate                                 | \$ 22.36  | \$ 22.28                                      |
| Increase   | 2%  | 1%  |
| Weighted Average Lease Term in Months    New       | 52  | 55  |
| Weighted Average Lease Term in Months    Renewal   | 42  | 41  |

|  |                   |                   |
|--|-------------------|-------------------|
| Tenant Improvements and Commissions (per square foot): |                   |                   |
| New <sup>(3)</sup>                                     | \$ 21.83          | \$ 20.97          |
|  | <u>          </u> | <u>          </u> |
| Renewal  | \$ 10.39          | \$ 8.91           |
|  | <u>          </u> | <u>          </u> |
| Capital Expenditures (per square foot):                |                   |                   |
| Recurring  | \$ 0.06           | \$ 0.13           |
|  | <u>          </u> | <u>          </u> |
| Non-recurring  | \$ 0.01           | \$ 0.04           |
|  | <u>          </u> | <u>          </u> |

- 
- (1) Represents the difference between initial market rents on new and renewed leases as compared to the expiring cash rents on the same space.
- (2) Represents cash rent growth adjusted for straight-line rents.
- (3) Excludes development/renovation space.



Table of Contents**PORTFOLIO DIVERSIFICATION**

As of June 30, 2004

| <b>North American Industrial Classification System Description</b>       | <b>NAICS Code</b> | <b>Occupied Square Feet</b> | <b>Percentage of Total Occupied Portfolio</b> |
|--|-------------------|-----------------------------|---|
| Professional, Scientific, and Technical Services                         | 541               | 4,355,879                   | 26.01%  |
| Finance and Insurance  | 521-525           | 2,841,077                   | 16.97%  |
| Information  | 511-519           | 1,720,032                   | 10.27%  |
| Manufacturing  | 311-339           | 1,341,723                   | 8.01%   |
| Health Care and Social Assistance  | 621-624           | 1,168,085                   | 6.97%   |
| Administrative and Support and Waste Management and Remediation Services | 561-562           | 751,234                     | 4.49%   |
| Public Administration  | 921-928           | 736,069                     | 4.40%   |
| Educational Services   | 611               | 748,680                     | 4.47%   |
| Real Estate, Rental and Leasing  | 531-533           | 710,730                     | 4.24%   |
| Wholesale Trade  | 423-425           | 553,723                     | 3.31%   |
| Transportation and Warehousing   | 481-493           | 394,249                     | 2.35%   |
| Arts, Entertainment, and Recreation                                      | 711-713           | 313,778                     | 1.87%   |
| Construction   | 236-238           | 287,980                     | 1.72%   |
| Other Services (except Public Administration)                            | 811-814           | 287,851                     | 1.72%   |
| Accommodation and Food Services  | 721-722           | 171,792                     | 1.03%   |
| Retail Trade   | 441-454           | 121,673                     | 0.73%   |
| Mining   | 211-213           | 58,392                      | 0.35%   |
| Management of Companies and Enterprises                                  | 551               | 28,305                      | 0.17%   |
| Utilities  | 221               | 8,975                       | 0.05%   |
| Agriculture, Forestry, Fishing and Hunting                               | 111-115           | 6,261                       | 0.04%   |
| Other Uncategorized  |                   | 138,911                     | 0.83%   |
|  |                   | <b>16,745,399</b>           | <b>100.00%</b>                                |

**Table of Contents****LEASE EXPIRATIONS ANNUAL**

As of June 30, 2004

|                            |                               | <b>2004</b>      | <b>2005</b>      | <b>2006</b>      | <b>2007</b>      | <b>2008</b>      | <b>2009 and<br/>Thereafter</b> |
|----------------------------|-------------------------------|------------------|------------------|------------------|------------------|------------------|--------------------------------|
| <b>Los Angeles County:</b> |                               |                  |                  |                  |                  |                  |                                |
| West                       | Expiring SF <sup>(1)</sup>    | 287,598          | 633,370          | 542,349          | 615,436          | 523,235          | 2,126,458                      |
|                            | % of Leased SF <sup>(2)</sup> | 1.68%            | 3.71%            | 3.18%            | 3.60%            | 3.06%            | 12.45%                         |
|                            | Rent per SF <sup>(3)</sup>    | \$ 29.04         | \$ 28.11         | \$ 28.65         | \$ 29.06         | \$ 30.14         | \$ 33.11                       |
| North                      | Expiring SF <sup>(1)</sup>    | 308,349          | 458,499          | 453,394          | 477,906          | 603,566          | 567,628                        |
|                            | % of Leased SF <sup>(2)</sup> | 1.81%            | 2.68%            | 2.65%            | 2.80%            | 3.53%            | 3.32%                          |
|                            | Rent per SF <sup>(3)</sup>    | \$ 20.28         | \$ 23.13         | \$ 24.17         | \$ 22.63         | \$ 24.58         | \$ 22.47                       |
| South                      | Expiring SF <sup>(1)</sup>    | 144,879          | 817,796          | 321,260          | 287,809          | 410,700          | 729,830                        |
|                            | % of Leased SF <sup>(2)</sup> | 0.85%            | 4.78%            | 1.88%            | 1.68%            | 2.41%            | 4.27%                          |
|                            | Rent per SF <sup>(3)</sup>    | \$ 19.65         | \$ 16.05         | \$ 22.46         | \$ 22.30         | \$ 21.77         | \$ 22.18                       |
| <b>Subtotal</b>            |                               |                  |                  |                  |                  |                  |                                |
| <b>Los Angeles County</b>  | Expiring SF <sup>(1)</sup>    | 740,826          | 1,909,665        | 1,317,003        | 1,381,151        | 1,537,501        | 3,423,916                      |
|                            | % of Leased SF <sup>(2)</sup> | 4.34%            | 11.17%           | 7.71%            | 8.08%            | 9.00%            | 20.04%                         |
|                            | Rent per SF <sup>(3)</sup>    | \$ 23.56         | \$ 21.75         | \$ 25.60         | \$ 25.43         | \$ 25.72         | \$ 29.01                       |
| <b>Orange County</b>       | Expiring SF <sup>(1)</sup>    | 373,705          | 588,433          | 639,736          | 586,620          | 313,507          | 691,357                        |
|                            | % of Leased SF <sup>(2)</sup> | 2.19%            | 3.45%            | 3.74%            | 3.43%            | 1.83%            | 4.04%                          |
|                            | Rent per SF <sup>(3)</sup>    | \$ 15.94         | \$ 20.65         | \$ 21.15         | \$ 18.55         | \$ 20.45         | \$ 22.05                       |
| <b>San Diego County</b>    | Expiring SF <sup>(1)</sup>    | 210,439          | 606,897          | 437,134          | 240,913          | 264,630          | 878,309                        |
|                            | % of Leased SF <sup>(2)</sup> | 1.23%            | 3.55%            | 2.56%            | 1.41%            | 1.55%            | 5.14%                          |
|                            | Rent per SF <sup>(3)</sup>    | \$ 19.13         | \$ 18.67         | \$ 23.40         | \$ 23.00         | \$ 25.19         | \$ 23.41                       |
| <b>All Others</b>          | Expiring SF <sup>(1)</sup>    | 84,397           | 182,744          | 181,951          | 54,365           | 75,143           | 186,593                        |
|                            | % of Leased SF <sup>(2)</sup> | 0.49%            | 1.07%            | 1.06%            | 0.32%            | 0.44%            | 1.09%                          |
|                            | Rent per SF <sup>(3)</sup>    | \$ 18.46         | \$ 20.11         | \$ 20.58         | \$ 19.89         | \$ 21.45         | \$ 18.58                       |
| <b>Total Portfolio</b>     | Expiring SF <sup>(1)</sup>    | <b>1,409,367</b> | <b>3,287,739</b> | <b>2,575,824</b> | <b>2,263,049</b> | <b>2,190,781</b> | <b>5,180,175</b>               |
|                            | % of Leased SF <sup>(2)</sup> | <b>8.25%</b>     | <b>19.24%</b>    | <b>15.07%</b>    | <b>13.24%</b>    | <b>12.82%</b>    | <b>30.31%</b>                  |

Edgar Filing: ARDEN REALTY INC - Form 10-Q

|                            |    |       |    |       |    |       |    |       |    |       |    |       |
|----------------------------|----|-------|----|-------|----|-------|----|-------|----|-------|----|-------|
| Rent per SF <sup>(3)</sup> | \$ | 20.57 | \$ | 20.89 | \$ | 23.76 | \$ | 23.25 | \$ | 24.76 | \$ | 26.76 |
|----------------------------|----|-------|----|-------|----|-------|----|-------|----|-------|----|-------|

- (1) Represents the rentable square footage of expiring leases. For 2004, represents expirations from April 1, 2004 through December 31, 2004, not including month-to-month tenants.
- (2) Percentage of total rentable square footage expiring during the period.
- (3) Represents annualized ending cash rents of expiring leases.

**LEASE EXPIRATIONS NEXT FOUR QUARTERS**

As of June 30, 2004

|                                    |                               | <b>Q3-04</b> | <b>Q4-04</b> | <b>Q1-05</b> | <b>Q2-05</b> |
|------------------------------------|-------------------------------|--------------|--------------|--------------|--------------|
| <b>Los Angeles County:</b>         |                               |              |              |              |              |
| West                               | Expiring SF <sup>(1)</sup>    | 130,839      | 156,759      | 119,284      | 142,443      |
|                                    | % of Leased SF <sup>(2)</sup> | 0.76%        | 0.92%        | 0.70%        | 0.83%        |
|                                    | Rent per SF <sup>(3)</sup>    | \$ 27.99     | \$ 29.92     | \$ 28.69     | \$ 27.25     |
| North                              | Expiring SF <sup>(1)</sup>    | 107,254      | 201,095      | 65,714       | 98,343       |
|                                    | % of Leased SF <sup>(2)</sup> | 0.63%        | 1.18%        | 0.39%        | 0.58%        |
|                                    | Rent per SF <sup>(3)</sup>    | \$ 23.08     | \$ 18.79     | \$ 23.25     | \$ 23.83     |
| South                              | Expiring SF <sup>(1)</sup>    | 84,680       | 60,199       | 118,512      | 218,750      |
|                                    | % of Leased SF <sup>(2)</sup> | 0.50%        | 0.35%        | 0.69%        | 1.28%        |
|                                    | Rent per SF <sup>(3)</sup>    | \$ 18.50     | \$ 21.27     | \$ 17.98     | \$ 18.56     |
| <b>Subtotal Los Angeles County</b> | Expiring SF <sup>(1)</sup>    | 322,773      | 418,053      | 303,510      | 459,536      |
|                                    | % of Leased SF <sup>(2)</sup> | 1.89%        | 2.45%        | 1.78%        | 2.69%        |
|                                    | Rent per SF <sup>(3)</sup>    | \$ 23.87     | \$ 23.32     | \$ 23.33     | \$ 22.38     |
| <b>Orange County</b>               | Expiring SF <sup>(1)</sup>    | 144,120      | 229,585      | 146,666      | 167,088      |
|                                    | % of Leased SF <sup>(2)</sup> | 0.85%        | 1.34%        | 0.85%        | 0.98%        |
|                                    | Rent per SF <sup>(3)</sup>    | \$ 19.30     | \$ 13.83     | \$ 19.03     | \$ 18.85     |
| <b>San Diego County</b>            | Expiring SF <sup>(1)</sup>    | 109,577      | 100,862      | 145,269      | 99,783       |
|                                    | % of Leased SF <sup>(2)</sup> | 0.64%        | 0.59%        | 0.85%        | 0.58%        |
|                                    | Rent per SF <sup>(3)</sup>    | \$ 23.99     | \$ 13.85     | \$ 21.93     | \$ 20.83     |
| <b>All Others</b>                  | Expiring SF <sup>(1)</sup>    | 16,419       | 67,978       | 44,137       | 21,347       |
|                                    | % of Leased SF <sup>(2)</sup> | 0.09%        | 0.40%        | 0.26%        | 0.13%        |
|                                    | Rent per SF <sup>(3)</sup>    | \$ 19.89     | \$ 18.11     | \$ 19.67     | \$ 18.20     |
| <b>Total Portfolio</b>             | Expiring SF <sup>(1)</sup>    | 592,889      | 816,478      | 639,582      | 747,754      |
|                                    | % of Leased SF <sup>(2)</sup> | 3.47%        | 4.78%        | 3.74%        | 4.38%        |

Edgar Filing: ARDEN REALTY INC - Form 10-Q

|                            |                   |                   |                   |                   |
|----------------------------|-------------------|-------------------|-------------------|-------------------|
|                            | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Rent per SF <sup>(3)</sup> | \$ 22.67          | \$ 19.05          | \$ 21.78          | \$ 21.27          |
|                            | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

---

(1) Represents the square footage of expiring leases, not including month-to-month tenants.

(2) Percentage of total rentable square footage expiring during the period.

(3) Represents annualized ending cash rents of expiring leases.

Table of Contents**RENOVATION SUMMARY**

As of June 30, 2004

| <b>Building</b>          | <b>Square Feet</b> | <b>Costs Incurred</b>         |                                  | <b>Estimated Percent Leased at 8/3/04</b> | <b>Estimated Construction Date</b> | <b>Estimated Property Operating Results (in thousands)</b> | <b>Estimated Year 1 Annual Cash Yield</b> | <b>Estimated Year 1 Annual GAAP Yield</b> |
|--------------------------|--------------------|-------------------------------|----------------------------------|---|------------------------------------|--|---|---|
|                          |                    | <b>To Date (in thousands)</b> | <b>Total Cost (in thousands)</b> |   |                                    |  |   |   |
| 22745 Savi Ranch Parkway | 130,000            | \$ 191                        | \$ 9,244                         | 100%                                      | 4th Qtr 2004                       | \$ 1,881   | 10.0%                                     | 11.7%                                     |

(1) Estimated Year 1 Annual GAAP Yield includes an adjustment for straight-line rents.

In addition, we have preliminary architectural designs completed for additional build-to-suit projects at the Howard Hughes Center totaling approximately 475,000 net rentable square feet of office space. We also have construction entitlements at the Howard Hughes Center for up to 600 hotel rooms. Build-to-suit projects consist of properties constructed to the tenant's specifications in return for the tenant's long-term commitment to the property. We do not intend to commence construction on any additional build-to-suit or multi-tenant projects at the Howard Hughes Center until development plans and budgets are finalized with terms allowing us to achieve yields commensurate with the project's development risk.

In addition to our development at the Howard Hughes Center, we have completed preliminary designs and are marketing an approximate 170,000 square foot build-to-suit office building at our Long Beach Airport Business Park. Also, as part of our Gateway Towers acquisition in August 2002, we acquired a 5-acre developable land parcel in Torrance, California that we intend to market for a build-to-suit office building. We currently do not intend to commence construction on these projects until build-to-suit tenant leases are signed with terms allowing us to achieve yields commensurate with the project's development risk.

We expect to finance our development activities over the next 24 months through net cash provided by operating activities, proceeds from asset sales, proceeds from our unsecured lines of credit or other secured borrowings.

**Item 3. Quantitative and Qualitative Disclosure about Market Risk**

Market risk is the exposure or loss resulting from changes in interest rates, foreign currency exchange rates, commodity prices and equity prices. The primary market risk to which we are exposed is interest rate risk, which is sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors that are beyond our control.

*Interest Rate Risk*

In order to modify and manage the interest characteristics of our outstanding debt and limit the effects of interest rates on our operations, we use a variety of financial instruments, including interest rate swaps, caps, floors and other interest rate exchange contracts. The use of these types of instruments to hedge our exposure to changes in interest rates carries additional risks such as counter-party credit risk. We do not enter into any transactions for speculative or trading purposes. During 2002, we entered into interest rate swap agreements fixing the interest rates on variable debt with notional amounts totaling \$175.0 million. During 2003, we entered into \$150 million of forward-starting swap agreements fixing the 10-year Treasury rate for borrowings that are anticipated to occur in 2004 to refinance some of our scheduled debt maturities. In October and November of 2003, we also entered into reverse interest rate swap agreements to float \$100 million of the fixed interest rate associated with the 7.00% senior unsecured notes due in November 2007.

Some of our future earnings, cash flows and fair values relating to financial instruments are dependent upon prevailing market rates of interest, such as LIBOR. Based on interest rates and outstanding balances as of June 30, 2004, a 1% increase in interest rates on our \$332.0 million of floating rate debt would decrease annual future earnings and cash flows by approximately \$3.3 million and would not have an impact on the fair value of the floating rate debt. Conversely, a 1% decrease in interest rates on our \$332.0 million of floating rate debt would increase annual future earnings and cash flows by approximately \$3.3 million and would not have an impact on the fair value of the floating rate debt. The weighted average interest rate on our floating debt as of June 30, 2004 was 3.72%.

Our fixed rate debt totaled \$959.0 million as of June 30, 2004 with a weighted average interest rate of 7.33% and a total fair value of approximately \$998.4 million. A 1% decrease in interest rates would increase the fair value of our fixed rate debt by approximately \$29.7 million and would not have an impact on future earnings and cash flows. A 1% increase in interest rates would decrease the fair value of our fixed rate debt by approximately \$27.9 million and would not have an impact on future earnings and cash flows.

These amounts are determined by considering the impact of hypothetical interest rates on our borrowing cost. These analyses do not consider the effects of the reduced level of overall economic activity that could exist in that environment. Further, in the event of a change of this magnitude, we would consider taking actions to further mitigate our exposure to the change. Due to the uncertainty of the specific actions that would be taken and their possible effects, however, this sensitivity analysis assumes no changes in our capital structure.

**Table of Contents**

**Item 4. Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, our management was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Our disclosure controls and procedures are designed to provide a reasonable level of assurance of reaching our desired disclosure control objectives. Also, we have an investment in an unconsolidated entity. Because we do not control or manage this entity, our disclosure controls and procedures with respect to such entity is necessarily substantially more limited than those we maintain with respect to our consolidated subsidiaries.

As required by SEC Rule 13a-15(b), we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the second quarter of 2004 covered by this report. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective and were operating at the reasonable assurance level.

There has been no change in our internal controls over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

**Table of Contents****Part II OTHER INFORMATION****Item 1. Legal Proceedings**

We are presently subject to various lawsuits, claims and proceedings arising in the ordinary course of business, none of which if determined unfavorably to us is expected to have a material adverse effect on our cash flows, financial condition or results of operations. There were no material changes in our legal proceedings during the three months ended June 30, 2004.

**Item 2. Changes in Securities None****Item 3. Defaults Upon Senior Securities None****Item 4. Submission of Matters to a Vote of Security Holders**

On May 11, 2004 we held our annual meeting of stockholders in Santa Monica, California. The matters voted on at that meeting and the results were as follows:

- To elect directors of Arden Realty, Inc. to hold office until the annual meeting of stockholders in the year 2007 or until their respective successors are elected and qualified as follows:

|             |                    | <b>Number of Shares<br/>Voted For</b> | <b>Number of<br/>Shares<br/>Withheld</b> |
|-------------|--------------------|---------------------------------------|--|
| Director #1 | Leslie E. Bider    | 60,434,659                            | 732,698                                  |
| Director #2 | Steven C. Good     | 58,674,953                            | 2,492,404                                |
| Director #3 | Alan I. Rothenberg | 60,432,285                            | 735,072                                  |

- To request the Compensation Committee of the Board of Directors to establish a policy to seek shareholder approval for future severance agreements with senior executives that provide benefits in an amount exceeding 2.99 times the sum of the executive's base salary plus bonus. Results of the vote were as follows:

| <b>Number of Shares</b> | <b>Number of Shares<br/>Voted</b> | <b>Number of<br/>Shares</b> |
|-------------------------|-----------------------------------|-----------------------------|
| <b>Voted For</b>        | <b>Against</b>                    | <b>Abstained</b>            |
| 43,743,970              | 13,183,845                        | 245,501                     |

**Item 5. Other Information None****Item 6. Exhibits and Reports on Form 8-K****(a) Exhibits**

10.46\*



Edgar Filing: ARDEN REALTY INC - Form 10-Q

Second Amended and Restated Agreement of Limited Partnership of Arden Realty Limited Partnership, dated September 7, 1999, filed as an exhibit to Arden Realty's quarterly report on Form 10-Q filed with the Commission on November 15, 1999.

- 10.47\* Admission of New Partners and Amendment to Limited Partnership Agreement entered into as of the 20th day of December, 2000, by and between Arden Realty Limited Partnership and the persons identified as the New Partners therein, filed as an exhibit to Arden Realty Limited Partnership's annual report on Form 10-K filed with the Commission on March 30, 2001.
- 10.48\* Second Amendment to Limited Partnership Agreement entered into as of September 13, 2003, by Arden Realty Limited Partnership, filed as an exhibit to Arden Realty Limited Partnership's quarterly report on Form 10-Q filed with the Commission on November 13, 2003.
- 31.1 Officers' certifications pursuant to Rule 13a-14(a) or Rule 15d-14(a).
- 32.1 Officers' certifications pursuant to Section 906 of the Sarbanes-Oxley Act of 2002<sup>(1)</sup>

---

(\*) Incorporated by reference.

(1) In accordance with SEC Release No. 33-8212, the following exhibit is being furnished, and is not being filed as part of this Report or as a separate disclosure document, and is not being incorporated by reference into any Securities Act of 1933 registration statement.

**(b) Reports on Form 8-K**

On April 29, 2004, we filed a report on Form 8-K (Item 12) relating to our financial information for the quarter ended March 31, 2004 as presented in a press release dated April 28, 2004 attached to the report.

**Table of Contents**

**SIGNATURES**

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

ARDEN REALTY, INC.

Date: August 6, 2004

By: /s/ Andrew J. Sobel

---

Andrew J. Sobel  
Executive Vice President Strategic Planning  
and Operations

Date: August 6, 2004

By: /s/ Richard S. Davis

---

Richard S. Davis  
Senior Vice President and  
Chief Financial Officer