PS BUSINESS PARKS INC/CA
Form 10-Q
November 01, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2012

or

¨ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from to

Commission File Number 1-10709

PS BUSINESS PARKS, INC.

(Exact name of registrant as specified in its charter)

California	**95-4300881**
(State or Other Jurisdiction	**(I.R.S. Employer**
of Incorporation)	**Identification Number)**
701 Western Avenue,	
Glendale, California	**91201-2397**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (818) 244-8080

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

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

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

Large accelerated filer	x	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

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

As of October 29, 2012, the number of shares of the registrant s common stock, $0.01 par value per share, outstanding was 24,284,548.

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PS BUSINESS PARKS, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

	September 30, 2012 (Unaudited)	December 31, 2011
ASSETS		
Cash and cash equivalents	$ 159,792	$ 4,980
Real estate facilities, at cost:		
Land	792,146	772,573
Buildings and improvements	2,211,220	2,155,772
	3,003,366	2,928,345
Accumulated depreciation	(917,728)	(845,700)
	2,085,638	2,082,645
Properties held for disposition, net	1,201	1,218
Land held for development	6,829	6,829
	2,093,668	2,090,692
Rent receivable	4,418	3,198
Deferred rent receivable	25,843	23,388
Other assets	17,088	16,361
Total assets	$ 2,300,809	$ 2,138,619
LIABILITIES AND EQUITY		
Accrued and other liabilities	$ 73,656	$ 60,940
Preferred stock called for redemption	132,250	
Credit facility		185,000
Term loan	200,000	250,000
Mortgage notes payable	281,448	282,084
Total liabilities	687,354	778,024
Commitments and contingencies		
Equity:		
PS Business Parks, Inc. s shareholders equity:		
Preferred stock, $0.01 par value, 50,000,000 shares authorized, 35,400 and 23,942 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively	885,000	598,546
Common stock, $0.01 par value, 100,000,000 shares authorized, 24,284,548 and 24,128,184 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively	242	240
Paid-in capital	535,496	534,322
Cumulative net income	944,245	878,704

Cumulative distributions	(919,988)	(832,607)
Total PS Business Parks, Inc. s shareholders equity	1,444,995	1,179,205
Noncontrolling interests:		
Preferred units		5,583
Common units	168,460	175,807
Total noncontrolling interests	168,460	181,390
Total equity	1,613,455	1,360,595
Total liabilities and equity	$ 2,300,809	$ 2,138,619

See accompanying notes.

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PS BUSINESS PARKS, INC.

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited, in thousands, except per share data)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenues:				
Rental income	$ 87,020	$ 76,463	$ 257,324	$ 222,894
Facility management fees	159	170	489	517
Total operating revenues	87,179	76,633	257,813	223,411
Expenses:				
Cost of operations	29,294	24,778	85,126	74,589
Depreciation and amortization	26,884	21,382	81,326	63,100
General and administrative	2,240	1,365	6,925	4,683
Total operating expenses	58,418	47,525	173,377	142,372
Other income and (expense):				
Interest and other income	37	37	160	174
Interest expense	(5,172)	(1,261)	(15,733)	(3,621)
Total other income and (expense)	(5,135)	(1,224)	(15,573)	(3,447)
Income from continuing operations	23,626	27,884	68,863	77,592
Discontinued operations:				
Income from discontinued operations	69	25	32	297
Gain on sale of real estate facility		2,717		2,717
Total discontinued operations	69	2,742	32	3,014
Net income	$ 23,695	$ 30,626	$ 68,895	$ 80,606
Net income allocation:				
Net income allocable to noncontrolling interests:				
Noncontrolling interests common units	$ 1,557	$ 4,597	$ 3,031	$ 12,858
Noncontrolling interests preferred units		99	323	(7,091)
Total net income allocable to noncontrolling interests	1,557	4,696	3,354	5,767
Net income allocable to PS Business Parks, Inc.:				
Common shareholders	5,172	15,444	10,049	43,382
Preferred shareholders	16,936	10,450	55,386	31,349
Restricted stock unit holders	30	36	106	108
Total net income allocable to PS Business Parks, Inc.	22,138	25,930	65,541	74,839

Net income	$ 23,695	$ 30,626	$ 68,895	$ 80,606
Net income per common share basic:				
Continuing operations	$ 0.21	$ 0.54	$ 0.41	$ 1.67
Discontinued operations	$	$ 0.09	$	$ 0.09
Net income	$ 0.21	$ 0.63	$ 0.41	$ 1.76
Net income per common share diluted:				
Continuing operations	$ 0.21	$ 0.54	$ 0.41	$ 1.66
Discontinued operations	$	$ 0.09	$	$ 0.09
Net income	$ 0.21	$ 0.63	$ 0.41	$ 1.75
Weighted average common shares outstanding:				
Basic	24,257	24,543	24,216	24,647
Diluted	24,350	24,612	24,309	24,738

See accompanying notes.

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PS BUSINESS PARKS, INC.

CONSOLIDATED STATEMENT OF EQUITY

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2012

(Unaudited, in thousands, except share data)

	Preferred Stock		Common Stock		Paid-in	Cumulative Net	Cumulative	Total PS Business Parks, Inc.'s Shareholders'	Noncontrolling	Total
	Shares	Amount	Shares	Amount	Capital	Income	Distributions	Equity	Interests	Equity
Balances at December 31, 2011	23,942	$ 598,546	24,128,184	$ 240	$ 534,322	$ 878,704	$ (832,607)	$ 1,179,205	$ 181,390	$ 1,360,595
Issuance of preferred stock, net of issuance costs	32,400	810,000			(25,608)			784,392		784,392
Redemption of preferred stock, net of issuance costs	(20,942)	(523,546)			17,167		(17,167)	(523,546)		(523,546)
Redemption of preferred units, net of issuance costs					149			149	(5,732)	(5,583)
Exercise of stock options			129,116	2	5,264			5,266		5,266
Stock compensation, net			27,248		3,506			3,506		3,506
Shelf registration					(40)			(40)		(40)
Net income						65,541		65,541	3,354	68,895
Distributions:										
Preferred stock							(38,219)	(38,219)		(38,219)
Common stock							(31,995)	(31,995)		(31,995)
Noncontrolling interests									(9,816)	(9,816)
Adjustment to noncontrolling interests in underlying operating partnership					736			736	(736)	
Balances at September 30, 2012	35,400	$ 885,000	24,284,548	$ 242	$ 535,496	$ 944,245	$ (919,988)	$ 1,444,995	$ 168,460	$ 1,613,455

See accompanying notes.

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PS BUSINESS PARKS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, in thousands)

	For the Nine Months Ended September 30, 2012	For the Nine Months Ended September 30, 2011
Cash flows from operating activities:		
Net income	$ 68,895	$ 80,606
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	81,422	63,340
In-place lease adjustment	402	643
Tenant improvement reimbursements net of lease incentives	(561)	(615)
Amortization of mortgage premium		(177)
Gain on sale of real estate facility		(2,717)
Stock compensation	4,061	1,202
Increase in receivables and other assets	(5,966)	(2,317)
Increase in accrued and other liabilities	9,824	1,955
Total adjustments	89,182	61,314
Net cash provided by operating activities	158,077	141,920
Cash flows from investing activities:		
Capital improvements to real estate facilities	(43,838)	(29,856)
Acquisition of real estate facilities	(37,125)	(30,060)
Proceeds from the sale of real estate facility		9,183
Net cash used in investing activities	(80,963)	(50,733)
Cash flows from financing activities:		
Borrowings on credit facility	154,000	146,000
Note payable to affiliate		121,000
Repayment of borrowings on credit facility	(339,000)	(93,000)
Repayment of borrowings on term loan debt	(50,000)	
Repayment of borrowings on note payable to affiliate		(121,000)
Principal payments on mortgage notes payable	(636)	(824)
Repayment of mortgage note payable		(2,660)
Net proceeds from the issuance of preferred stock	784,392	
Proceeds from the exercise of stock options	5,266	1,050
Shelf registration	(40)	
Redemption/repurchase of preferred units	(5,583)	(39,087)
Redemption/repurchase of preferred stock	(391,296)	
Repurchase of common stock		(30,252)
Distributions paid to common shareholders	(31,995)	(32,430)
Distributions paid to preferred shareholders	(37,594)	(31,349)
Distributions paid to noncontrolling interests common units	(9,642)	(9,642)
Distributions paid to noncontrolling interests preferred units	(174)	(298)
Net cash provided by (used in) financing activities	77,698	(92,492)
Net increase (decrease) in cash and cash equivalents	154,812	(1,305)

Cash and cash equivalents at the beginning of the period	4,980	5,066
Cash and cash equivalents at the end of the period	$ 159,792	$ 3,761

See accompanying notes.

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PS BUSINESS PARKS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, in thousands)

	For the Nine Months Ended September 30, 2012	2011
Supplemental schedule of non-cash investing and financing activities:		
Adjustment to noncontrolling interests in underlying operating partnership:		
Noncontrolling interests common units	$ (736)	$ 5,538
Paid-in capital	$ 736	$ (5,538)
Gain on repurchase of preferred equity:		
Preferred units	$	$ (8,748)
Paid-in capital	$	$ 8,748
Issuance costs related to the redemption/repurchase of preferred equity:		
Cumulative distributions	$ (17,167)	$
Noncontrolling interest common units	$ (149)	$ (1,359)
Paid-in capital	$ 17,316	$ 1,359
Preferred stock called for redemption:		
Preferred stock	$ (132,250)	$
Preferred stock called for redemption	$ 132,250	$
Accrued preferred stock distribution:		
Accrued and other liabilities	$ 625	$
Cumulative distributions	$ (625)	$

See accompanying notes.

PS BUSINESS PARKS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2012

1. Organization and description of business

PS Business Parks, Inc. (PSB) was incorporated in the state of California in 1990. As of September 30, 2012, PSB owned 76.9% of the common partnership units of PS Business Parks, L.P. (the Operating Partnership). The remaining common partnership units are owned by Public Storage (PS). PSB, as the sole general partner of the Operating Partnership, has full, exclusive and complete responsibility and discretion in managing and controlling the Operating Partnership. PSB and the Operating Partnership are collectively referred to as the Company.

The Company is a fully-integrated, self-advised and self-managed real estate investment trust (REIT) that owns, operates, acquires, and develops commercial properties, primarily multi-tenant flex, office and industrial space. As of September 30, 2012, the Company owned and operated 28.2 million rentable square feet of commercial space located in eight states. The Company also manages 1.2 million rentable square feet on behalf of PS.

References to the number of properties or square footage are unaudited and outside the scope of the Company s independent registered public accounting firm s review of the Company s financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States).

2. Summary of significant accounting policies

Basis of presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ended December 31, 2012. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2011.

The accompanying consolidated financial statements include the accounts of PSB and the Operating Partnership. All significant inter-company balances and transactions have been eliminated in the consolidated financial statements.

Noncontrolling Interests

The Company s noncontrolling interests are reported as a component of equity separate from the parent s equity. Purchases or sales of equity interests that do not result in a change in control are accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest is included in consolidated net income on the face of the income statement and, upon a gain or loss of control, the interest purchased or sold, as well as any interest retained, is recorded at fair value with any gain or loss recognized in earnings.

Use of estimates

The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from these estimates.

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Allowance for doubtful accounts

The Company monitors the collectability of its receivable balances including the deferred rent receivable on an ongoing basis. Based on these reviews, the Company maintains an allowance for doubtful accounts for estimated losses resulting from the possible inability of tenants to make contractual rent payments to the Company. A provision for doubtful accounts is recorded during each period. The allowance for doubtful accounts, which represents the cumulative allowances less write-offs of uncollectible rent, is netted against tenant and other receivables on the consolidated balance sheets. Tenant receivables are net of an allowance for uncollectible accounts totaling $400,000 at September 30, 2012 and December 31, 2011.

Financial instruments

The methods and assumptions used to estimate the fair value of financial instruments are described below. The Company has estimated the fair value of financial instruments using available market information and appropriate valuation methodologies. Considerable judgment is required in interpreting market data to develop estimates of market value. Accordingly, estimated fair values are not necessarily indicative of the amounts that could be realized in current market exchanges. The Company determines the estimated fair value of financial assets and liabilities utilizing a hierarchy of valuation techniques based on whether the inputs to a fair value measurement are considered to be observable or unobservable in a marketplace. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect market assumptions. This hierarchy requires the use of observable market data when available. The following is the fair value hierarchy:

Level 1 quoted prices for identical instruments in active markets

Level 2 quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which significant inputs and significant value drivers are observable in active markets; and

Level 3 fair value measurements derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable

Financial assets that are exposed to credit risk consist primarily of cash and cash equivalents and receivables. The Company considers all highly liquid investments with a remaining maturity of three months or less at the date of purchase to be cash equivalents. Cash and cash equivalents, which consist primarily of money market investments, are only invested in entities with an investment grade rating. Receivables are comprised of balances due from a large number of customers. Balances that the Company expects to become uncollectible are reserved for or written off. Due to the short period to maturity of the Company s cash and cash equivalents, accounts receivable, other assets and accrued and other liabilities, the carrying values as presented on the consolidated balance sheets are reasonable estimates of fair value.

Carrying values of the Company s mortgage notes payable, unsecured credit facility and term loan are deemed to approximate fair value. The characteristics of these financial instruments, market data and other comparative metrics utilized in determining these fair values are Level 2 inputs.

Real estate facilities

Real estate facilities are recorded at cost. Costs related to the renovation or improvement of the properties are capitalized. Expenditures for repairs and maintenance are expensed as incurred. Expenditures that are expected to benefit a period greater than two years and exceed $2,000 are capitalized and depreciated over their estimated useful life. Buildings and improvements are depreciated using the straight-line method over their estimated useful lives, which generally range from five to 30 years. Transaction costs, which include tenant improvements and lease commissions, in excess of $1,000 for leases with terms greater than one year are capitalized and depreciated over their estimated useful lives. Transaction costs less than $1,000 or leases of one year or less are expensed as incurred.

Properties held for disposition

An asset is classified as an asset held for disposition when it meets certain requirements, which include, among other criteria, the approval of the sale of the asset, the marketing of the asset for sale and the expectation by the Company that the sale will likely occur within the next 12 months. Upon classification of an asset as held for disposition, depreciation of the asset is ceased, the operating results of the asset are included in discontinued operations for all periods presented and the net book value of the asset is included on the balance sheet as properties held for disposition.

Intangible assets/liabilities

Intangible assets and liabilities include above-market and below-market in-place lease values of acquired properties based on the present value (using an interest rate which reflects the risks associated with the leases acquired) of the difference between (i) the contractual amounts to be paid pursuant to the in-place leases and (ii) management s estimate of fair market lease rates for the corresponding in-place leases, measured over a period equal to the remaining non-cancelable term of the lease. The capitalized above-market and below-market lease values (included in other assets and accrued liabilities in the accompanying consolidated balance sheets) are amortized to rental income over the remaining non-cancelable terms of the respective leases. The Company recorded net amortization of $116,000 and $223,000 of intangible assets and liabilities resulting from the above-market and below-market lease values during the three months ended September 30, 2012 and 2011, respectively. Amortization was $402,000 and $643,000 for the nine months ended September 30, 2012 and 2011, respectively. As of September 30, 2012, the value of in-place leases resulted in a net intangible asset of $5.5 million, net of $4.1 million of accumulated amortization with a weighted average amortization period of 6.2 years, and a net intangible liability of $5.1 million, net of $2.5 million of accumulated amortization with a weighted average amortization period of 4.9 years. As of December 31, 2011, the value of in-place leases resulted in a net intangible asset of $6.9 million, net of $2.3 million of accumulated amortization and a net intangible liability of $6.4 million, net of $1.1 million of accumulated amortization.

Evaluation of asset impairment

The Company evaluates its assets used in operations for impairment by identifying indicators of impairment and by comparing the sum of the estimated undiscounted future cash flows for each asset to the asset s carrying value. When indicators of impairment are present and the sum of the estimated undiscounted future cash flows is less than the carrying value of such asset, an impairment loss is recorded equal to the difference between the asset s current carrying value and its value based on discounting its estimated future cash flows. In addition, the Company evaluates its assets held for disposition for impairment. Assets held for disposition are reported at the lower of their carrying value or fair value, less cost of disposition. At September 30, 2012, the Company did not consider any assets to be impaired.

Stock compensation

All share-based payments to employees, including grants of employee stock options, are recognized as stock compensation in the Company s income statement based on their grant date fair values. See Note 11.

Revenue and expense recognition

The Company must meet four basic criteria before revenue can be recognized: persuasive evidence of an arrangement exists; the delivery has occurred or services rendered; the fee is fixed or determinable; and collectability is reasonably assured. All leases are classified as operating leases. Rental income is recognized on a straight-line basis over the terms of the leases. Straight-line rent is recognized for all tenants with contractual fixed increases in rent that are not included on the Company s credit watch list. Deferred rent receivable represents rental revenue recognized on a straight-line basis in excess of billed rents. Reimbursements from tenants for real estate taxes and other recoverable operating expenses are recognized as rental income in the period the applicable costs are incurred. Property management fees are recognized in the period earned.

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Costs incurred in connection with leasing (primarily tenant improvements and lease commissions) are capitalized and amortized over the lease period.

Gains from sales of real estate facilities

The Company recognizes gains from sales of real estate facilities at the time of sale using the full accrual method, provided that various criteria related to the terms of the transactions and any subsequent involvement by the Company with the properties sold are met. If the criteria are not met, the Company defers the gains and recognizes them when the criteria are met or using the installment or cost recovery methods as appropriate under the circumstances.

General and administrative expenses

General and administrative expenses include executive and other compensation, office expense, professional fees, acquisition transaction costs, state income taxes and other such administrative items.

Income taxes

The Company has qualified and intends to continue to qualify as a REIT, as defined in Section 856 of the Internal Revenue Code. As a REIT, the Company is not subject to federal income tax to the extent that it distributes its REIT taxable income to its shareholders. A REIT must distribute at least 90% of its taxable income each year. In addition, REITs are subject to a number of organizational and operating requirements. If the Company fails to qualify as a REIT in any taxable year, the Company will be subject to federal income tax (including any applicable alternative minimum tax) based on its taxable income using corporate income tax rates. Even if the Company qualifies for taxation as a REIT, the Company may be subject to certain state and local taxes on its income and property and to federal income and excise taxes on its undistributed taxable income. The Company believes it met all organization and operating requirements to maintain its REIT status during 2011 and intends to continue to meet such requirements for 2012. Accordingly, no provision for income taxes has been made in the accompanying consolidated financial statements.

The Company can recognize a tax benefit only if it is more likely than not that a particular tax position will be sustained upon examination or audit. To the extent that the more likely than not standard has been satisfied, the benefit associated with a position is measured as the largest amount that is greater than 50% likely of being recognized upon settlement. As of September 30, 2012, the Company did not recognize any tax benefit for uncertain tax positions.

Accounting for preferred equity issuance costs

The Company records issuance costs as a reduction to paid-in capital on its balance sheet at the time the preferred securities are issued and reflects the carrying value of the preferred equity at the stated value. The Company records issuance costs as non-cash preferred equity distributions at the time it notifies the holders of preferred stock or units of its intent to redeem such shares or units.

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Net income allocation

Net income was allocated as follows *(in thousands)*:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income allocable to noncontrolling interests:				
Noncontrolling interests common units:				
Continuing operations	$ 1,541	$ 3,969	$ 3,024	$ 12,170
Discontinued operations	16	628	7	688
Total net income allocable to noncontrolling interests common units	1,557	4,597	3,031	12,858
Noncontrolling interests preferred units:				
Distributions to preferred unit holders		99	174	298
Issuance costs related to the redemption of preferred units			149	
Gain on repurchase of preferred units, net of issuance costs				(7,389)
Total net income allocable to noncontrolling interests preferred units		99	323	(7,091)
Total net income allocable to noncontrolling interests	1,557	4,696	3,354	5,767
Net income allocable to PS Business Parks, Inc.:				
Common shareholders:				
Continuing operations	5,119	13,335	10,024	41,062
Discontinued operations	53	2,109	25	2,320
Total net income allocable to common shareholders	5,172	15,444	10,049	43,382
Preferred shareholders:				
Distributions to preferred shareholders	13,088	10,450	38,219	31,349
Issuance costs related to the redemption of preferred stock	3,848		17,167	
Total net income allocable to preferred shareholders	16,936	10,450	55,386	31,349
Restricted stock unit holders:				
Continuing operations	30	31	106	102
Discontinued operations		5		6
Total net income allocable to restricted stock unit holders	30	36	106	108
Total net income allocable to PS Business Parks, Inc.	22,138	25,930	65,541	74,839
Net income	$ 23,695	$ 30,626	$ 68,895	$ 80,606

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Net income per common share

Per share amounts are computed using the number of weighted average common shares outstanding. Diluted weighted average common shares outstanding includes the dilutive effect of stock options and restricted stock units under the treasury stock method. Basic weighted average common shares outstanding excludes such effect. The Company s restricted stock units are participating securities and included in the computation of basic and diluted weighted average common shares outstanding. The Company s allocation of net income to the restricted stock unit holders are paid non-forfeitable dividends in excess of the expense recorded which results in a reduction in net income allocable to common shareholders and unit holders. Earnings per share has been calculated as follows *(in thousands, except per share amounts)*:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income allocable to common shareholders	$ 5,172	$ 15,444	$ 10,049	$ 43,382
Weighted average common shares outstanding:				
Basic weighted average common shares outstanding	24,257	24,543	24,216	24,647
Net effect of dilutive stock compensation based on treasury stock method using average market price	93	69	93	91
Diluted weighted average common shares outstanding	24,350	24,612	24,309	24,738
Net income per common share Basic	$ 0.21	$ 0.63	$ 0.41	$ 1.76
Net income per common share Diluted	$ 0.21	$ 0.63	$ 0.41	$ 1.75

Options to purchase 27,200 and 92,000 shares for the three months ended September 30, 2012 and 2011, respectively, were not included in the computation of diluted net income per share because such options were considered anti-dilutive. Options to purchase 51,200 and 92,000 shares for the nine months ended September 30, 2012 and 2011, respectively, were not included in the computation of diluted net income per share because such options were considered anti-dilutive.

Segment reporting

The Company views its operations as one segment.

Reclassifications

Certain reclassifications have been made to the consolidated financial statements for 2011 in order to conform to the 2012 presentation.

3. Real estate facilities

The activity in real estate facilities for the nine months ended September 30, 2012 is as follows *(in thousands)*:

	Land	Buildings and Improvements	Accumulated Depreciation	Total
Balances at December 31, 2011	$ 772,573	$ 2,155,772	$ (845,700)	$ 2,082,645
Acquisition of real estate	19,573	17,695		37,268
Capital improvements, net		47,130		47,130
Disposals		(9,298)	9,298	
Depreciation expense			(81,422)	(81,422)
Transfer to properties held for disposition		(79)	96	17

Balances at September 30, 2012	$ 792,146	$ 2,211,220	$ (917,728)	$ 2,085,638

The purchase price of acquired properties is recorded to land, buildings and improvements and intangible assets and liabilities associated with in-place leases (including tenant improvements, unamortized lease commissions, value of above-market and below-market leases, acquired in-place lease values, and tenant relationships, if any) based on their respective estimated fair values. Acquisition-related costs are expensed as incurred.

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In determining the fair value of the tangible assets of the acquired properties, management considers the value of the properties as if vacant as of the acquisition date. Management must make significant assumptions in determining the value of assets acquired and liabilities assumed. Using different assumptions in the recording of the purchase cost of the acquired properties would affect the timing of recognition of the related revenue and expenses. Amounts recorded to land are derived from comparable sales of land within the same region. Amounts recorded to buildings and improvements, tenant improvements and unamortized lease commissions are based on current market replacement costs and other market information. The amount recorded to acquired in-place leases is determined based on management s assessment of current market conditions and the estimated lease-up periods for the respective spaces.

On July 24, 2012, the Company acquired a 958,000 square foot industrial park consisting of eight single-story buildings located in Kent Valley, Washington, for a purchase price of $37.6 million. The Company incurred and expensed acquisition transaction costs of $158,000 for the three and nine months ended September 30, 2012.

The following table summarizes the assets acquired and liabilities assumed for the nine months ended September 30, *(in thousands)*:

	2012
Land	$ 19,573
Buildings and improvements	17,695
Above-market in-place lease value	473
Below-market in-place lease value	(191)
Total purchase price	37,550
Net operating assets acquired and liabilities assumed	(425)
Total cash paid	$ 37,125

On December 20, 2011, the Company acquired a 5.3 million square foot industrial and flex portfolio located in the Northern California Bay Area (the Portfolio), with concentrations in Oakland, Hayward, Fremont, Milpitas, San Jose, Santa Clara and Sunnyvale, for an aggregate purchase price of $520.0 million. In connection with the transaction, the Company assumed a $250.0 million mortgage note described in Note 6. The Company also obtained a $250.0 million unsecured three-year term loan described in Note 5.

The results of operations of the Portfolio acquired have been included in the Company s consolidated financial statements since the date of acquisition of December 20, 2011. The unaudited pro forma data presented below assumes that the Portfolio acquisition occurred as of the beginning of the respective period, and includes pro forma adjustments to (i) increase depreciation expense to reflect the Company s book basis for buildings and improvements acquired, (ii) increase amortization expense to reflect the above-market and below-market in-place lease value acquired, and (iii) increase interest expense to reflect the financing of the Portfolio acquisition related to the $250.0 million mortgage note assumption, borrowings from the term loan and credit facility. Rental income of $11.2 million and $32.1 million related to the Portfolio acquisition for the three and nine months ended September 30, 2012, respectively, was reported in the Company s consolidated statements of income. Net losses of $1.3 million and $5.5 million related to the Portfolio acquisition for the three and nine months end September 30, 2012, respectively, were reported in the Company s consolidated statements of income. The net loss includes rental income less cost of operations, depreciation and mortgage note interest. The Company s unaudited pro forma results have been prepared for comparative purposes only and do not purport to be indicative of the results of operations that would have occurred had the Portfolio acquisition been consummated at the beginning of the period presented *(in thousands, except per share amounts)*:

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	For the Three Months Ended September 30, 2011	For the Nine Months Ended September 30, 2011
Pro Forma Revenues	$ 86,375	$ 253,260
Pro Forma Net income	$ 33,456	$ 75,695
Pro Forma Net income per common share:		
Basic	$ 0.72	$ 1.61
Diluted	$ 0.72	$ 1.60

In August, 2011, the Company completed the sale of Westchase Corporate Park, a 177,000 square foot flex park consisting of 13 buildings in Houston, Texas, for a sales price of $9.8 million, resulting in a net gain of $2.7 million.

Subsequent to September 30, 2012, the Company completed the sale of Quail Valley Business Park, a 66,000 square foot flex park in Houston, Texas, for $2.3 million.

The following table summarizes the condensed results of operations of the properties held for disposition as of September 30, 2012 and the property sold during 2011 *(in thousands)*:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Rental income	$ 112	$ 337	$ 267	$ 1,330
Cost of operations	(43)	(271)	(139)	(793)
Depreciation		(41)	(96)	(240)
Income from discontinued operations	$ 69	$ 25	$ 32	$ 297

In addition to minimum rental payments, tenants reimburse the Company for their pro rata share of specified operating expenses, which amounted to $34,000 and $138,000 for the three months ended September 30, 2012 and 2011, respectively. Reimbursements were $51,000 and $523,000 for the nine months ended September 30, 2012 and 2011, respectively. These amounts are included as rental income in the table presented above.

4. Leasing activity

The Company leases space in its real estate facilities to tenants primarily under non-cancelable leases generally ranging from one to 10 years. Future minimum rental revenues excluding recovery of operating expenses as of September 30, 2012 under these leases are as follows *(in thousands)*:

2012	$ 65,932
2013	228,795
2014	162,599
2015	109,904
2016	75,160
Thereafter	122,750
Total	$ 765,140

In addition to minimum rental payments, certain tenants reimburse the Company for their pro rata share of specified operating expenses. Such reimbursements amounted to $18.7 million and $14.6 million for the three months ended September 30, 2012 and 2011, respectively and $53.6 million and $44.7 million for the nine months ended September 30, 2012 and 2011, respectively. These amounts are included as rental income in the accompanying consolidated statements of income.

Leases accounting for 6.9% of total leased square footage are subject to termination options which include leases accounting for 1.5% of total leased square footage having termination options exercisable through December 31, 2012. In general, these leases provide for termination payments should the termination options be exercised. The above table is prepared assuming such options are not exercised.

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5. Bank loans

The Company has a line of credit (the Credit Facility) with Wells Fargo Bank, National Association (Wells Fargo) which expires on August 1, 2015. The Credit Facility has a borrowing limit of $250.0 million. The rate of interest charged on borrowings is equal to a rate ranging from the London Interbank Offered Rate (LIBOR) plus 1.00% to LIBOR plus 1.85% depending on the Company s credit ratings. Currently, the Company s rate under the Credit Facility is LIBOR plus 1.10%. In addition, the Company is required to pay an annual facility fee ranging from 0.15% to 0.45% of the borrowing limit depending on the Company s credit ratings (currently 0.15%). The Company had no balance outstanding on the Credit Facility at September 30, 2012. The Company had $185.0 million outstanding on the Credit Facility at an interest rate of 1.41% at December 31, 2011. The Company had $868,000 and $1.1 million of unamortized commitment fees as of September 30, 2012 and December 31, 2011, respectively. The Credit Facility requires the Company to meet certain covenants, with which the Company was in compliance at September 30, 2012. Interest on outstanding borrowings is payable monthly.

In connection with the Northern California Portfolio acquisition described in Note 3, the Company entered into a term loan on December 20, 2011 with Wells Fargo, as Administrative Agent and the lenders named therein (the Term Loan). Pursuant to the Term Loan, the Company borrowed $250.0 million for a three year term through December 31, 2014. However, the maturity date of the Term Loan Agreement can be extended by one year at the Company s election. Interest on the amounts borrowed under the Term Loan will accrue based on an applicable rate ranging from LIBOR plus 1.15% to LIBOR plus 2.25% depending on the Company s credit ratings. Currently, the Company s rate under the Term Loan is LIBOR plus 1.20%. The Company had $200.0 million outstanding on the Term Loan at an interest rate of 1.42% at September 30, 2012 and $250.0 million outstanding at an interest rate of 1.50% at December 31, 2011. The Company had $433,000 and $729,000 of unamortized commitment fees as of September 30, 2012 and December 31, 2011, respectively. The covenants and events of default contained in the Credit Facility are incorporated into the Term Loan by reference, and the Term Loan is cross-defaulted to the Credit Facility. The Term Loan can be repaid in full or part at any time prior to its maturity without penalty.

6. Mortgage notes payable

Mortgage notes payable consist of the following *(in thousands)*:

	September 30, 2012	**December 31, 2011**
5.73% mortgage note, secured by one commercial property with a net book value of $27.7 million, principal and interest payable monthly, due November, 2012	$ 13,207	$ 13,436
5.52% mortgage note, secured by one commercial property with a net book value of $14.8 million, principal and interest payable monthly, due May, 2013	9,106	9,311
5.68% mortgage note, secured by one commercial property with a net book value of $16.5 million, principal and interest payable monthly, due May, 2013	9,135	9,337
5.45% mortgage note, secured by 4.8 million square feet with a net book value of $451.8 million, interest payable monthly, due December, 2016	250,000	250,000
Total	$ 281,448	$ 282,084

At September 30, 2012, mortgage notes payable had a weighted average interest rate of 5.47% and a weighted average maturity of 3.8 years with principal payments as follows *(in thousands)*:

2012	$ 13,347
2013	18,101
2014	
2015	
2016	250,000
Total	$ 281,448

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7. Noncontrolling interests

As described in Note 2, the Company reports noncontrolling interests within equity in the consolidated financial statements, but separate from the Company s shareholders equity. In addition, net income allocable to noncontrolling interests is shown as a reduction from net income in calculating net income allocable to common shareholders.

Common partnership units

The Company presents the accounts of PSB and the Operating Partnership on a consolidated basis. Ownership interests in the Operating Partnership that can be redeemed for common stock, other than PSB s interest, are classified as noncontrolling interests common units in the consolidated financial statements. Net income allocable to noncontrolling interests common units consists of the common units share of the consolidated operating results after allocation to preferred units and shares. Beginning one year from the date of admission as a limited partner (common units) and subject to certain limitations described below, each limited partner other than PSB has the right to require the redemption of its partnership interest.

A limited partner (common units) that exercises its redemption right will receive cash from the Operating Partnership in an amount equal to the market value (as defined in the Operating Partnership Agreement) of the partnership interests redeemed. In lieu of the Operating Partnership redeeming the common units for cash, PSB, as general partner, has the right to elect to acquire the partnership interest directly from a limited partner exercising its redemption right, in exchange for cash in the amount specified above or by issuance of one share of PSB common stock for each unit of limited partnership interest redeemed.

A limited partner (common units) cannot exercise its redemption right if delivery of shares of PSB common stock would be prohibited under the applicable articles of incorporation, or if the general partner believes that there is a risk that delivery of shares of common stock would cause the general partner to no longer qualify as a REIT, would cause a violation of the applicable securities laws, or would result in the Operating Partnership no longer being treated as a partnership for federal income tax purposes.

At September 30, 2012, there were 7,305,355 common units owned by PS, which are accounted for as noncontrolling interests. On a fully converted basis, assuming all 7,305,355 noncontrolling interests common units were converted into shares of common stock of PSB at September 30, 2012, the noncontrolling interests common units would convert into 23.1% of the shares of common stock outstanding. Combined with PS s common stock ownership, on a fully converted basis, PS has a combined ownership of 41.5% of the Company s common equity. At the end of each reporting period, the Company determines the amount of equity (book value of net assets) which is allocable to the noncontrolling interest based upon the ownership interest, and an adjustment is made to the noncontrolling interest, with a corresponding adjustment to paid-in capital, to reflect the noncontrolling interests equity interest in the Company.

Preferred partnership units

Through the Operating Partnership, the Company had the following preferred units outstanding as of September 30, 2012 and December 31, 2011:

				September 30, 2012		December 31, 2011	
Series	**Issuance Date**	**Earliest Potential Redemption Date**	**Dividend Rate**	**Units Outstanding**	**Amount (in thousands)**	**Units Outstanding**	**Amount (in thousands)**
Series N	December, 2005	December, 2010	7.125%		$	223,300	$ 5,583
Total					$	223,300	$ 5,583

On June 8, 2012, the Company redeemed 223,300 units of its 7.125% Series N Cumulative Redeemable Preferred Units for $5.6 million. The Company reported the excess of the redemption amount over the carrying amount of $149,000, equal to the original issuance costs, as a reduction of net income allocable to common shareholders and unit holders for the nine months ended September 30, 2012.

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In February, 2011, the Company paid an aggregate of $39.1 million to repurchase 1,710,000 units of its 7.50% Series J Cumulative Redeemable Preferred Units and 203,400 units of its 6.55% Series Q Cumulative Redeemable Preferred Units for a weighted average purchase price of $20.43 per unit. The aggregate par value of the repurchased preferred units was $47.8 million, which generated a gain of $7.4 million, net of original issuance costs of $1.4 million, which was added to net income allocable to common shareholders and unit holders for the nine months ended September 30, 2011.

8. Related party transactions

The Operating Partnership manages industrial, office and retail facilities for PS. These facilities, all located in the United States, operate under the Public Storage or PS Business Parks names. The PS Business Parks name and logo is owned by PS and licensed to the Company under a non-exclusive, royalty-free license agreement. The license can be terminated by either party for any reason with six months written notice.

Under the property management contract with PS, the Operating Partnership is compensated based on a percentage of the gross revenues of the facilities managed. Under the supervision of the property owners, the Operating Partnership coordinates rental policies, rent collections, marketing activities, the purchase of equipment and supplies, maintenance activities, and the selection and engagement of vendors, suppliers and independent contractors. In addition, the Operating Partnership assists and advises the property owners in establishing policies for the hire, discharge and supervision of employees for the operation of these facilities, including property managers and leasing, billing and maintenance personnel.

The property management contract with PS is for a seven-year term with the agreement automatically extending for an additional one-year period upon each one-year anniversary of its commencement (unless cancelled by either party). Either party can give notice of its intent to cancel the agreement upon expiration of its current term. Management fee revenues under this contract were $159,000 and $170,000 for the three months ended September 30, 2012 and 2011, respectively and $489,000 and $517,000 for the nine months ended September 30, 2012 and 2011, respectively.

PS also provides property management services for the self-storage component of two assets owned by the Company. These self-storage facilities, located in Palm Beach County, Florida, operate under the Public Storage name.

Under the property management contract, PS is compensated based on a percentage of the gross revenues of the facilities managed. Under the supervision of the Company, PS coordinates rental policies, rent collections, marketing activities, the purchase of equipment and supplies, maintenance activities, and the selection and engagement of vendors, suppliers and independent contractors. In addition, PS assists and advises the Company in establishing policies for the hire, discharge and supervision of employees for the operation of these facilities, including on-site managers, assistant managers and associate managers.

Either the Company or PS can cancel the property management contract upon 60 days notice. Management fee expenses under the contract were $14,000 and $13,000 for the three months ended September 30, 2012 and 2011, respectively and $41,000 and $39,000 for the nine months ended September 30, 2012 and 2011, respectively.

Pursuant to a cost sharing and administrative services agreement, the Company shares costs with PS for certain administrative services, which are allocated to PS in accordance with a methodology intended to fairly allocate those costs. These costs totaled $110,000 for the three months ended September 30, 2012 and 2011 and $331,000 for the nine months ended September 30, 2012 and 2011.

The Company had amounts due to PS of $281,000 at September 30, 2012 and due from PS of $205,000 at December 31, 2011 for these contracts, as well as for certain operating expenses paid by the Company on behalf of PS.

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On February 9, 2011, the Company entered into an agreement with PS to borrow $121.0 million with a maturity date of August 9, 2011 at an interest rate of LIBOR plus 0.85%. The Company repaid, in full, the note payable to PS upon maturity. Interest expense under this note payable was $138,000 and $664,000 for the three and nine months ended September 30, 2011.

9. Shareholders equity

Preferred stock

As of September 30, 2012 and December 31, 2011, the Company had the following series of preferred stock outstanding:

				September 30, 2012		December 31, 2011	
Series	**Issuance Date**	**Earliest Potential Redemption Date**	**Dividend Rate**	**Shares Outstanding**	**Amount (in thousands)**	**Shares Outstanding**	**Amount (in thousands)**
Series R	October, 2010	October, 2015	6.875%	3,000	75,000	3,000	75,000
Series S	January, 2012	January, 2017	6.450%	9,200	230,000		
Series T	May, 2012	May, 2017	6.000%	14,000	350,000		
Series U	September, 2012	September, 2017	5.750%	9,200	230,000		
Series H	January & October, 2004	January, 2009	7.000%			6,341	158,520
Series I	April, 2004	April, 2009	6.875%			2,745	68,626
Series M	May, 2005	May, 2010	7.200%			3,182	79,550
Series O	June & August, 2006	June, 2011	7.375%			3,384	84,600
Series P	January, 2007	January, 2012	6.700%			5,290	132,250
Total				35,400	$ 885,000	23,942	$ 598,546

Subsequent to September 30, 2012, the Company completed the redemption of its 6.70% Cumulative Preferred Stock, Series P, at its par value of $132.3 million. The Company reported the excess of the redemption amount over the carrying amount of $3.8 million, equal to the original issuance costs, as a reduction of net income allocable to common shareholders and unit holders for the three and nine months ended September 30, 2012. As of September 30, 2012, the Company reclassified the 6.70% Cumulative Preferred Stock, Series P, of $132.3 million from equity to liabilities as preferred stock called for redemption.

On September 14, 2012, the Company issued $230.0 million or 9.2 million depositary shares, each representing 1/1,000 of a share of the 5.75% Cumulative Preferred Stock, Series U, at $25.00 per depositary share.

On June 15, 2012, the Company completed the redemption of its 7.00% Cumulative Preferred Stock, Series H, at its par value of $158.5 million and its 6.875% Cumulative Preferred Stock, Series I, at its par value of $68.6 million. The Company reported the excess of the redemption amount over the carrying amount of $8.1 million, equal to the original issuance costs, as a reduction of net income allocable to common shareholders and unit holders for the nine months ended September 30, 2012.

On May 14, 2012, the Company issued $350.0 million or 14.0 million depositary shares, each representing 1/1,000 of a share of the 6.00% Cumulative Preferred Stock, Series T, at $25.00 per depositary share.

During February, 2012, the Company completed the redemption of its 7.20% Cumulative Preferred Stock, Series M, at its par value of $79.6 million and its 7.375% Cumulative Preferred Stock, Series O, at its par value of $84.6 million. The Company reported the excess of the redemption amount over the carrying amount of $5.3 million, equal to the original issuance costs, as a reduction of net income allocable to common shareholders and unit holders for the nine months ended September 30, 2012.

On January 18, 2012, the Company issued $230.0 million or 9.2 million depositary shares, each representing 1/1,000 of a share of the 6.45% Cumulative Preferred Stock, Series S, at $25.00 per depositary share.

The Company recorded $13.1 million and $10.4 million in distributions to its preferred shareholders for the three months ended September 30, 2012 and 2011, respectively. The Company recorded $38.2 million and $31.3 million in distributions to its preferred shareholders for the nine months ended September 30, 2012 and 2011, respectively.

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Holders of the Company s preferred stock will not be entitled to vote on most matters, except under certain conditions. In the event of a cumulative arrearage equal to six quarterly dividends, the holders of the preferred stock will have the right to elect two additional members to serve on the Company s Board of Directors until all events of default have been cured. At September 30, 2012, there were no dividends in arrears.

Except under certain conditions relating to the Company s qualification as a REIT, the preferred stock is not redeemable prior to the previously noted redemption dates. On or after the respective redemption dates, the respective series of preferred stock will be redeemable, at the option of the Company, in whole or in part, at $25.00 per depositary share, plus any accrued and unpaid dividends. As of September 30, 2012, the Company had $28.1 million of deferred costs in connection with the issuance of preferred stock, which the Company will report as additional non-cash distributions upon notice of its intent to redeem such shares.

Common stock

The Company s Board of Directors previously authorized the repurchase, from time to time, of up to 6.5 million shares of the Company s common stock on the open market or in privately negotiated transactions. During the nine months ended September 30, 2011, the Company repurchased 591,500 shares of common stock at an aggregate cost of $30.3 million. Since inception of the program, the Company has repurchased an aggregate of 4.9 million shares of common stock at an aggregate cost of $183.9 million or an average cost per share of $37.64. Under existing board authorizations, the Company can repurchase an additional 1.6 million shares. No shares of common stock were repurchased under this program during the nine months ended September 30, 2012.

The Company paid $10.7 million ($0.44 per common share) in distributions to its common shareholders for both the three months ended September 30, 2012 and 2011 and $32.0 million ($1.32 per common share) and $32.4 million ($1.32 per common share) for the nine months ended September 30, 2012 and 2011, respectively.

Equity stock

In addition to common and preferred stock, the Company is authorized to issue 100.0 million shares of Equity Stock. The Articles of Incorporation provide that the Equity Stock may be issued from time to time in one or more series and give the Board of Directors broad authority to fix the dividend and distribution rights, conversion and voting rights, redemption provisions and liquidation rights of each series of Equity Stock.

10. Commitments and contingencies

The Company currently is neither subject to any other material litigation nor, to management s knowledge, is any material litigation currently threatened against the Company other than routine litigation and administrative proceedings arising in the ordinary course of business.

11. Stock compensation

PSB has a 2003 Stock Option and Incentive Plan (the 2003 Plan) covering 1.5 million shares of PSB s common stock. Under the 2003 Plan, PSB has granted non-qualified options to certain directors, officers and key employees to purchase shares of PSB s common stock at a price not less than the fair market value of the common stock at the date of grant. Additionally, under the 2003 Plan, PSB has granted restricted stock units to officers and key employees. Effective February 20, 2012, PSB has a 2012 Equity and Performance-Based Incentive Compensation Plan (the 2012 Plan) covering 1.0 million shares of PSB s common stock. Under the 2012 Plan, PSB has granted non-qualified options to certain directors to purchase shares of PSB s common stock at a price not less than the fair market value of the common stock at the date of grant. Additionally, under the 2012 Plan, PSB has granted restricted shares of common stock to certain directors.

The weighted average grant date fair value of options granted during the nine months ended September 30, 2012 and 2011 was $4.85 per share and $5.38 per share, respectively. The Company has calculated the fair value of each option grant on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants during the nine months ended September 30, 2012 and 2011, respectively: a dividend yield of 2.6% and 2.9%; expected volatility of 13.4% and 13.9%; expected life of five years; and risk-free interest rates of 0.9% and 1.7%.

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The weighted average grant date fair value of restricted stock units granted during the nine months ended September 30, 2012 and 2011 was $65.14 and $51.63, respectively. The Company calculated the fair value of each restricted stock unit grant using the market value on the date of grant.

At September 30, 2012, there were a combined total of 981,000 options and restricted stock units authorized to grant. Information with respect to outstanding options and nonvested restricted stock units granted under the 2003 Plan and 2012 Plan is as follows:

Options:	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contract Life	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2011	567,216	$ 49.51		
Granted	44,000	$ 66.69		
Exercised	(129,116)	$ 40.77		
Forfeited	(13,600)	$ 61.05		
Outstanding at September 30, 2012	468,500	$ 53.20	6.26 Years	$ 6,468
Exercisable at September 30, 2012	243,100	$ 51.38	4.76 Years	$ 3,806

Restricted Stock Units:	Number of Units	Weighted Average Grant Date Fair Value
Nonvested at December 31, 2011	59,224	$ 52.24
Granted	17,800	$ 65.14
Vested	(20,094)	$ 51.36
Forfeited	(3,240)	$ 52.97
Nonvested at September 30, 2012	53,690	$ 55.73

In January of 2012, the Company entered into a performance-based restricted stock unit program with selected employees of the Company. Under the program, the Company established a targeted restricted stock unit award for selected employees, which would be earned only if the Company achieved targeted levels of total shareholder return during 2012 to 2015. The first type of award is an annual award following the end of each of the four years in the program, with the award subject to and based on the achievement of total return targets during the previous year. The second type of award is an award based on achieving a targeted average total return during the cumulative four-year period 2012-2015. In the event the total annual return is not met for an annual award, the shares allocated for award for such year are added to the shares that may be received if the four-year target is met. Both types of restricted stock unit awards vest in three equal annual installments beginning one year from the date of award. Up to approximately 38,284 restricted stock units would be granted for each of the four years assuming achievement was met and up to approximately 310,880 restricted stock units would be granted for the cumulative four-year period assuming achievement was met. Included in net compensation expense is $1.0 million and $2.9 million related to this performance-based restricted stock unit program during the three and nine months ended September 30, 2012.

Included in the Company s consolidated statements of income for the three months ended September 30, 2012 and 2011, was $98,000 and $113,000, respectively, in net compensation expense related to stock options. Net compensation expense of $321,000 and $375,000 related to stock options was recognized during the nine months ended September 30, 2012 and 2011, respectively. Net compensation expense of $1.2 million and $241,000 related to restricted stock units was recognized during the three months ended September 30, 2012 and 2011, respectively. Net compensation expense of $3.5 million and $729,000 related to restricted stock units was recognized during the nine months ended September 30, 2012 and 2011, respectively.

As of September 30, 2012, there was $1.1 million of unamortized compensation expense related to stock options expected to be recognized over a weighted average period of 2.5 years. As of September 30, 2012, there was $25.2 million of unamortized compensation expense related to restricted stock units expected to be recognized over a weighted average period of 6.1 years.

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Cash received from 129,116 stock options exercised during the nine months ended September 30, 2012 was $5.3 million. Cash received from 24,600 stock options exercised during the nine months ended September 30, 2011 was $1.1 million. The aggregate intrinsic value of the stock options exercised during the nine months ended September 30, 2012 and 2011 was $3.2 million and $457,000, respectively.

During the nine months ended September 30, 2012, 20,094 restricted stock units vested; in settlement of these units, 13,248 shares were issued, net of shares applied to income taxes. The aggregate fair value of the shares vested for the nine months ended September 30, 2012 was $1.3 million. During the nine months ended September 30, 2011, 29,890 restricted stock units vested; in settlement of these units, 18,907 shares were issued, net of shares applied to income taxes. The aggregate fair value of the shares vested for the nine months ended September 30, 2011 was $1.7 million.

In May of 2004, the shareholders of the Company approved the issuance of up to 70,000 shares of common stock under the Retirement Plan for Non-Employee Directors (the Director Plan). Under the Director Plan, the Company grants 1,000 shares of common stock for each year served as a director up to a maximum of 5,000 shares issued upon retirement. In December of 2011, the Director Plan was amended to increase the maximum shares from 5,000 shares to 7,000 shares, 1,000 shares of common stock for each year served as a director. Beginning in 2012, all grants of common stock to directors will be under the 2012 Plan. The Company recognizes compensation expense with regards to grants to be issued in the future under the Director Plan. As a result, included in the Company s consolidated statements of income was $67,000 and $26,000 in compensation expense for the three months ended September 30, 2012 and 2011, respectively and $220,000 and $97,000 for the nine months ended September 30, 2012 and 2011, respectively. As of September 30, 2012 and 2011, there was $1.3 million and $242,000, respectively, of unamortized compensation expense related to these shares. In April, 2012, the Company issued 14,000 shares to two directors upon retirement with an aggregate fair value of $956,000. In January, 2011, the Company issued 5,000 shares to a director upon retirement with an aggregate fair value of $290,000.

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

Forward-Looking Statements: Forward-looking statements are made throughout this Quarterly Report on Form 10-Q. For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, the words may, believes, anticipates, plans, expects, seeks, estimates, intends, and similar expressions are intended to ide forward-looking statements. There are a number of important factors that could cause the results of the Company to differ materially from those indicated by such forward-looking statements, including but not limited to: (a) changes in general economic and business conditions; (b) decreases in rental rates or increases in vacancy rates/failure to renew or replace expiring leases; (c) tenant defaults; (d) the effect of the recent credit and financial market conditions; (e) our failure to maintain our status as a real estate investment trust (REIT); (f) the economic health of our tenants; (g) increases in operating costs; (h) casualties to our properties not covered by insurance; (i) the availability and cost of capital; (j) increases in interest rates and its effect on our stock price; (k) other factors discussed under the heading Item 1A. Risk Factors in our annual report on Form 10-K for the year ended December 31, 2011. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by us or any other person that our objectives and plans will be achieved. Moreover, we assume no obligation to update these forward-looking statements to reflect actual results, changes in assumptions or changes in other factors affecting such forward-looking statements, except as required by law.

Overview

As of September 30, 2012, the Company owned and operated 28.2 million rentable square feet of multi-tenant flex, industrial and office properties located in eight states.

The Company focuses on increasing profitability and cash flow aimed at maximizing shareholder value. The Company strives to maintain high occupancy levels while increasing rental rates when market conditions allow, although the Company may decrease rental rates in markets where conditions require. The Company also acquires properties it believes will create long-term value, and from time to time disposes of properties which no longer fit within the Company s strategic objectives or in situations where the Company believes it can optimize cash proceeds. Operating results are driven primarily by income from rental operations and are therefore substantially influenced by rental demand for space within our properties and rental rates.

During the first nine months of 2012, the Company leased 6.1 million square feet of space including 3.1 million square feet of renewals of existing leases and 3.0 million square feet of new leases. Overall, the Company experienced a decrease in rental rates when comparing new rental rates to outgoing rental rates by 5.0%. See further discussion of operating results below.

Critical Accounting Policies and Estimates:

Our accounting policies are described in Note 2 to the consolidated financial statements included in this Form 10-Q. We believe our most critical accounting policies relate to revenue recognition, property acquisitions, allowance for doubtful accounts, impairment of long-lived assets, depreciation, accruals of operating expenses and accruals for contingencies, each of which we discuss below.

Revenue Recognition: The Company must meet four basic criteria before revenue can be recognized: persuasive evidence of an arrangement exists; the delivery has occurred or services rendered; the fee is fixed or determinable; and collectability is reasonably assured. All leases are classified as operating leases. Rental income is recognized on a straight-line basis over the terms of the leases. Straight-line rent is recognized for all tenants with contractual fixed increases in rent that are not included on the Company s credit watch list. Deferred rent receivable represents rental revenue recognized on a straight-line basis in excess of billed rents. Reimbursements from tenants for real estate taxes and other recoverable operating expenses are recognized as rental income in the period the applicable costs are incurred. Property management fees are recognized in the period earned.

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Property Acquisitions: The Company records the purchase price of acquired properties to land, buildings and improvements and intangible assets and liabilities associated with in-place leases (including tenant improvements, unamortized lease commissions, value of above-market and below-market leases, acquired in-place lease values, and tenant relationships, if any) based on their respective estimated fair values. Acquisition-related costs are expensed as incurred.

In determining the fair value of the tangible assets of the acquired properties, management considers the value of the properties as if vacant as of the acquisition date. Management must make significant assumptions in determining the value of assets acquired and liabilities assumed. Using different assumptions in the recording of the purchase cost of the acquired properties would affect the timing of recognition of the related revenue and expenses. Amounts recorded to land are derived from comparable sales of land within the same region. Amounts recorded to buildings and improvements, tenant improvements and unamortized lease commissions are based on current market replacement costs and other market rate information.

The value recorded to the above-market or below-market in-place lease values of acquired properties is determined based upon the present value (using a discount rate which reflects the risks associated with the acquired leases) of the difference between (i) the contractual rents to be paid pursuant to the in-place leases, and (ii) management s estimate of fair market lease rates for the corresponding in-place leases, measured over a period equal to the remaining non-cancelable term of the lease. The amounts recorded to above-market or below-market leases are included in other assets or other liabilities in the accompanying consolidated balance sheets and are amortized on a straight-line basis as an increase or reduction of rental income over the remaining non-cancelable term of the respective leases.

Allowance for Doubtful Accounts: Rental revenue from our tenants is our principal source of revenue. We monitor the collectability of our receivable balances including the deferred rent receivable on an ongoing basis. Based on these reviews, we maintain an allowance for doubtful accounts for estimated losses resulting from the possible inability of our tenants to make required rent payments to us. Tenant receivables and deferred rent receivables are carried net of the allowances for uncollectible tenant receivables and deferred rent. As discussed below, determination of the adequacy of these allowances requires significant judgments and estimates. Our estimate of the required allowance is subject to revision as the factors discussed below change and is sensitive to the effect of economic and market conditions on our tenants.

Tenant receivables consist primarily of amounts due for contractual lease payments, reimbursements of common area maintenance expenses, property taxes and other expenses recoverable from tenants. Determination of the adequacy of the allowance for uncollectible current tenant receivables is performed using a methodology that incorporates specific identification, aging analysis, an overall evaluation of the historical loss trends and the current economic and business environment. The specific identification methodology relies on factors such as the age and nature of the receivables, the payment history and financial condition of the tenant, the assessment of the tenant s ability to meet its lease obligations, and the status of negotiations of any disputes with the tenant. The allowance also includes a reserve based on historical loss trends not associated with any specific tenant. This reserve as well as the specific identification reserve is reevaluated quarterly based on economic conditions and the current business environment.

Deferred rent receivable represents the amount that the cumulative straight-line rental income recorded to date exceeds cash rents billed to date under the lease agreement. Given the long-term nature of these types of receivables, determination of the adequacy of the allowance for unbilled deferred rent receivable is based primarily on historical loss experience. Management evaluates the allowance for unbilled deferred rent receivable using a specific identification methodology for significant tenants designed to assess their financial condition and ability to meet their lease obligations.

Impairment of Long-Lived Assets: The Company evaluates a property for potential impairment whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. On a quarterly basis, we evaluate our entire portfolio for impairment based on current operating information. In the event that these periodic assessments reflect that the carrying amount of a property exceeds the sum of the undiscounted cash flows (excluding interest) that are expected to result from the use and eventual disposition of the property, the Company would recognize an impairment loss to the extent the carrying amount exceeded the estimated fair value of the property. The estimation of expected future net cash flows is inherently uncertain and relies on subjective assumptions dependent upon future and current market conditions and events that affect the ultimate value of the property. Management must make assumptions related to the property such as future rental rates, tenant allowances, operating expenditures, property taxes, capital improvements, occupancy levels and the estimated proceeds generated from the future sale of the property. These assumptions could differ materially from actual results in future periods. Our intent to hold properties over the long-term directly decreases the likelihood of recording an impairment loss. If our strategy changes or if market conditions otherwise dictate an earlier sale date, an impairment loss could be recognized, and such loss could be material.

Depreciation: We compute depreciation on our buildings and improvements using the straight-line method based on estimated useful lives generally ranging from five to 30 years. A significant portion of the acquisition cost of each property is recorded to building and building components. The recording of the acquisition cost to building and building components, as well as the determination of their useful lives, are based on estimates. If we do not appropriately record to these components or we incorrectly estimate the useful lives of these components, our computation of depreciation expense may not appropriately reflect the actual impact of these costs over future periods, which will affect net income. In addition, the net book value of real estate assets could be overstated or understated. The statement of cash flows, however, would not be affected.

Accruals of Operating Expenses: The Company accrues for property tax expenses, performance bonuses and other operating expenses each quarter based on historical trends and anticipated disbursements. If these estimates are incorrect, the timing and amount of expense recognized will be affected.

Accruals for Contingencies: The Company is exposed to business and legal liability risks with respect to events that may have occurred, but in accordance with U.S. generally accepted accounting principles (GAAP) has not accrued for such potential liabilities because the loss is either not probable or not estimable. Future events could result in such potential losses becoming probable and estimable, which could have a material adverse impact on our financial condition or results of operations.

Effect of Economic Conditions on the Company s Operations: During the first nine months of 2012, while certain markets reflected signs of improved occupancy, overall the Company continued to experience decreases in new rental rates over expiring rental rates on executed leases as a result of continued weak economic conditions. The rate of decrease eased from 8.3% for the year ended December 31, 2011 to 5.0% for the nine months ended September 30, 2012. Although it is uncertain what impact economic conditions will have on the Company s future ability to maintain existing occupancy levels and rental rates, management believes that the decrease in rental rates on lease transactions could result in a decrease in rental income for 2012 compared to 2011. Current and future economic conditions may continue to have a significant impact on the Company, potentially resulting in further reductions in occupancy and rental rates.

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While the Company historically has experienced a low level of write-offs of uncollectable rents, there is inherent uncertainty in a tenant s ability to continue paying rent and meet their full lease obligation. The table below summarizes the impact to the Company from tenants inability to pay rent or continue to meet their lease obligations *(in thousands)*:

	For The Nine Months Ended September 30, 2012	2011
Write offs of uncollectible rent	$ 828	$ 852
Write offs as a percentage of rental income	0.3%	0.4%
Square footage of leases terminated prior to their scheduled expiration due to business failures/bankruptcies	439	400
Accelerated depreciation expense related to unamortized tenant improvements and lease commissions associated with early terminations	$ 1,119	$ 1,081

As of October 29, 2012, the Company had 15,000 square feet of leased space occupied by tenants that are protected by Chapter 11 of the U.S. Bankruptcy Code. From time to time, tenants contact us, requesting early termination of their lease, a reduction in space under lease, or rent deferment or abatement. At this time, the Company cannot anticipate what impact, if any, the ultimate outcome of these discussions will have on our future operating results.

Company Performance and Effect of Economic Conditions on Primary Markets: The Company s operations are substantially concentrated in 10 regions. During the nine months ended September 30, 2012, initial rental rates on new and renewed leases within the Company s overall portfolio decreased 5.0% over expiring rents, an improvement from a decline of 8.3% for the year ended December 31, 2011. The Company s Same Park (defined below) occupancy rate at September 30, 2012 was 92.4%, compared to 91.6% at September 30, 2011. The Company s overall occupancy rate at September 30, 2012 was 88.9%, compared to 89.7% at September 30, 2011. Each of the 10 regions in which the Company owns assets is subject to its own unique market influences. See Supplemental Property Data and Trends below for more information on regional operating data.

Growth of the Company s Operations and Acquisitions and Dispositions of Properties: The Company is focused on maximizing cash flow from its existing portfolio of properties by looking for opportunities to expand its presence in existing and new markets through strategic acquisitions. The Company may from time to time dispose of non-strategic assets that do not meet this criterion. The Company has historically maintained a low-leverage-level approach intended to provide the Company with the greatest level of flexibility for future growth.

On July 24, 2012, the Company acquired a 958,000 square foot industrial park consisting of eight single-story buildings located in Kent Valley, Washington, for a purchase price of $37.6 million.

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As of September 30, 2012, the blended occupancy rate of the ten assets acquired from 2010 thru 2012 was 81.3% compared to a blended occupancy rate of 74.8% at the time of acquisition. As of September 30, 2012, the Company had 1.7 million square feet of vacancy spread over these ten acquisitions which we believe provides the Company with considerable opportunity to generate additional rental income given that the Company s other assets in these same submarkets have a blended occupancy of 94.2% at September 30, 2012. The table below reflects the assets acquired from 2010 thru 2012 *(in thousands)*:

Property	Date Acquired	Location	Purchase Price	Square Feet	Occupancy at Acquisition	Occupancy at September 30, 2012
212th Business Park	July, 2012	Kent Valley, Washington	$ 37,550	958	52.3%	52.3%
Northern Californi Portfolio	December, 2011	East Bay, California	520,000	5,334	82.2%	85.0%
Royal Tech	October, 2011	Las Colinas, Texas	2,835	80	0.0%	100.0%
MICC Center 22	August, 2011	Miami, Florida	3,525	46	33.3%	33.3%
Warren Building	June, 2011	Tysons Corner, Virginia	27,100	140	68.0%	83.7%
Westpark Business Campus	December, 2010	Tysons Corner, Virginia	140,000	735	61.9%	73.6%
Tysons Corporate Center	July, 2010	Tysons Corner, Virginia	35,400	270	47.0%	81.8%
Parklawn Business Park	June, 2010	Rockville, Maryland	23,430	232	70.6%	87.0%
Austin Flex Portfolio	April, 2010	Austin, Texas	42,900	704	88.0%	93.1%
Shady Grove Executive Center	March, 2010	Rockville, Maryland	60,000	350	73.5%	94.7%
Total			**$ 892,740**	**8,849**	**74.8%**	**81.3%**

In August, 2011, the Company completed the sale of Westchase Corporate Park, a 177,000 square foot flex park consisting of 13 buildings in Houston, Texas, for a gross sales price of $9.8 million, resulting in a net gain of $2.7 million.

Subsequent to September 30, 2012, the Company completed the sale of Quail Valley Business Park, a 66,000 square foot flex park in Houston, Texas, for $2.3 million.

Scheduled Lease Expirations: In addition to the 3.1 million square feet, or 11.1%, of space available in our total portfolio as of September 30, 2012, 523 leases representing 6.2% of the leased square footage of our total portfolio or 6.2% of annualized rental income are scheduled to expire during the remainder of 2012. Our ability to re-lease available space will depend upon market conditions in the specific submarkets in which our properties are located. As a result, we cannot predict with certainty the rate at which expiring leases will be re-leased.

Impact of Inflation: Although inflation has not been significant in recent years, it remains a potential factor in our economy, and the Company continues to seek ways to mitigate its potential impact. A substantial portion of the Company s leases require tenants to pay operating expenses, including real estate taxes, utilities, and insurance, as well as increases in common area expenses, partially reducing the Company s exposure to inflation.

Concentration of Portfolio by Region: The table below reflects the Company s square footage from continuing operations based on regional concentration as of September 30, 2012 *(in thousands)*:

Region	Square Footage	Percent of Total
California		
Northern California	7,153	25.4%
Southern California	3,988	14.2%
Virginia	4,165	14.8%
Florida	3,717	13.2%
Texas		
Northern Texas	1,769	6.3%
Southern Texas	1,491	5.3%
Maryland	2,352	8.4%

Washington	1,479	5.3%
Oregon	1,314	4.7%
Arizona	679	2.4%
Total Square Footage	28,107	100.0%

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Concentration of Credit Risk by Industry: The information below depicts the industry concentration of our tenant base as of September 30, 2012. The Company analyzes this concentration to minimize significant industry exposure risk.

Industry	**Percent of Annualized Rental Income**
Business services	14.9%
Health services	11.3%
Government	10.5%
Computer hardware, software and related services	10.4%
Warehouse, distribution, transportation and logistics	9.5%
Insurance and financial services	6.1%
Engineering and construction	5.6%
Retail, food and automotive	5.4%
Communications	4.7%
Aerospace/defense products and services	3.3%
Electronics	3.3%
Home furnishings	3.2%
Educational services	1.8%
Other	10.0%
Total	100.0%

The information below depicts the Company s top 10 customers by annualized rental income as of September 30, 2012 *(in thousands)*:

Tenants	**Square Footage**	**Annualized Rental Income (1)**	**Percent of Annualized Rental Income**
U.S. Government	856	$ 19,737	5.5%
Lockheed Martin Corporation	176	4,971	1.4%
Kaiser Permanente	199	4,167	1.2%
Level 3 Communication	197	3,741	1.0%
Luminex Corporation	149	2,270	0.6%
Wells Fargo	120	2,214	0.6%
Keeco LLC.	280	1,995	0.6%
AARP	102	1,797	0.5%
ATS Corporation	58	1,778	0.5%
JP Morgan	102	1,664	0.5%
Total	2,239	$ 44,334	12.4%

(1) For leases expiring prior to December 31, 2012, annualized rental income represents income to be received under existing leases from October 1, 2012 through the date of expiration.

Comparative Analysis of the Three and Nine Months Ended September 30, 2012 to the Three and Nine Months Ended September 30, 2011

Results of Operations: In order to evaluate the performance of the Company s portfolio over comparable periods, management analyzes the operating performance of properties owned and operated throughout both periods (herein referred to as Same Park). Effective January 1, 2012, the Company revised its Same Park definition to include all operating properties owned or acquired prior to January 1, 2010. We believe that this will provide the most meaningful perspective on how our assets are performing period to period, while not inflating comparative growth results with the continued lease-up of recently acquired assets. Operating properties that the Company acquired subsequent to January 1, 2010 are referred to as Non-Same Park. For the three and nine months ended September 30, 2012 and 2011, the Same Park facilities constitute 19.2 million rentable square feet, representing 68.1% of the 28.2 million square feet in the Company s portfolio as of September 30, 2012.

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Rental income, cost of operations and rental income less cost of operations, excluding depreciation and amortization, or net operating income (defined as NOI for purposes of the following tables), are summarized for the three and nine months ended September 30, 2012 and 2011. The Company uses NOI and its components as a measurement of the performance of its commercial real estate. Management believes that these financial measures provide them, as well as the investor, the most consistent measurement on a comparative basis of the performance of the commercial real estate and its contribution to the value of the Company. Depreciation and amortization have been excluded from NOI as they are generally not used in determining the value of commercial real estate by management or the investment community. Depreciation and amortization are generally not used in determining value as they consider the historical costs of an asset compared to its current value; therefore, to understand the effect of the assets historical cost on the Company s results, investors should look at GAAP financial measures, such as total operating costs including depreciation and amortization. The Company s calculation of NOI may not be comparable to those of other companies and should not be used as an alternative to measures of performance calculated in accordance with GAAP. As part of the tables below, we have reconciled total NOI to income from continuing operations, which we consider the most directly comparable financial measure calculated in accordance with GAAP.

The following table presents the operating results of the Company s properties for the three and nine months ended September 30, 2012 and 2011 in addition to other income and expense items affecting income from continuing operations *(in thousands, except per square foot data)*:

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,		
	2012	2011	Change	2012	2011	Change
Rental income:						
Same Park (19.2 million rentable square feet) [1]	$ 63,342	$ 65,925	(3.9%)	$ 189,814	$ 193,264	(1.8%)
Non-Same Park (8.9 million rentable square feet)	23,678	10,538	124.7%	67,510	29,630	127.8%
Total rental income	87,020	76,463	13.8%	257,324	222,894	15.4%
Cost of operations:						
Same Park	21,190	20,925	1.3%	62,141	63,301	(1.8%)
Non-Same Park	8,104	3,853	110.3%	22,985	11,288	103.6%
Total cost of operations	29,294	24,778	18.2%	85,126	74,589	14.1%
Net operating income:						
Same Park [2]	42,152	45,000	(6.3%)	127,673	129,963	1.8%
Non-Same Park	15,574	6,685	133.0%	44,525	18,342	142.7%
Total net operating income	57,726	51,685	11.7%	172,198	148,305	16.1%
Other income and (expenses):						
Facility management fees	159	170	(6.5%)	489	517	(5.4%)
Interest and other income	37	37		160	174	(8.0%)
Interest expense	(5,172)	(1,261)	310.2%	(15,733)	(3,621)	334.5%
Depreciation and amortization	(26,884)	(21,382)	25.7%	(81,326)	(63,100)	28.9%
General and administrative	(2,240)	(1,365)	64.1%	(6,925)	(4,683)	47.9%
Income from continuing operations	$ 23,626	$ 27,884	(15.3%)	$ 68,863	$ 77,592	(11.2%)
Same Park gross margin [3]	66.5%	66.8%	(0.4%)	67.3%	66.7%	0.9%
Same Park weighted average occupancy	91.9%	90.9%	1.1%	92.0%	91.0%	1.1%
Non-Same Park weighted average occupancy	82.0%	76.1%	7.8%			