ARDEN REALTY INC
Form 10-Q
May 10, 2004

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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 March 31, 2004

Commission file number 1-12193

ARDEN REALTY, INC.

(Exact name of registrant as specified in its charter)

Maryland	**95-4578533**
(State or other jurisdiction of incorporation or organization)	(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 [x] No [ ]

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

Yes [x] No [ ]

As of May 5, 2004 there were 65,504,754 shares of the registrant s common stock, $.01 par value, issued and outstanding.

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Part I. FINANCIAL INFORMATION

Item 1. Financial Statements

Arden Realty, Inc.

Consolidated Balance Sheets
(in thousands, except share amounts)

	March 31, 2004	December 31, 2003
	(unaudited)	
Assets		
Investment in real estate:		
Land	$ 467,216	$ 467,216
Buildings and improvements	2,123,691	2,122,216
Tenant improvements and leasing commissions	347,075	345,604
	2,937,982	2,935,036
Less: accumulated depreciation and amortization	(465,799)	(455,261)
	2,472,183	2,479,775
Properties under development	77,778	75,627
Land available for development	23,731	23,723
Properties held for disposition, net	8,103	67,574
Net investment in real estate	2,581,795	2,646,699
Cash and cash equivalents	11,784	4,707
Restricted cash	21,030	19,694
Rent and other receivables, net of allowance of $3,956 and $4,041 at March 31, 2004 and December 31, 2003, respectively	5,745	3,688
Deferred rent, net of allowance of $2,178 and $2,216 at March 31, 2004 and December 31, 2003, respectively	43,508	44,203
Prepaid financing costs, expenses and other assets, net of accumulated amortization of $14,767 and $13,781 at March 31, 2004 and December 31, 2003, respectively	20,984	22,442
Total assets	$2,684,846	$2,741,433
Liabilities		
Mortgage loans payable	$ 563,377	$ 564,829
Unsecured lines of credit	96,000	161,000

Unsecured term loan	125,000	125,000
Unsecured senior notes, net of discount	501,005	498,952
Accounts payable and accrued expenses	60,633	54,317
Security deposits	22,484	22,321
Dividends payable	33,080	32,535
Total liabilities	1,401,579	1,458,954
Minority interest	71,546	72,194
Stockholders Equity		
Preferred stock, $.01 par value, 20,000,000 shares authorized, none issued		
Common stock, $.01 par value, 100,000,000 shares authorized, 65,504,754 and 64,425,450 issued and outstanding at March 31, 2004 and December 31, 2003, respectively	656	646
Additional paid-in capital	1,234,911	1,225,192
Deferred compensation	(15,197)	(14,952)
Accumulated other comprehensive loss	(8,649)	(601)
Total stockholders equity	1,211,721	1,210,285
Total liabilities and stockholders equity	$2,684,846	$2,741,433

See accompanying notes to consolidated financial statements.

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Arden Realty, Inc.

Consolidated Statements of Income
(in thousands, except per share data)
(unaudited)

	Three Months Ended March 31, 2004	Three Months Ended March 31, 2003
Property revenues	$104,479	$100,976
Property operating expenses	34,097	31,343
	70,382	69,633
General and administrative expenses	4,484	3,590
Interest expense	23,313	23,035
Depreciation and amortization	30,276	28,408
Interest and other income, net	(766)	(104)
Income from continuing operations before minority interest	13,075	14,704
Minority interest	(1,382)	(1,438)
Income from continuing operations	11,693	13,266
Discontinued operations, net of minority interest	739	2,811
Gain (loss) on sale of discontinued properties	6,429	(639)
Net income	$ 18,861	$ 15,438
Basic net income per common share:		
Income from continuing operations	$ 0.18	$ 0.21
Income from discontinued operations	0.11	0.03
Net income per common share- basic	$ 0.29	$ 0.24
Weighted average number of common shares basic	64,813	63,040
Diluted net income per common share:		
Income from continuing operations	$ 0.18	$ 0.21
Income from discontinued operations	0.11	0.03

Net income per common share- diluted	$ 0.29	$ 0.24
Weighted average number of common shares- diluted	$ 65,228	$ 63,126

See accompanying notes to consolidated financial statements.

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Arden Realty, Inc.

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

	Three Months Ended March 31, 2004	Three Months Ended March 31, 2003
Operating Activities:		
Net income	$ 18,861	$ 15,438
Adjustments to reconcile net income to net cash provided by operating activities:		
Minority interest, including discontinued operations	1,568	1,498
(Gain) loss on sale of discontinued properties	(6,429)	639
Depreciation and amortization, including discontinued operations	30,332	29,622
Amortization of loan costs	1,079	946
Non-cash compensation expense	746	389
Changes in operating assets and liabilities:		
Rent and other receivables	(2,057)	(642)
Deferred rent	(1,637)	(118)
Prepaid financing costs, expenses and other assets	(533)	(1,494)
Accounts payable and accrued expenses	1,641	3,280
Security deposits	271	(128)
Net cash provided by operating activities	43,842	49,430
Investing Activities:		
Improvements to commercial properties	(24,786)	(19,482)
Proceeds from sale of properties	67,884	31,943
Net cash provided by investing activities	43,098	12,461
Financing Activities:		
Repayments of mortgage loans	(1,452)	(749)
Proceeds from unsecured lines of credit	40,000	36,500
Repayments of unsecured lines of credit	(105,000)	(49,500)
Proceeds from issuance of common stock	22,391	64
Distributions to preferred operating partnership unit holders	(1,078)	(1,078)
Increase in restricted cash	(1,336)	(3,090)
Distributions to minority interests	(853)	(867)
Dividends paid	(32,535)	(31,806)

Net cash used in financing activities	(79,863)	(50,526)
Net increase in cash and cash equivalents	7,077	11,365
Cash and cash equivalents at beginning of period	4,707	4,063
Cash and cash equivalents at end of period	$ 11,784	$ 15,428
Supplemental Disclosure of Cash Flow Information:		
Cash paid during the period for interest, net of amounts capitalized	$ 22,032	$ 23,555

See accompanying notes to consolidated financial statements.

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Arden Realty, Inc.

Notes to Consolidated Condensed Financial Statements
March 31, 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 March 31, 2004, our portfolio was comprised of 128 primarily suburban office properties, consisting of 210 buildings with approximately 18.6 million net rentable square feet, including one development project with approximately 283,000 net rentable square feet currently under lease-up. As of March 31, 2004, our operating portfolio was 88.7% occupied.

The minority interests at March 31, 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 do not have any unconsolidated investments other than an investment in the securities of a non-publicly traded company. This investment represents approximately 2.9% of the total equity outstanding for this particular company as of the date of this report. (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

On February 4, 2004, we sold an approximate 133,000 square foot retail property located in Riverside County for a sales price of approximately $17.0 million. The terms of this sale included an approximate $800,000 guarantee for the future rent and retenanting costs, if necessary, for certain tenants in this property. In addition, we recorded a $400,000 environmental reserve related to the future completion of an environmental review. We recognized this sale net of the guarantee and environmental reserve and will record any subsequent amounts recovered over the next twelve months.

On March 16, 2004, we sold an approximate 162,000 square foot office property located in Los Angeles County for a gross sales price of approximately $52.5 million.

The net proceeds from these dispositions were used to reduce the outstanding balance on our Wells Fargo unsecured line of credit.

4. Non-Real Estate Investments

Included in our other assets balance at March 31, 2004 is a 2.7 million passive investment in the securities of a non-publicly traded company formed in 2000 to provide distributed energy generation to commercial real estate owners. On March 8, 2004, we received information from the company that they are currently assessing their business and financing strategies. The ultimate outcome of their analysis on the company s operations and the recoverability of our investment is currently uncertain. No adjustments have been made in these financial statements as a result of this uncertainty.

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5. Outstanding Indebtedness

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

Type of Debt	March 31, 2004	December 31, 2003	Stated Annual Interest Rate at March 31, 2004	Rate Fixed/Floating	Number of Properties Securing Loan	Maturity
	(in thousands)					
Mortgage Loans Payable:						
Fixed Rate						
Mortgage Financing I[(1),(2)]	$ 175,000	$ 175,000	7.52%	Fixed	18	6/04
Mortgage Financing III[(3)]	134,159	134,544	6.74%	Fixed	22	4/08
Mortgage Financing IV[(3)]	109,654	109,960	6.61%	Fixed	12	4/08
Mortgage Financing V[(3)]	105,306	105,899	6.94%	Fixed	12	4/09
Mortgage Financing VI[(3)]	21,533	21,578	7.54%	Fixed	3	4/09
Activity Business Center[(3)]	7,364	7,394	8.85%	Fixed	1	5/06
145 South Fairfax[(3)]	3,901	3,912	8.93%	Fixed	1	1/27
Marin Corporate Center[(3)]	2,690	2,724	9.00%	Fixed	1	7/15
Conejo Business Center[(3)]	2,636	2,669	8.75%	Fixed	(Note 4)	7/15
Conejo Business Center[(3)]	1,134	1,149	7.88%	Fixed	(Note 4)	7/15
	563,377	564,829				
Unsecured Lines of Credit:						
Floating Rate						
Wells Fargo - $310 mm[(1)]	86,000	158,000	3.25%	LIBOR + 1.00% (Notes 5,6)		4/06
City National Bank - $20 mm[(1)]	10,000	3,000	2.13%	(Note 7)		8/04

	96,000	161,000			
Unsecured Term Loan:					
Fixed Rate					
Wells Fargo - $125 mm[1]	125,000	125,000	4.14%	Fixed (Note 8)	6/06
Unsecured Senior Notes:					
Fixed Rate					
2005 Notes[9]	199,897	199,872	8.88%	Fixed	3/05
2007 Notes[9]	151,903	149,907	7.00%	(Note 10)	11/07
2010 Notes[9]	49,755	49,744	9.15%	Fixed	3/10
2010 Notes[9]	99,450	99,429	8.50%	Fixed	11/10
	501,005	498,952			
Total Debt	$1,285,382	$1,349,781			

(1) Requires monthly payments of interest only, with outstanding principal balance due upon maturity.

(2) This mortgage financing was repaid in full on April 9, 2004 with proceeds from our unsecured lines of credit.

(3) Requires monthly payments of principal and interest.

(4) Both mortgage loans are secured by the Conejo Business Center property.

(5) This line of credit also has an annual 20 basis point facility fee on the entire $310 million commitment amount.

(6) In 2002, we entered into interest rate swap agreements that fixed the interest rate on $50 million of the outstanding balance on this line of credit at 4.06% 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 at approximately 3.64% in 2003, 4.25% in 2004, 4.75% in 2005 and 4.90% 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 5.32% as of March 31, 2004.

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 March 31, 2004 are classified as cash flow hedges with their fair value of approximately $8.6 million reported in accumulated other comprehensive loss 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 $2.5 million reported in both the unsecured senior notes and prepaid financing costs, expenses and other assets 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.

During the three months ended March 31, 2004, we issued a total of 1,023,304 common shares relating to exercises of stock options.

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On February 27, 2004, we issued a total of 38,000 restricted stock awards to several key executive officers and employees. Holders of these shares have full voting rights and will receive any dividends but are prohibited from selling or transferring unvested shares. The fair market value on the date of the grant for these restricted shares was $31.60. These restricted shares vest equally over three years.

On March 18, 2004, we declared a quarterly dividend of $0.505 per share to stockholders of record on March 31, 2004. For the three months ended March 31, 2003, we declared a quarterly dividend of $0.505 per share.

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):

	Three Months Ended March 31,	
	2004	**2003**
Revenue from Rental Operations:		
Scheduled cash rents	$ 90,532	$ 88,170
Straight-line rents	892	379
Tenant reimbursements	4,753	6,037
Parking, net of expenses	5,700	5,123
Other rental operations	2,602	1,267
	104,479	100,976
Property Expenses:		
Repairs and maintenance	11,341	10,038
Utilities	7,567	7,883
Real estate taxes	8,021	7,276
Insurance	2,061	2,074
Ground rent	125	42
Administrative	4,982	4,030
	34,097	31,343
	$ 70,382	$ 69,633

9. Income 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, in our consolidated statements of income from general and administrative expenses to interest and other income, net. Nextedge provides energy consulting services to commercial real estate owners. The following is a breakdown of the components of interest and other income, net, for each of the periods presented (in thousands):

	Three Months Ended March 31,	
	2004	**2003**
Net income (loss) from TRS	$ 638	$ (28)
Interest and other income	128	132
	$ 766	$ 104

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 March 31 2004 and March 31, 2003, we expensed approximately $8,000 of stock option based employee compensation costs.

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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):

	Three Months Ended March 31,	
	2004	**2003**
Net income available to common stockholders, as reported	$18,861	$15,438
Stock based employee compensation costs for options granted prior to 2003 assuming fair value method	(77)	(264)
Net income available to common stockholders, as adjusted	$18,784	$15,174
Earnings per share:		
Basic as reported	$ 0.29	$ 0.24
Basic as adjusted	$ 0.29	$ 0.24
Diluted as reported	$ 0.29	$ 0.24
Diluted as adjusted	$ 0.29	$ 0.24

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):

	Three Months Ended March 31,	
	2004	**2003**
Net income	$18,861	$15,438
Other comprehensive loss:		
Unrealized derivative loss on cash flow hedges	(8,048)	(1,097)

Comprehensive income	$10,813	$14,341

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 March 31, 2004.

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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 12 to 34 years and who collectively have an average of 18 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 March 31, 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 18.6 million net rentable square feet, including one development project with approximately 283,000 net rentable square feet currently under lease-up. As of March 31, 2004 and March 31, 2003, our operating portfolio was 88.7% and 89.7% 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 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 expe