

Hudson Pacific Properties, Inc.
Form 10-Q
August 08, 2012
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UNITED STATES
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 quarterly period ended June 30, 2012

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 001-34789

Hudson Pacific Properties, Inc.
(Exact name of Registrant as specified in its charter)

Maryland (State or other jurisdiction of incorporation or organization) 11601 Wilshire Blvd., Suite 1600 Los Angeles, California (Address of principal executive offices) (310) 445-5700 (Registrant's telephone number, including area code) (Former name, former address and former fiscal year if changed since last report)	27-1430478 (I.R.S. Employer Identification Number) 90025 (Zip Code)
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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No .

Indicate by check mark whether the registrant 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No .

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

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input checked="" type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input type="checkbox"/>

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

The number of shares of common stock outstanding at August 1, 2012 was 47,219,875.

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PART I—FINANCIAL INFORMATION

HUDSON PACIFIC PROPERTIES, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	June 30, 2012 (Unaudited)	December 31, 2011
ASSETS		
REAL ESTATE ASSETS		
Land	\$387,890	\$368,608
Building and improvements	688,735	601,812
Tenant improvements	67,684	69,021
Furniture and fixtures	11,624	11,536
Property under development	10,628	9,527
Total real estate held for investment	1,166,561	1,060,504
Accumulated depreciation and amortization	(68,539)	(53,329)
Investment in real estate, net	1,098,022	1,007,175
Cash and cash equivalents	102,525	13,705
Restricted cash	10,241	9,521
Accounts receivable, net	10,371	8,963
Straight-line rent receivables	13,274	10,801
Deferred leasing costs and lease intangibles, net	77,784	84,131
Deferred finance costs, net	4,800	5,079
Interest rate contracts	172	164
Goodwill	8,754	8,754
Prepaid expenses and other assets	14,234	4,498
TOTAL ASSETS	\$1,340,177	\$1,152,791
LIABILITIES AND EQUITY		
Notes payable	\$350,332	\$399,871
Accounts payable and accrued liabilities	13,924	12,469
Below-market leases	30,100	22,861
Security deposits	6,215	5,651
Prepaid rent	9,982	10,795
TOTAL LIABILITIES	410,553	451,647
6.25% series A cumulative redeemable preferred units of the Operating Partnership	12,475	12,475
EQUITY		
Hudson Pacific Properties, Inc. stockholders' equity:		
Preferred stock, \$0.01 par value, 10,000,000 authorized; 8.375% series B cumulative redeemable preferred stock, \$25.00 liquidation preference, 5,800,000 shares and 3,500,000 shares outstanding at June 30, 2012 and December 31, 2011, respectively	145,000	87,500
Common Stock, \$0.01 par value 490,000,000 authorized, 47,218,151 shares and 33,840,854 shares outstanding at June 30, 2012 and December 31, 2011, respectively	472	338
Additional paid-in capital	735,872	552,043
Accumulated other comprehensive (deficit) income	(1,215)	(883)
Accumulated deficit	(21,383)	(13,685)
Total Hudson Pacific Properties, Inc. stockholders' equity	858,746	625,313
Non-controlling common units in the Operating Partnership	58,403	63,356

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TOTAL EQUITY	917,149	688,669
TOTAL LIABILITIES AND EQUITY	\$1,340,177	\$1,152,791

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

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HUDSON PACIFIC PROPERTIES, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(in thousands, except share and per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Revenues				
Office				
Rental	\$22,591	\$17,821	\$44,971	\$35,335
Tenant recoveries	5,593	4,962	10,973	9,925
Parking and other	2,450	1,253	4,558	4,408
Total office revenues	30,634	24,036	60,502	49,668
Media & entertainment				
Rental	5,805	5,592	11,256	11,072
Tenant recoveries	417	516	665	859
Other property-related revenue	3,697	3,242	6,321	6,513
Other	62	21	102	99
Total media & entertainment revenues	9,981	9,371	18,344	18,543
Total revenues	40,615	33,407	78,846	68,211
Operating expenses				
Office operating expenses	13,778	9,533	25,134	19,807
Media & entertainment operating expenses	6,289	5,771	11,059	10,950
General and administrative	4,151	3,062	8,665	6,208
Depreciation and amortization	13,708	10,626	25,840	21,987
Total operating expenses	37,926	28,992	70,698	58,952
Income from operations	2,689	4,415	8,148	9,259
Other expense (income)				
Interest expense	4,575	4,530	9,466	9,172
Interest income	(2)	(23)	(7)	(31)
Acquisition-related expenses	299	—	360	—
Other expenses (income)	46	118	90	235
	4,918	4,625	9,909	9,376
Net loss	(2,229)	(210)	(1,761)	(117)
Less: Net income attributable to preferred stock and units	(3,231)	(2,027)	(6,462)	(4,054)
Less: Net income attributable to restricted shares	(79)	(62)	(157)	(124)
Less: Net (income) loss attributable to non-controlling interest in consolidated real estate entities	—	10	—	(803)
Add: Net loss attributable to common units in the Operating Partnership	322	188	525	487
Net loss attributable to Hudson Pacific Properties, Inc. shareholders	\$(5,217)	\$(2,101)	\$(7,855)	\$(4,611)
Net loss attributable to shareholders' per share - basic and diluted	\$(0.13)	\$(0.07)	\$(0.21)	\$(0.18)
Weighted average shares of common stock outstanding - basic and diluted	39,772,030	29,161,139	36,546,240	25,575,051
Dividends declared per common share	0.1250	0.1250	0.5000	0.5000

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

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HUDSON PACIFIC PROPERTIES, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited)
(in thousands, except share and per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net loss	\$(2,229)	\$(210)	\$(1,761)	\$(117)
Other comprehensive loss: cash flow hedge adjustment	(262)	(359)	(353)	(499)
Comprehensive loss	(2,491)	(569)	(2,114)	(616)
Less: Comprehensive income attributable to preferred stock and units	(3,231)	(2,027)	(6,462)	(4,054)
Less: Comprehensive income attributable to restricted shares	(79)	(62)	(157)	(124)
Less: Comprehensive (income) loss attributable to non-controlling interest in consolidated real estate entities	—	10	—	(803)
Less: Comprehensive loss attributable to common units in the Operating Partnership	337	217	546	531
Comprehensive loss attributable to Hudson Pacific Properties, Inc. shareholders	(5,464)	(2,431)	(8,187)	(5,066)

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

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HUDSON PACIFIC PROPERTIES, INC.
CONSOLIDATED STATEMENTS OF EQUITY
(Unaudited)
(in thousands, except share and per share amounts)

Hudson Pacific Properties Inc., Stockholders' Equity										
	Common Shares	Stock Amount	Series B Cumulative Redeemable Preferred Stock	Additional Paid in Capital	Accumulated Deficit	Accumulated Other Comprehensive (Deficit) Income	Non- controlling Interests — Common units in the Operating Partnership	Total Equity	Non- controlling Interests — Series A Cumulative Redeemable Preferred Units	Non- controlling Interests — Interests in Consolidated Entities
Balance, January 1, 2011	22,436,950	\$ 224	\$ 87,500	\$ 411,598	\$(3,482)	\$ 6	\$ 65,684	\$ 561,530	\$ 12,475	\$ 40,328
Contributions				—				—		
Distributions				(452)				(452)		(41,131)
Proceeds from sale of common stock, net of underwriters discount	7,992,500	80		110,928				111,008		
Proceed from private placement	3,125,000	31		45,657				45,688		
Common stock issuance transaction costs				(712)				(712)		
Series B stock issuance transaction costs				(600)				(600)		
Issuance of restricted stock	36,305	1		(1)				—		
Forfeiture of restricted stock Shares repurchased	(7,535)							—		
	(12,378)							—		
Declared Dividend			(3,664)	(7,004)			(652)	(11,320)	(390)	
Amortization of stock based compensation				1,313				1,313		
Net income (loss)			3,664		(4,487)		(487)	(1,310)	390	\$ 803
Cash Flow Hedge Adjustment						(455)	(44)	(499)		

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Balance, June 30, 2011 33,570,842 \$ 336 \$ 87,500 \$ 560,727 \$ (7,969) \$ (449) \$ 64,501 \$ 704,646 \$ 12,475 \$ —

Hudson Pacific Properties Inc., Stockholders' Equity

	Common Shares	Stock Amount	Series B Cumulative Redeemable Preferred Stock	Additional Paid in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Deficit)	Non-controlling Interests — Common units in the Operating Partnership	Total Equity	Non-controlling Interests — Series A Cumulative Redeemable Preferred Units
Balance, January 1, 2012	33,840,854	\$ 338	\$ 87,500	\$ 552,043	\$ (13,685)	\$ (883)	\$ 63,356	\$ 688,669	\$ 12,475
Proceeds from sale of common stock, net of underwriters discount	13,225,000	132		190,666				190,798	
Common stock issuance transaction costs				(107)				(107)	
Issuance of Series B Cumulative Redeemable Preferred Stock			57,500					57,500	
Series B stock issuance transaction costs				(1,865)				(1,865)	
Issuance of unrestricted stock	3,748							—	
Issuance of restricted stock	21,567							—	
Shares repurchased	(28,896)			(503)				(503)	
Declared Dividend			(6,072)	(10,158)			(625)	(16,855)	(390)
Amortization of stock based compensation				2,016				2,016	
Net income (loss)			6,072		(7,698)		(525)	(2,151)	390
Cash Flow Hedge Adjustment						(332)	(21)	(353)	
Exchange of Non-controlling Interests — Common units in the Operating Partnership for common stock	155,878	2		3,780			(3,782)	—	
Balance, June 30, 2012	47,218,151	\$ 472	\$ 145,000	\$ 735,872	\$ (21,383)	\$ (1,215)	\$ 58,403	\$ 917,149	\$ 12,475

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

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HUDSON PACIFIC PROPERTIES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(in thousands)

	Six Months Ended June 30,	
	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$(1,761	) \$(117
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	25,840	21,987
Amortization of deferred financing costs and loan premium, net	644	368
Amortization of stock based compensation	2,002	1,313
Straight-line rent receivables	(2,473	) (2,029
Amortization of above-market leases	1,921	1,687
Amortization of below-market leases	(3,010	) (1,901
Amortization of lease incentive costs	45	361
Bad debt expense	406	650
Amortization of ground lease	124	142
Change in operating assets and liabilities:		
Restricted cash	(720	) (4,063
Accounts receivable	(1,916	) (7,558
Deferred leasing costs and lease intangibles	(1,963	) (1,667
Prepaid expenses and other assets	(934	) 259
Accounts payable and accrued liabilities	4,445	2,550
Security deposits	564	391
Prepaid rent	(813	) 2,107
Net cash provided by operating activities	22,401	14,480
CASH FLOWS FROM INVESTING ACTIVITIES		
Additions to investment property	(10,019	) (6,661
Property acquisitions	(93,476) —
Deposits for property acquisitions	(8,900	) (1,575
Net cash used in investing activities	(112,395	) (8,236
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from notes payable	83,000	244,500
Payments of notes payable	(132,158	) (311,030
Proceeds from issuance of common stock	190,798	111,008
Proceeds from private placement of common stock	—	45,688
Common stock issuance transaction costs	(107	) (712
Proceeds from issuance of Series B cumulative redeemable preferred stock	57,500	—
Series B stock issuance transaction costs	(1,865	) (600
Dividends paid to common stock and unit holders	(10,783	) (7,656
Dividends paid to preferred stock and unit holders	(6,462	) (4,054
Distribution to members	—	(93
Acquisition of non-controlling member in consolidated real estate entity	—	(41,131

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Payment of loan costs	(1,109) (4,146)
Net cash provided by financing activities	178,814	31,774	
Net increase in cash and cash equivalents	88,820	38,018	
Cash and cash equivalents-beginning of period	13,705	48,875	
Cash and cash equivalents-end of period	\$102,525	\$86,893	
Supplemental disclosure of cash flow information			
Cash paid for interest, net of amounts capitalized	\$9,054	\$8,103	
Supplemental schedule of noncash investing and financing activities			
Accounts payable and accrued liabilities for investment in property	\$3,031	\$1,966	
Accounts payable and accrued liabilities for distributions to members	\$—	\$359	

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

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Notes to Consolidated Financial Statements

(Unaudited and in thousands, except square footage and share data or as otherwise noted)

1. Organization

Hudson Pacific Properties, Inc. (which is referred to in these financial statements as the “Company,” “we,” “us,” or “our”) is a Maryland corporation formed on November 9, 2009 that did not have any meaningful operating activity until the consummation of our initial public offering and the related acquisition of our predecessor and certain other entities on June 29, 2010 (“IPO”). Concurrently with the closing of our IPO, we combined with our predecessor and Howard Street Associates, LLC and acquired certain other entities.

We have determined that one of the entities comprising our predecessor, SGS Realty II, LLC, was the acquirer for accounting purposes in our formation transactions that occurred in connection with our IPO. In addition, we have concluded that any interests contributed by the controlling member of the other entities comprising our predecessor and Howard Street Associates, LLC in connection with our IPO was a transaction between entities under common control. As a result, the contribution of interests in each of these entities has been recorded at historical cost.

Since the completion of the IPO, the concurrent private placement, and the related formation transactions that occurred on June 29, 2010, we have been a fully integrated, self-administered, and self-managed real estate investment trust (“REIT”). Through our controlling interest in Hudson Pacific Properties, L.P. (our “Operating Partnership”) and its subsidiaries, we own, manage, lease, acquire and develop real estate, consisting primarily of office and media and entertainment properties. As of June 30, 2012, we owned a portfolio of 17 office properties and two media and entertainment properties. All of these properties are located in California. The results of operations for properties acquired after our IPO are included in our consolidated statements of operations from the date of each such acquisition.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements of the Company are prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). The effect of all significant intercompany balances and transactions has been eliminated.

The accompanying unaudited interim financial statements have been prepared pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in the financial statements prepared in accordance with accounting principles generally accepted in the United States may have been condensed or omitted pursuant to SEC rules and regulations, although we believe that the disclosures are adequate to make their presentation not misleading. The accompanying unaudited financial statements include, in our opinion, all adjustments, consisting of normal recurring adjustments, necessary to present fairly the financial information set forth therein. The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the year ended December 31, 2012. The interim financial statements should be read in conjunction with the consolidated financial statements in our 2011 Annual Report on Form 10-K and the notes thereto. Any reference to the number of properties and square footage are unaudited and outside the scope of our independent registered public accounting firm’s review of our financial statements in accordance with the standards of the United States Public Company Accounting Oversight Board.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of commitments and contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, the Company evaluates its estimates, including those related to acquiring, developing and assessing the carrying values of its real estate properties, its accrued liabilities, its performance-based equity compensation awards, and its qualification as a REIT. The Company bases its estimates on historical experience, current market conditions, and various other assumptions that are believed to be reasonable under the circumstances. Actual results could materially differ from these estimates.

Investment in Real Estate Properties

The properties are carried at cost less accumulated depreciation and amortization. The Company accounts for the cost

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Notes to Consolidated Financial Statements—(Continued)

(Unaudited and in thousands, except square footage and share data)

of an acquisition, including the assumption of liabilities, to the acquired tangible assets and identifiable intangible assets and liabilities based on their estimated fair values in accordance with GAAP. The Company assesses fair value based on estimated cash flow projections that utilize discount and/or capitalization rates and available market information. Estimates of future cash flows are based on a number of factors including historical operating results, known and anticipated trends, and market and economic conditions. The fair value of tangible assets of an acquired property considers the value of the property as if it was vacant.

Acquisition-related expenses associated with acquisition of operating properties are expensed in the period incurred.

The Company records acquired “above and below” market leases at fair value using discount rates that reflect the risks associated with the leases acquired. The amount recorded is based on the present value of the difference between (i) the contractual amounts to be paid pursuant to each in-place lease and (ii) management’s estimate of fair market lease rates for each in-place lease, measured over a period equal to the remaining term of the lease for above-market leases and the initial term plus the extended term for any leases with below-market renewal options. Other intangible assets acquired include amounts for in-place lease values that are based on the Company’s evaluation of the specific characteristics of each tenant’s lease. Factors considered include estimates of carrying costs during hypothetical expected lease-up periods, market conditions and costs to execute similar leases. In estimating carrying costs, the Company includes estimates of lost rents at market rates during the hypothetical expected lease-up periods, which are dependent on local market conditions. In estimating costs to execute similar leases, the Company considers leasing commissions, legal and other related costs.

The Company capitalizes direct construction and development costs, including predevelopment costs, interest, property taxes, insurance and other costs directly related and essential to the acquisition, development or construction of a real estate project. Construction and development costs are capitalized while substantial activities are ongoing to prepare an asset for its intended use. The Company considers a construction project as substantially complete and held available for occupancy upon the completion of tenant improvements, but no later than one year after cessation of major construction activity. Costs incurred after a project is substantially complete and ready for its intended use, or after development activities have ceased, are expensed as incurred. Costs previously capitalized related to abandoned acquisitions or developments are charged to earnings. Expenditures for repairs and maintenance are expensed as incurred.

The Company computes depreciation using the straight-line method over the estimated useful lives of a range of 39 years for building and improvements, 15 years for land improvements, 5 or 7 years for furniture and fixtures and equipment, and over the shorter of asset life or life of the lease for tenant improvements. Depreciation is discontinued when a property is identified as held for sale. Above- and below-market lease intangibles are amortized to revenue over the remaining non-cancellable lease terms and bargain renewal periods, if applicable. Other in-place lease intangibles are amortized to expense over the remaining non-cancellable lease term.

Impairment of Long-Lived Assets

The Company assesses the carrying value of real estate assets and related intangibles whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable in accordance with GAAP. Impairment losses are recorded on real estate assets held for investment when indicators of impairment are present and the future undiscounted cash flows estimated to be generated by those assets are less than the assets’ carrying amount. The Company recognizes impairment losses to the extent the carrying amount exceeds the fair value of the properties. Properties held for sale are recorded at the lower of cost or estimated fair value less cost to sell. The

Company did not record any impairment charges related to its real estate assets and related intangibles during the six months ended June 30, 2012 and 2011. There are no properties held for sale at June 30, 2012 or December 31, 2011.

Goodwill

Goodwill represents the excess of acquisition cost over the fair value of net tangible and identifiable intangible assets acquired in business combinations. Our goodwill balance as of June 30, 2012 is \$8,754. We do not amortize this asset but instead analyze it on an annual basis for impairment. No impairment indicators have been noted during the six months ended June 30, 2012 and 2011.

Cash and Cash Equivalents

Cash and cash equivalents are defined as cash on hand and in banks plus all short-term investments with a maturity of three months or less when purchased.

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Notes to Consolidated Financial Statements—(Continued)

(Unaudited and in thousands, except square footage and share data)

The Company maintains some of its cash in bank deposit accounts that, at times, may exceed the federally insured limit. No losses have been experienced related to such accounts.

Restricted Cash

Restricted cash consists of amounts held by lenders to provide for future real estate taxes and insurance expenditures, repairs and capital improvements reserves, general and other reserves and security deposits.

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable consist of amounts due for monthly rents and other charges. The Company maintains an allowance for doubtful accounts for estimated losses resulting from tenant defaults or the inability of tenants to make contractual rent and tenant recovery payments. The Company monitors the liquidity and creditworthiness of its tenants and operators on an ongoing basis. This evaluation considers industry and economic conditions, property performance, credit enhancements and other factors. For straight-line rent amounts, the Company's assessment is based on amounts estimated to be recoverable over the term of the lease. At June 30, 2012, the Company has reserved \$4 of straight-line receivables. The Company evaluates the collectability of accounts receivable based on a combination of factors. The allowance for doubtful accounts is based on specific identification of uncollectible accounts and the Company's historical collection experience. The Company recognizes an allowance for doubtful accounts based on the length of time the receivables are past due, the current business environment and the Company's historical experience. Historical experience has been within management's expectations. The Company recognized \$406 and \$650 of bad debt expense for the six months ended June 30, 2012 and 2011.

Revenue Recognition

The Company recognizes rental revenue from tenants on a straight-line basis over the lease term when collectability is reasonably assured and the tenant has taken possession or controls the physical use of the leased asset. If the lease provides for tenant improvements, the Company determines whether the tenant improvements, for accounting purposes, are owned by the tenant or the Company. When the Company is the owner of the tenant improvements, the tenant is not considered to have taken physical possession or have control of the physical use of the leased asset until the tenant improvements are substantially completed. When the tenant is the owner of the tenant improvements, any tenant improvement allowance that is funded is treated as a lease incentive and amortized as a reduction of revenue over the lease term. Tenant improvement ownership is determined based on various factors including, but not limited to:

- whether the lease stipulates how and on what a tenant improvement allowance may be spent;
- whether the tenant or landlord retains legal title to the improvements at the end of the lease term;
- whether the tenant improvements are unique to the tenant or general-purpose in nature; and
- whether the tenant improvements are expected to have any residual value at the end of the lease.

Certain leases provide for additional rents contingent upon a percentage of the tenant's revenue in excess of specified base amounts or other thresholds. Such revenue is recognized when actual results reported by the tenant, or estimates

of tenant results, exceed the base amount or other thresholds. Such revenue is recognized only after the contingency has been removed (when the related thresholds are achieved), which may result in the recognition of rental revenue in periods subsequent to when such payments are received.

Other property-related revenue is revenue that is derived from the tenants' use of lighting, equipment rental, parking, power, HVAC and telecommunications (phone and internet). Other property-related revenue is recognized when these items are provided.

Tenant recoveries related to reimbursement of real estate taxes, insurance, repairs and maintenance, and other operating expenses are recognized as revenue in the period the applicable expenses are incurred. The reimbursements are recognized and presented gross, as the Company is generally the primary obligor with respect to purchasing goods and services from third-party suppliers, has discretion in selecting the supplier and bears the associated credit risk.

The Company recognizes gains on sales of properties upon the closing of the transaction with the purchaser. Gains on

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Notes to Consolidated Financial Statements—(Continued)

(Unaudited and in thousands, except square footage and share data)

properties sold are recognized using the full accrual method when (i) the collectability of the sales price is reasonably assured, (ii) the Company is not obligated to perform significant activities after the sale, (iii) the initial investment from the buyer is sufficient and (iv) other profit recognition criteria have been satisfied. Gains on sales of properties may be deferred in whole or in part until the requirements for gain recognition have been met.

Deferred Financing Costs

Deferred financing costs are amortized over the term of the respective loan.

Derivative Financial Instruments

The Company manages interest rate risk associated with borrowings by entering into interest rate derivative contracts. The Company recognizes all derivatives on the consolidated balance sheet at fair value. Derivatives that are not hedges are adjusted to fair value and the changes in fair value are reflected as income or expense. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives are either offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings, or recognized in other comprehensive income, which is a component of equity. The ineffective portion of a derivative's change in fair value is immediately recognized in earnings.

The Company held two interest rate contracts as of June 30, 2012, which have been accounted for as cash flow hedges as more fully described in note 6 below. The Company held one interest rate contract at December 31, 2011, which has been accounted for as a cash flow hedge as more fully described in footnote 6 below.

Stock Based Compensation

Accounting Standard Codification, or ASC, Topic 718, Compensation—Stock Compensation (referred to as ASC Topic 718 and formerly known as FASB 123R), requires us to recognize an expense for the fair value of equity-based compensation awards. Grants of stock options, restricted stock, restricted stock units and performance units under our equity incentive award plans are accounted for under ASC Topic 718. Our compensation committee will regularly consider the accounting implications of significant compensation decisions, especially in connection with decisions that relate to our equity incentive award plans and programs.

Income Taxes

Our taxable income prior to the completion of our IPO is reportable by the members of the limited liability companies that comprise our predecessor. Our property-owning subsidiaries are limited liability companies and are treated as pass-through entities for income tax purposes. Accordingly, no provision has been made for federal income taxes in the accompanying consolidated financial statements for the activities of these entities.

We have elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended (the "Code") commencing with our initial taxable year. To qualify as a REIT, we are required to distribute at least 90% of our REIT taxable income to our stockholders and meet the various other requirements imposed by the Code relating to such matters as operating results, asset holdings, distribution levels and diversity of stock ownership. Provided we qualify for taxation as a REIT, we are generally not subject to corporate level income tax on the earnings distributed currently to our stockholders that we derive from our REIT qualifying activities. If we fail to qualify as a REIT in any taxable year, and are unable to avail ourselves of certain savings provisions set forth in the Code, all of our taxable income would

be subject to federal income tax at regular corporate rates, including any applicable alternative minimum tax.

We have elected, together with one of our subsidiaries, to treat such subsidiary as a taxable REIT subsidiary (“TRS”) for federal income tax purposes. Certain activities that we undertake must be conducted by a TRS, such as non-customary services for our tenants, and holding assets that we cannot hold directly. A TRS is subject to federal and state income taxes.

The Company is subject to the statutory requirements of the state in which it conducts business.

The Company periodically evaluates its tax positions to evaluate whether it is more likely than not that such positions would be sustained upon examination by a tax authority for all open tax years, as defined by the statute of limitations, based on their technical merits. As of June 30, 2012, the Company has not established a liability for uncertain tax positions.

Fair Value of Assets and Liabilities

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Notes to Consolidated Financial Statements—(Continued)

(Unaudited and in thousands, except square footage and share data)

Under GAAP, the Company is required to measure certain financial instruments at fair value on a recurring basis. In addition, the Company is required to measure other financial instruments and balances at fair value on a non-recurring basis (e.g., carrying value of impaired real estate and long-lived assets). Fair value is defined as the price that would be received upon the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The GAAP fair value framework uses a three-tiered approach. Fair value measurements are classified and disclosed in one of the following three categories:

Level 1: unadjusted quoted prices in active markets that are accessible at the measurement date for identical assets or liabilities;

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: prices or valuation techniques where little or no market data is available that requires inputs that are both significant to the fair value measurement and unobservable.

When available, the Company utilizes quoted market prices from an independent third-party source to determine fair value and classifies such items in Level 1 or Level 2. In instances where the market for a financial instrument is not active, regardless of the availability of a nonbinding quoted market price, observable inputs might not be relevant and could require the Company to make a significant adjustment to derive a fair value measurement. Additionally, in an inactive market, a market price quoted from an independent third party may rely more on models with inputs based on information available only to that independent third party. When the Company determines the market for a financial instrument owned by the Company to be illiquid or when market transactions for similar instruments do not appear orderly, the Company uses several valuation sources (including internal valuations, discounted cash flow analysis and quoted market prices) and establishes a fair value by assigning weights to the various valuation sources.

Changes in assumptions or estimation methodologies can have a material effect on these estimated fair values. In this regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, may not be realized in an immediate settlement of the instrument.

The Company considers the following factors to be indicators of an inactive market: (i) there are few recent transactions, (ii) price quotations are not based on current information, (iii) price quotations vary substantially either over time or among market makers (for example, some brokered markets), (iv) indexes that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability, (v) there is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the Company's estimate of expected cash flows, considering all available market data about credit and other nonperformance risk for the asset or liability, (vi) there is a wide bid-ask spread or significant increase in the bid-ask spread, (vii) there is a significant decline or absence of a market for new issuances (that is, a primary market) for the asset or liability or similar assets or liabilities, and (viii) little information is released publicly (for example, a principal-to-principal market).

The Company considers the following factors to be indicators of non-orderly transactions: (i) there was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and

customary for transactions involving such assets or liabilities under current market conditions, (ii) there was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant, (iii) the seller is in or near bankruptcy or receivership (that is, distressed), or the seller was required to sell to meet regulatory or legal requirements (that is, forced), and (iv) the transaction price is an outlier when compared with other recent transactions for the same or similar assets or liabilities.

The Company's interest rate contract agreements are classified as Level 2 and their fair value is derived from estimated values obtained from observable market data for similar instruments.

As of June 30, 2012, the Company had the following outstanding interest rate derivatives that were designated as cash flow hedges of interest rate risk:

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Notes to Consolidated Financial Statements—(Continued)

(Unaudited and in thousands, except square footage and share data)

Interest Rate Derivative	Number of Instruments	Notional Amount
Interest Rate Caps	2	\$92.0 million

Non-designated Hedges

For the six months ended June 30, 2012 and 2011, all of the Company's derivatives were designated as cash flow hedges.

Tabular Disclosure of Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the Balance Sheet as of June 30, 2012 and December 31, 2011.

	Asset Derivatives		Liability Derivative			
	Balance Sheet Location	Fair Value as of June 30, 2012	December 31, 2011	Balance Sheet Location	Fair Value as of June 30, 2012	December 31, 2011
Derivatives designated as hedging instruments:						
Interest rate products	Interest rate contracts	\$ 172	\$ 164	Interest rate contracts	—	—
Total		\$ 172	\$ 164		—	—

Tabular Disclosure of the Effect of Derivative Instruments on the Income Statement

The tables below present the effect of the Company's derivative financial instruments on the Statement of Operations for the six months ended June 30, 2012 and 2011.

	Six Months Ended	
	June 30, 2012	2011
Beginning Balance of OCI related to interest rate contracts	960	7
Unrealized Loss Recognized in OCI Due to Change in Fair Value of interest rate contracts	(356)	(559)
Loss Reclassified from OCI into Income (as Interest Expense)	3	60
Net Change in OCI	(353)	(499)
Ending Balance of Accumulated OCI Related to Derivatives	607	(492)

Credit-risk-related Contingent Features

As of June 30, 2012, the Company did not have any derivatives that were in a net liability position.

Recently Issued Accounting Literature

Changes to GAAP are established by the FASB in the form of ASUs. We consider the applicability and impact of all ASUs. Recently issued ASUs not listed below are not expected to have a material impact on our consolidated financial

position and results of operations, because either the ASU is not applicable or the impact is expected to be immaterial.

In June 2011, the FASB issued Accounting Standard Update (ASU) No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income. This ASU requires an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income, or in two separate but consecutive statements. This ASU eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. This ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, which for the Company means the first quarter of 2012. The Company adopted this guidance in the first quarter of 2012 and it did not have an effect on its financial position or results of operations as it only affected presentation.

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Notes to Consolidated Financial Statements—(Continued)

(Unaudited and in thousands, except square footage and share data)

3. Investment in Real Estate

During 2011, we acquired the 604 Arizona property, the 275 Brannan property, the 625 Second Street property, the 6922 Hollywood Boulevard property, and the 6050 Ocean Way/1445 N. Beachwood property. The results of operations for each of these acquisitions are included in our consolidated statements of operations from the date of acquisition. The following table represents our purchase price allocation for these acquisitions:

	604 Arizona	275 Brannan	625 Second Street	6922 Hollywood Boulevard	6050 Ocean Way/1445 N. Beachwood	Total
Date of Acquisition	July 26, 2011	August 19, 2011	September 1, 2011	November 22, 2011	December 12, 2011	
Consideration paid						
Cash consideration	\$21,373	\$12,370	\$23,419	\$50,555	\$6,502	\$114,219
Debt Assumed	—	—	33,700	42,247	—	75,947
Total consideration	\$21,373	\$12,370	\$57,119	\$92,802	\$6,502	\$190,166
Allocation of consideration paid						
Investment in real estate, net	20,366	12,250	53,394	88,999	6,916	181,925
Above-market leases	—	—	465	2,571	—	3,036
Leases in-place	1,121	—	2,799	4,767	—	8,687
Other lease intangibles	117	—	1,286	2,028	—	3,431
Fair market unfavorable debt value	—	—	(490)	(1,600)	—	(2,090)
Below-market leases	(104)	—	(1,054)	(4,265)	(416)	(5,839)
Other (liabilities) asset assumed, net	(127)	120	719	302	2	1,016
Total consideration paid	\$21,373	\$12,370	\$57,119	\$92,802	\$6,502	\$190,166

In addition, we acquired a 51% joint venture interest in the Rincon Center property on December 16, 2010. On April 29, 2011 we acquired the remaining 49% interest in the Rincon Center property for approximately \$38.7 million (before closing costs and prorations).

During 2012, we acquired the 1900 Washington property and the 901 Market Street property. The results of operations for each of these acquisitions are included in our consolidated statements of operations from the date of acquisition. The following table represents our purchase price allocation for each of these acquisitions:

	10900 Washington	901 Market	Total
Date of Acquisition	April 5, 2012	June 1, 2012	
Consideration paid			
Cash consideration	\$2,605	\$90,871	\$93,476
Debt Assumed	—	—	—
Total consideration	\$2,605	\$90,871	\$93,476
Allocation of consideration paid			

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Investment in real estate, net	2,600	96,733	99,333
Above-market leases	—	—	—
Leases in-place	—	2,968	2,968
Other lease intangibles	—	1,002	1,002
Fair market unfavorable debt value	—	—	—
Below-market leases	—	(10,249	) (10,249
Other (liabilities) asset assumed, net	5	417	422
Total consideration paid	\$2,605	\$90,871	\$93,476

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Notes to Consolidated Financial Statements—(Continued)

(Unaudited and in thousands, except square footage and share data)

The table below shows the pro forma financial information for the six months ended June 30, 2012 and 2011 as if these properties had been acquired as of January 1, 2011.

	Six Months Ended June 30,	
	2012	2011
Total revenues	\$81,754	\$80,634
Net loss	\$(3,015	)\$ (1,191

During the six months ended June 30, 2012, we made a deposit of approximately \$8.9 million in connection with a potential acquisition.

4. Lease Intangibles

The following summarizes our deferred leasing cost and lease intangibles as of:

	June 30, 2012	December 31, 2011
Above-market leases	\$18,547	\$18,748
Lease in-place	56,051	53,876
Below-market ground leases	7,513	7,513
Other lease intangibles	29,501	29,245
Lease commissions	642	642
Deferred leasing costs	10,290	7,988
	122,544	118,012
Accumulated amortization	(44,760	) (33,881
Deferred leasing costs and lease intangibles, net	\$77,784	\$84,131
Below-market leases	40,470	30,418
Accumulated accretion	(10,370	) (7,557
Acquired lease intangible liabilities, net	\$30,100	22,861

5. Notes Payable

Senior Secured Revolving Credit Facility

In conjunction with our IPO and formation transactions, we entered into a \$200.0 million secured revolving credit facility with a group of lenders for which an affiliate of Barclays Capital Inc. acts as administrative agent and joint lead arranger and affiliates of Merrill Lynch, Pierce, Fenner & Smith Incorporated act as syndication agent and joint lead arranger. Until it was amended on April 4, 2011, the credit facility bore interest at a rate per annum equal to LIBOR plus 325 basis points to 400 basis points, depending on our leverage ratio, subject to a LIBOR floor of 1.50%. On April 4, 2011, we amended this facility as described more fully in this note below.

The amount available for us to borrow under the facility is subject to the lesser of a percentage of the appraisal value of our properties that form the borrowing base of the facility and a minimum implied debt service coverage ratio. As a result of the April 4, 2011 amendment, the secured revolving credit facility now bears interest at a rate per annum

equal to LIBOR plus 250 basis points to 325 basis points (down from 325 basis points to 400 basis points), depending on our leverage ratio, and is no longer subject to a LIBOR floor of 1.50%. The secured revolving credit facility continues to include an accordion feature that allows us to increase the availability by \$50.0 million, to \$250.0 million, under specified circumstances. Our ability to borrow under the facility is subject to continued compliance with a number of customary restrictive covenants, including:

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Notes to Consolidated Financial Statements—(Continued)

(Unaudited and in thousands, except square footage and share data)

- a maximum leverage ratio (defined as consolidated total indebtedness to total asset value) of 0.60:1.00;
- a minimum fixed charge coverage ratio (defined as consolidated earnings before interest, taxes; depreciation and amortization to consolidated fixed charges) of 1.75:1.00;
- a maximum consolidated floating rate debt ratio (defined as consolidated floating rate indebtedness to total asset value) of 0.25:1.00;
- a maximum recourse debt ratio (defined as recourse indebtedness other than indebtedness under the revolving credit facility but including unsecured lines of credit to total asset value) of 0.15:1.00; and
- a minimum tangible net worth equal to at least 85% of our tangible net worth at the closing of our IPO plus 75% of the net proceeds of any additional equity issuances.

At June 30, 2012, we are in compliance with these covenants. As of June 30, 2012, we had approximately \$167.4 million of total capacity under our credit facility, of which nothing had been drawn.

On August 3, 2012, we replaced the \$200.0 million secured revolving credit facility with a \$250.0 million unsecured revolving credit facility. Please see the Subsequent Events section below for a description of the \$250.0 million unsecured revolving credit facility.

The following table sets forth information as of June 30, 2012 with respect to our outstanding indebtedness.