

HIGHWOODS PROPERTIES INC

Form 10-K

February 12, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 2012

OR

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

HIGHWOODS PROPERTIES, INC.

(Exact name of registrant as specified in its charter)

Maryland

001-13100

56-1871668

(State or other jurisdiction

(Commission

(I.R.S. Employer

of incorporation or organization)

File Number)

Identification Number)

HIGHWOODS REALTY LIMITED PARTNERSHIP

(Exact name of registrant as specified in its charter)

North Carolina

000-21731

56-1869557

(State or other jurisdiction

(Commission

(I.R.S. Employer

of incorporation or organization)

File Number)

Identification Number)

3100 Smoketree Court, Suite 600

Raleigh, NC 27604

(Address of principal executive offices) (Zip Code)

919-872-4924

(Registrants' telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class

Name of Each Exchange on  
Which Registered

Common Stock, \$.01 par value, of Highwoods Properties, Inc.

New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Highwoods Properties, Inc. Yes  No  Highwoods Realty Limited Partnership Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Securities Exchange Act.

Highwoods Properties, Inc. Yes  No  Highwoods Realty Limited Partnership Yes  No

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.

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Highwoods Properties, Inc. Yes S No £ Highwoods Realty Limited Partnership Yes S 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).

Highwoods Properties, Inc. Yes S No £ Highwoods Realty Limited Partnership Yes S No £

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of such registrants' knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. S

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 Securities Exchange Act.

Highwoods Properties, Inc.

Large accelerated filer S Accelerated filer £ Non-accelerated filer £ Smaller reporting company £

Highwoods Realty Limited Partnership

Large accelerated filer £ Accelerated filer £ Non-accelerated filer S Smaller reporting company £

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act).

Highwoods Properties, Inc. Yes £ No S Highwoods Realty Limited Partnership Yes £ No S

The aggregate market value of shares of Common Stock of Highwoods Properties, Inc. held by non-affiliates (based upon the closing sale price on the New York Stock Exchange) on June 30, 2012 was approximately \$2.5 billion. At February 1, 2013, there were 80,555,117 shares of Common Stock outstanding.

There is no public trading market for the Common Units of Highwoods Realty Limited Partnership. As a result, an aggregate market value of the Common Units of Highwoods Realty Limited Partnership cannot be determined.

#### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement of Highwoods Properties, Inc. to be filed in connection with its Annual Meeting of Stockholders to be held May 15, 2013 are incorporated by reference in Part II, Item 5 and Part III, Items 10, 11, 12, 13 and 14.

HIGHWOODS PROPERTIES, INC.  
HIGHWOODS REALTY LIMITED PARTNERSHIP

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PART I

We refer to Highwoods Properties, Inc. as the “Company,” Highwoods Realty Limited Partnership as the “Operating Partnership,” the Company’s common stock as “Common Stock” or “Common Shares,” the Company’s preferred stock as “Preferred Stock” or “Preferred Shares,” the Operating Partnership’s common partnership interests as “Common Units,” the Operating Partnership’s preferred partnership interests as “Preferred Units” and in-service properties (excluding rental residential units and for-sale residential condominiums) to which the Company and/or the Operating Partnership have title and 100.0% ownership rights as the “Wholly Owned Properties.” References to “we” and “our” mean the Company and the Operating Partnership, collectively, unless the context indicates otherwise. References to “same property” mean the Company's in-service properties that were wholly-owned during the entirety of the periods being compared.

The Company conducts virtually all of its activities through the Operating Partnership and is its sole general partner. The partnership agreement provides that the Operating Partnership will assume and pay when due, or reimburse the Company for payment of, all costs and expenses relating to the ownership and operations of, or for the benefit of, the Operating Partnership. The partnership agreement further provides that all expenses of the Company are deemed to be incurred for the benefit of the Operating Partnership.

ITEM 1. BUSINESS

General

Highwoods Properties, Inc., headquartered in Raleigh, North Carolina, is a publicly-traded real estate investment trust (“REIT”) and its Common Stock is included in the S&P MidCap 400 Index. The Company is a fully integrated, self-administered REIT that provides leasing, management, development, construction and other customer-related services for its properties and for third parties. Our Common Stock is traded on the New York Stock Exchange (“NYSE”) under the symbol “HIW.” At December 31, 2012, we owned or had an interest in 333 in-service office, industrial and retail properties, encompassing 34.6 million square feet, two development properties and 649 acres of development land. Our properties and development land are located in Florida, Georgia, Missouri, North Carolina, Pennsylvania, South Carolina, Tennessee and Virginia.

At December 31, 2012, the Company owned all of the Preferred Units and 79.9 million, or 95.6%, of the Common Units. Limited partners, including two directors of the Company, own the remaining 3.7 million Common Units. Generally, the Operating Partnership is obligated to redeem each Common Unit at the request of the holder thereof for cash equal to the value of one share of Common Stock based on the average of the market price for the 10 trading days immediately preceding the notice date of such redemption provided that the Company, at its option, may elect to acquire any such Common Units presented for redemption for cash or one share of Common Stock. The Common Units owned by the Company are not redeemable.

The Company was incorporated in Maryland in 1994. The Operating Partnership was formed in North Carolina in 1994. Our executive offices are located at 3100 Smoketree Court, Suite 600, Raleigh, NC 27604, and our telephone number is (919) 872-4924.

Our business is the operation, acquisition and development of rental real estate properties. We operate office, industrial and retail properties. There are no material inter-segment transactions. See Note 19 to our Consolidated Financial Statements for a summary of the rental and other revenues, net operating income and assets for each reportable segment.

Our website is [www.highwoods.com](http://www.highwoods.com). In addition to this Annual Report, all quarterly and current reports, proxy statements, interactive data and other information are made available, without charge, on our website as soon as

reasonably practicable after they are filed or furnished with the Securities and Exchange Commission ("SEC"). The information on our website does not constitute part of this Annual Report. Reports filed or furnished with the SEC may also be viewed at [www.sec.gov](http://www.sec.gov) or obtained at the SEC's public reference facilities. Please call the SEC at (800) 732-0330 for further information about the public reference facilities.

During 2012, the Company filed unqualified Section 303A certifications with the NYSE. The Company and the Operating Partnership have also filed the CEO and CFO certifications required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002 as exhibits to this Annual Report.

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### Business and Operating Strategy

Our Strategic Plan focuses on:

- owning high-quality, differentiated real estate assets in the key infill business districts in our core markets;
- improving the operating results of our existing properties through concentrated leasing, asset management, cost control and customer service efforts;
- developing and acquiring office properties in key infill business districts that improve the overall quality of our portfolio and generate attractive returns over the long-term for our stockholders;
- selectively disposing of properties no longer considered to be core assets primarily due to location, age, quality and overall strategic fit; and
- maintaining a conservative, flexible balance sheet with ample liquidity to meet our funding needs and growth prospects.

**Local Market Leadership.** We focus our real estate activities in markets where we have extensive local knowledge and own a significant amount of assets. In each of our core markets, we maintain offices that are led by division officers with significant real estate experience. Our real estate professionals are seasoned and cycle-tested. Our senior leadership team has significant experience and maintains important relationships with market participants in each of our core markets.

**Customer Service-Oriented Organization.** We provide a complete line of real estate services to our customers. We believe that our in-house leasing and asset management, development, acquisition and construction management services generally allow us to respond to the many demands of our existing and potential customer base. We provide our customers with cost-effective services such as build-to-suit construction and space modification, including tenant improvements and expansions. In addition, the breadth of our capabilities and resources provides us with market information not generally available. We believe that operating efficiencies achieved through our fully integrated organization and the strength of our balance sheet also provide a competitive advantage in retaining existing customers and attracting new customers as well as setting our lease rates and pricing other services. In addition, our relationships with our customers may lead to development projects when these customers seek new space.

**Geographic Diversification.** Our core portfolio consists primarily of office properties in Raleigh, Tampa, Nashville, Memphis, Pittsburgh, Richmond and Orlando, office and industrial properties in Atlanta and Greensboro and retail and office properties in Kansas City. We do not believe that our operations are significantly dependent upon any particular geographic market.

**Conservative and Flexible Balance Sheet.** We are committed to maintaining a conservative and flexible balance sheet that allows us to capitalize on favorable development and acquisition opportunities as they arise. Our balance sheet also allows us to proactively assure our existing and prospective customers that we are able to fund tenant improvements and maintain our properties in good condition.

### Competition

Our properties compete for customers with similar properties located in our markets primarily on the basis of location, rent, services provided and the design, quality and condition of the facilities. We also compete with other REITs,

financial institutions, pension funds, partnerships, individual investors and others when attempting to acquire, develop and operate properties.

#### Employees

At December 31, 2012, we had 415 full-time employees.

#### ITEM 1A. RISK FACTORS

An investment in our securities involves various risks. Investors should carefully consider the following risk factors in conjunction with the other information contained in this Annual Report before trading in our securities. If any of these risks actually occur, our business, operating results, prospects and financial condition could be harmed.



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Adverse economic conditions in our markets that negatively impact the demand for office space, such as high unemployment, may result in lower occupancy and rental rates for our portfolio, which would adversely affect our operating results. While we own and operate a limited number of industrial, retail and residential properties, our operating results depend heavily on successfully leasing and operating our office properties, which represent nearly 90% of rental and other revenues. Economic growth and employment levels in our core markets are and will continue to be important determinative factors in predicting our future operating results.

Key components affecting our rental and other revenues include average occupancy and rental rates. Average occupancy generally increases during times of improving economic growth, as our ability to lease space outpaces vacancies that occur upon the expirations of existing leases. Average occupancy generally declines during times of slower or negative economic growth and decreasing office employment because new vacancies tend to outpace our ability to lease space. In addition, the timing of changes in occupancy levels tends to lag the timing of changes in overall economic activity and employment levels. For additional information regarding our average occupancy and rental rate trends over the past five years, see “Item 2. Properties - Wholly Owned Properties”. Lower rental revenues that may result from lower average occupancy or lower rental rates with respect to our same property portfolio will generally reduce our operating results unless offset by the impact of any newly acquired or developed properties or lower variable operating expenses, general and administrative expenses and/or interest expense.

We face considerable competition in the leasing market and may be unable to renew existing leases or re-let space on terms similar to the existing leases, or we may expend significant capital in our efforts to re-let space, which may adversely affect our operating results. Generally, 10-15% of our rental revenues at the beginning of any particular year are subject to leases that expire by the end of that year. See “Item 2. Properties - Lease Expirations”. As a result, in addition to seeking to increase our average occupancy by leasing current vacant space, we also concentrate our leasing efforts on renewing leases on expiring space. Because we compete with a number of other developers, owners and operators of office and office-oriented, mixed-use properties, we may be unable to renew leases with our existing customers and, if our current customers do not renew their leases, we may be unable to re-let the space to new customers. To the extent that we are able to renew leases that are scheduled to expire in the short-term or re-let such space to new customers, heightened competition resulting from adverse market conditions may require us to utilize rent concessions and tenant improvements to a greater extent than we historically have. Further, customers may seek to downsize by leasing less space from us upon any renewal.

If our competitors offer space at rental rates below current market rates or below the rental rates we currently charge our customers, we may lose potential customers, and we may be pressured to reduce our rental rates below those we currently charge in order to retain customers upon expiration of their existing leases. Even if our customers renew their leases or we are able to re-let the space, the terms and other costs of renewal or re-letting, including the cost of required renovations, increased tenant improvement allowances, leasing commissions, reduced rental rates and other potential concessions, may be less favorable than the terms of our current leases and could require significant capital expenditures. From time to time, we may also agree to modify the terms of existing leases to incentivize customers to renew their leases. If we are unable to renew leases or re-let space in a reasonable time, or if our rental rates decline or our tenant improvement costs, leasing commissions or other costs increase, our financial condition, cash flows, cash available for distribution, value of our common stock, and ability to satisfy our debt service obligations could be materially adversely affected.

Difficulties or delays in renewing leases with large customers or re-leasing space vacated by large customers could materially impact our operating results. The 20 largest customers of our Wholly Owned Properties account for a significant portion of our revenues. See “Item 2. Properties - Customers” and “Item 2. Properties - Lease Expirations.” There are no assurances that these customers, or any of our other large customers, will renew all or any of their space upon expiration of their current leases.

Some of our leases provide customers with the right to terminate their leases early, which could have an adverse effect on our cash flow and results of operations. Certain of our leases permit our customers to terminate their leases as to all or a portion of the leased premises prior to their stated lease expiration dates under certain circumstances, such as providing notice by a certain date and, in most cases, paying a termination fee. To the extent that our customers exercise early termination rights, our cash flow and earnings will be adversely affected, and we can provide no assurances that we will be able to generate an equivalent amount of net effective rent by leasing the vacated space to new third party customers.

An oversupply of space in our markets would typically cause rental rates and occupancies to decline, making it more difficult for us to lease space at attractive rental rates, if at all. Undeveloped land in many of the markets in which we operate is generally more readily available and less expensive than in higher barrier-to-entry markets such as New York, Chicago, Boston, San Francisco and Los Angeles. As a result, even during times of positive economic growth, our competitors could construct new buildings that would compete with our properties. Any such oversupply could result in lower occupancy and rental rates in our portfolio, which would have a negative impact on our operating results.

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In order to maintain the quality of our properties and successfully compete against other properties, we regularly must spend money to maintain, repair and renovate our properties, which reduces our cash flows. If our properties are not as attractive to customers due to physical condition as properties owned by our competitors, we could lose customers or suffer lower rental rates. As a result, we may from time to time be required to make significant capital expenditures to maintain the competitiveness of our properties. There can be no assurances that any such expenditures would result in higher occupancy or higher rental rates or deter existing customers from relocating to properties owned by our competitors.

Our operating results and financial condition could be adversely affected by financial difficulties experienced by a major customer, or by a number of smaller customers, including bankruptcies, insolvencies or general downturns in business. The success of our investments and stability of our operations depend on the financial stability of our customers. A default or termination by a significant customer on its lease payments to us would cause us to lose the revenue associated with such lease. In the event of a customer default or bankruptcy, we may experience delays in enforcing our rights as landlord and may incur substantial costs in protecting our investment and re-leasing the property. We cannot evict a customer solely because of its bankruptcy. On the other hand, a court might authorize the customer to reject and terminate its lease. In such case, our claim against the bankrupt customer for unpaid, future rent would be subject to a statutory cap that might be substantially less than the remaining rent actually owed under the lease. As a result, our claim for unpaid rent would likely not be paid in full. If a customer defaults on or terminates a significant lease, we may not be able to recover the full amount of unpaid rent or be able to lease the property for the rent previously received, if at all. In any of these instances, we may also be required to write off deferred leasing costs and accrued straight-line rents receivable. These events would adversely impact our operating results.

Costs of complying with governmental laws and regulations may reduce our operating results. All real property and the operations conducted on real property are subject to federal, state and local laws and regulations relating to environmental protection and human health and safety. Some of these laws and regulations may impose joint and several liability on customers, owners or operators for the costs to investigate or remediate contaminated properties, regardless of fault or whether the acts causing the contamination were legal. In addition, the presence of hazardous substances, or the failure to properly remediate these substances, may hinder our ability to sell, rent or pledge such property as collateral for future borrowings.

Compliance with new laws or regulations or stricter interpretation of existing laws may require us to incur significant expenditures. Future laws or regulations may impose significant environmental liability. Additionally, our customers' operations, operations in the vicinity of our properties, such as the presence of underground storage tanks, or activities of unrelated third parties may affect our properties. In addition, there are various local, state and federal fire, health, life-safety and similar regulations with which we may be required to comply and that may subject us to liability in the form of fines or damages for noncompliance. Any expenditures, fines or damages we must pay would reduce our operating results. Proposed legislation to address climate change could increase utility and other costs of operating our properties which, if not offset by rising rental income, would reduce our net income.

Discovery of previously undetected environmentally hazardous conditions may decrease our operating results and limit our ability to make distributions. Under various federal, state and local environmental laws and regulations, a current or previous property owner or operator may be liable for the cost to remove or remediate hazardous or toxic substances on such property. These costs could be significant. Such laws often impose liability whether or not the owner or operator knew of, or was responsible for, the presence of such hazardous or toxic substances. Environmental laws also may impose restrictions on the manner in which property may be used or businesses may be operated, and these restrictions may require significant expenditures or prevent us from entering into leases with prospective customers that may be impacted by such laws. Environmental laws provide for sanctions for noncompliance and may be enforced by governmental agencies or private parties. Certain environmental laws and common law principles

could be used to impose liability for release of and exposure to hazardous substances, including asbestos-containing materials. Third parties may seek recovery from real property owners or operators for personal injury or property damage associated with exposure to released hazardous substances. The cost of defending against claims of liability, of complying with environmental regulatory requirements, of remediating any contaminated property, or of paying personal injury claims could reduce our operating results.

Our operating results may suffer if costs of operating our properties, such as real estate taxes, utilities, insurance, maintenance and other costs, rise faster than our ability to increase rental revenues and/or cost recovery income. While we receive additional rent from our customers that is based on recovering a portion of operating expenses, increased operating expenses will negatively impact our operating results. Our revenues, including cost recovery income, are subject to longer-term leases and may not be quickly increased sufficient to recover an increase in operating costs and expenses. Furthermore, the costs associated with owning and operating a property are not necessarily reduced when circumstances such as market factors and competition cause a reduction in rental revenues from the property.

Increases in same property operating expenses would reduce

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our operating results unless offset by higher rental rates, higher cost recovery income, the impact of any newly acquired or developed properties, or lower general and administrative expenses and/or interest expense.

Recent and future acquisitions and development properties may fail to perform in accordance with our expectations and may require renovation and development costs exceeding our estimates. In the normal course of business, we typically evaluate potential acquisitions, enter into non-binding letters of intent, and may, at any time, enter into contracts to acquire additional properties. Acquired properties may fail to perform in accordance with our expectations due to lease-up risk, renovation cost risks and other factors. In addition, the renovation and improvement costs we incur in bringing an acquired property up to market standards may exceed our estimates. We may not have the financial resources to make suitable acquisitions or renovations on favorable terms or at all.

Further, we face significant competition for attractive investment opportunities from an indeterminate number of other real estate investors, including investors with significantly greater capital resources and access to capital than we have, such as domestic and foreign corporations and financial institutions, publicly-traded and privately-held REITs, private institutional investment funds, investment banking firms, life insurance companies and pension funds. Moreover, owners of office properties may be reluctant to sell, resulting in fewer acquisition opportunities. As a result of such increased competition and limited opportunities, we may be unable to acquire additional properties or the purchase price of such properties may be significantly elevated, which may impede our growth and materially and adversely affect us.

In addition to acquisitions, we periodically consider developing or re-developing properties. Risks associated with development and re-development activities include:

- the unavailability of favorable construction and/or permanent financing;
- construction costs exceeding original estimates;
- construction and lease-up delays resulting in increased debt service expense and construction costs; and
- lower than anticipated occupancy rates and rents causing a property to be unprofitable or less profitable than originally estimated.

Development and re-development activities are also subject to risks relating to our ability to obtain, or delays in obtaining, all necessary zoning, land-use, building, occupancy and other required governmental and utility company authorizations.

Illiquidity of real estate investments and the tax effect of dispositions could significantly impede our ability to sell assets or respond to favorable or adverse changes in the performance of our properties. Because real estate investments are relatively illiquid, our ability to promptly sell one or more properties in our portfolio in response to changing economic, financial and investment conditions is limited. In addition, we have a significant amount of mortgage debt under which we would incur significant prepayment penalties if such loans were paid off in connection with the sale of the underlying real estate assets.

We intend to continue to sell some of our properties in the future as part of our investment strategy and activities. However, we cannot predict whether we will be able to sell any property for the price or on the terms set by us, or whether the price or other terms offered by a prospective purchaser would be acceptable to us. We also cannot predict the length of time needed to find a willing purchaser and close the sale of a property.

Certain of our properties have low tax bases relative to their estimated current fair values, and accordingly, the sale of such assets would generate significant taxable gains unless we sold such properties in a tax-deferred exchange under Section 1031 of the Internal Revenue Code or another tax-free or tax-deferred transaction. For an exchange to qualify for tax-deferred treatment under Section 1031, the net proceeds from the sale of a property must be held by an escrow agent until applied toward the purchase of real estate qualifying for gain deferral. Given the competition for properties meeting our investment criteria, there could be a delay in reinvesting such proceeds. Any delay in using the reinvestment proceeds to acquire additional income producing assets would reduce our operating results.

Because holders of Common Units, including two of the Company's directors, may suffer adverse tax consequences upon the sale of some of our properties, they may seek to influence us not to sell certain properties even if such a sale would otherwise be in our best interest. Holders of Common Units may suffer adverse tax consequences upon the sale of certain properties. Therefore, holders of Common Units, including two of our directors, may have different objectives than our stockholders regarding the appropriate pricing and timing of a property's sale. Although the Company is the sole general partner of the Operating Partnership and has the exclusive authority to sell any of our Wholly Owned Properties, those who hold Common Units may seek

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to influence us not to sell certain properties even if such sale might be financially advantageous to stockholders, creditors, bondholders or our business as a whole or influence us to enter into tax deferred exchanges with the proceeds of such sales when such a reinvestment might not otherwise be in our best interest.

The value of our joint venture investments could be adversely affected if we are unable to work effectively with our partners or our partners become unable to satisfy their financial obligations. Instead of owning properties directly, we have in some cases invested, and may continue to invest, as a partner or a co-venturer with one or more third parties. Under certain circumstances, this type of investment may involve risks not otherwise present, including the possibility that a partner or co-venturer might be unable to fund its obligations or might have business interests or goals inconsistent with ours. Also, such a partner or co-venturer may take action contrary to our requests or contrary to provisions in our joint venture agreements that could harm us. If we want to sell our interests in any of our joint ventures or believe that the properties in the joint venture should be sold, we may not be able to do so in a timely manner or at all, and our partner(s) may not cooperate with our desires, which could harm us.

Our insurance coverage on our properties may be inadequate. We carry insurance on all of our properties, including insurance for liability, fire, windstorms, floods, earthquakes and business interruption. Insurance companies, however, limit coverage against certain types of losses, such as losses due to terrorist acts, named windstorms, earthquakes and toxic mold. Thus, we may not have insurance coverage, or sufficient insurance coverage, against certain types of losses and/or there may be decreases in the insurance coverage available. Should an uninsured loss or a loss in excess of our insured limits occur, we could lose all or a portion of the capital we have invested in a property or properties, as well as the anticipated future revenue from the property or properties. If any of our properties were to experience a catastrophic loss, it could disrupt our operations, delay revenue and result in large expenses to repair or rebuild the property. Further, if any our insurance carriers were to become insolvent, we would be forced to replace the existing insurance coverage with another suitable carrier, and any outstanding claims would be at risk for collection. In such an event, we cannot be certain that we would be able to replace the coverage at similar or otherwise favorable terms. Such events could adversely affect our operating results and financial condition.

Our use of debt to finance a significant portion of our operations could have a material adverse effect on our cash flow and ability to make distributions. We are subject to risks associated with debt financing, such as the sufficiency of cash flow to meet required payment obligations, ability to comply with financial ratios and other covenants and the availability of capital to refinance existing indebtedness or fund important business initiatives. If we fail to comply with the financial ratios and other covenants under our credit facilities, we would likely not be able to borrow any further amounts under such facilities, which could adversely affect our ability to fund our operations, and our lenders could accelerate outstanding debt. Further, we request corporate credit ratings from Moody's Investors Service and Standard and Poor's Rating Services based on their evaluation of our creditworthiness. These agencies' ratings are based on a number of factors, some of which are not within our control. In addition to factors specific to our financial strength and performance, the rating agencies also consider conditions affecting REITs generally. We cannot assure you that our credit ratings will not be downgraded. If our credit ratings are downgraded or other negative action is taken, we could be required, among other things, to pay additional interest and fees on outstanding borrowings under our revolving credit facility and term loans.

Increases in interest rates would increase our interest expense. From time to time, we may manage our exposure to interest rate risk by a combination of interest rate hedge contracts to effectively fix or cap a portion of our variable rate debt. In addition, we refinance fixed rate debt at times when we believe rates and terms are appropriate. Our efforts to manage these exposures may not be successful. Our use of interest rate hedge contracts to manage risk associated with interest rate volatility may expose us to additional risks, including a risk that a counterparty to a hedge contract may fail to honor its obligations. Developing an effective interest rate risk strategy is complex and no strategy can completely insulate us from risks associated with interest rate fluctuations. There can be no assurance that our hedging activities will have the desired beneficial impact on our results of operations or financial condition. Termination of

interest rate hedge contracts typically involves costs, such as transaction fees or breakage costs.

We generally do not intend to reserve funds to retire existing secured or unsecured debt upon maturity. We may not be able to repay, refinance or extend any or all of our debt at maturity or upon any acceleration. If any refinancing is done at higher interest rates, the increased interest expense could adversely affect our cash flow and ability to pay distributions. Any such refinancing could also impose tighter financial ratios and other covenants that restrict our ability to take actions that could otherwise be in our best interest, such as funding new development activity, making opportunistic acquisitions, repurchasing our securities or paying distributions. If we do not meet our mortgage financing obligations, any properties securing such indebtedness could be foreclosed on, which could have a material adverse effect on our cash flow and ability to pay distributions.

We depend on our revolving credit facility for working capital purposes and for the short-term funding of our development and acquisition activity and, in certain instances, the repayment of other debt upon maturity. Our ability to borrow under the revolving credit facility also allows us to quickly capitalize on accretive opportunities at short-term interest rates. If our lenders



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default under their obligations under the revolving credit facility or we become unable to borrow additional funds under the facility for any reason, we would be required to seek alternative equity or debt capital, which could be more costly and adversely impact our financial condition. If such alternative capital were unavailable, we may not be able to make new investments and could have difficulty repaying other debt.

Failure to comply with Federal government contractor requirements could result in substantial costs and loss of substantial revenue. We are subject to compliance with a wide variety of complex legal requirements because we are a Federal government contractor. These laws regulate how we conduct business, require us to administer various compliance programs and require us to impose compliance responsibilities on some of our contractors. Our failure to comply with these laws could subject us to fines and penalties, cause us to be in default of our leases and other contracts with the Federal government and bar us from entering into future leases and other contracts with the Federal government. There can be no assurance that these costs and loss of revenue will not have a material adverse effect on our properties, operations or business.

The Company may be subject to taxation as a regular corporation if it fails to maintain its REIT status, which would also have a material adverse effect on the Company's stockholders and on the Operating Partnership. We may be subject to adverse consequences if the Company fails to continue to qualify as a REIT for federal income tax purposes. While we intend to operate in a manner that will allow the Company to continue to qualify as a REIT, we cannot provide any assurances that the Company will remain qualified as such in the future, which would have particularly adverse consequences to the Company's stockholders. Many of the requirements for taxation as a REIT are highly technical and complex and depend upon various factual matters and circumstances that may not be entirely within our control. The fact that the Company holds virtually all of its assets through the Operating Partnership and its subsidiaries further complicates the application of the REIT requirements. Even a technical or inadvertent mistake could jeopardize our REIT status. Furthermore, Congress and the Internal Revenue Service might change the tax laws and regulations and the courts might issue new rulings that make it more difficult, or impossible, for the Company to remain qualified as a REIT. If the Company fails to qualify as a REIT, it would (a) not be allowed a deduction for dividends paid to stockholders in computing its taxable income, (b) be subject to federal income tax at regular corporate rates (and potentially the alternative minimum tax and increased state and local taxes) and (c) unless entitled to relief under the tax laws, not be able to re-elect REIT status until the fifth calendar year after it failed to qualify as a REIT. Additionally, the Company would no longer be required to make distributions. As a result of these factors, the Company's failure to qualify as a REIT would likely impair our ability to expand our business and would adversely affect the price of the Common Stock.

Even if we remain qualified as a REIT, we may face other tax liabilities that reduce our cash flows. Even if we remain qualified for taxation as a REIT, we may be subject to certain federal, state and local taxes on our income and assets, including taxes on any undistributed income, tax on income from some activities conducted as a result of a foreclosure, and state or local income, property and transfer taxes. In addition, our taxable REIT subsidiary is subject to regular corporate federal, state and local taxes. Any of these taxes would decrease cash available for distributions to stockholders.

Complying with REIT requirements may cause us to forego otherwise attractive opportunities or liquidate otherwise attractive investments. To remain qualified as a REIT for federal income tax purposes, we must continually satisfy tests concerning, among other things, the sources of our income, the nature and diversification of our assets, the amounts we distribute to our stockholders and the ownership of our capital stock. In order to meet these tests, we may be required to forego investments we might otherwise make. Thus, compliance with the REIT requirements may hinder our performance.

In particular, we must ensure that at the end of each calendar quarter, at least 75% of the value of our assets consists of cash, cash items, government securities and qualified real estate assets. The remainder of our investment in securities

(other than government securities, securities of taxable REIT subsidiaries and qualified real estate assets) generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of our assets (other than government securities, securities of taxable REIT subsidiaries and qualified real estate assets) can consist of the securities of any one issuer, and no more than 25% of the value of our total assets can be represented by the securities of one or more taxable REIT subsidiaries. If we fail to comply with these requirements at the end of any calendar quarter, we must correct the failure within 30 days after the end of the calendar quarter or qualify for certain statutory relief provisions to avoid losing our REIT qualification and suffering adverse tax consequences. As a result, we may be required to liquidate otherwise attractive investments. These actions could have the effect of reducing our income and amounts available for distribution to our stockholders.

The prohibited transactions tax may limit our ability to dispose of our properties. A REIT's net income from prohibited transactions is subject to a 100% tax. In general, prohibited transactions are sales or other dispositions of property held primarily for sale to customers in the ordinary course of business. We may be subject to the prohibited transaction tax equal to 100% of net gain upon a disposition of real property. Although a safe harbor to the characterization of the sale of real property by a REIT as a prohibited transaction is available, we cannot assure you that we can in all cases comply with the safe harbor or that we will

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avoid owning property that may be characterized as held primarily for sale to customers in the ordinary course of business. Consequently, we may choose not to engage in certain sales of our properties or may conduct such sales through our taxable REIT subsidiary, which would be subject to federal and state income taxation.

Dividends payable by REITs do not qualify for the reduced tax rates available for some dividends. The maximum tax rate applicable to “qualified dividend income” payable to U.S. stockholders that are taxed at individual rates is 20%. Dividends payable by REITs, however, generally are not eligible for the reduced rates on qualified dividend income. The more favorable rates applicable to regular corporate qualified dividends could cause investors who are taxed at individual rates to perceive investments in REITs to be relatively less attractive than investments in the stocks of non-REIT corporations that pay dividends, which could adversely affect the value of the shares of REITs, including our stock.

We face possible state and local tax audits. Because we are organized and qualify as a REIT, we are generally not subject to federal income taxes, but are subject to certain state and local taxes. In the normal course of business, certain entities through which we own real estate have undergone tax audits. Collectively, tax deficiency notices received to date from the jurisdictions conducting previous audits have not been material. However, there can be no assurance that future audits will not occur with increased frequency or that the ultimate result of such audits will not have a material adverse effect on our results of operations.

The market value of the Common Stock can be adversely affected by many factors. As with any public company, a number of factors may adversely influence the public market price of the Common Stock. These factors include:

- the level of institutional interest in us;
- the perceived attractiveness of investment in us, in comparison to other REITs;
- the attractiveness of securities of REITs in comparison to other asset classes;
- our financial condition and performance;
- the market's perception of our growth potential and potential future cash dividends;
- government action or regulation, including changes in tax laws;
- increases in market interest rates, which may lead investors to expect a higher annual yield from our distributions in relation to the price of the Common Stock;
- changes in our credit ratings; and
- any negative change in the level or stability of our dividend.

We cannot assure you that we will continue to pay dividends at historical rates. We generally expect to use cash flows from operating activities to fund dividends. The following factors will affect such cash flows and, accordingly, influence the decisions of the Company's board of directors regarding dividends:

debt service requirements after taking into account debt covenants and the repayment and restructuring of certain indebtedness and the availability of alternative sources of debt and equity capital and their impact on our ability to refinance existing debt and grow our business;

- scheduled increases in base rents of existing leases;
- changes in rents attributable to the renewal of existing leases or replacement leases;
- changes in occupancy rates at existing properties and execution of leases for newly acquired or developed properties;
- changes in operating expenses;
- anticipated leasing capital expenditures attributable to the renewal of existing leases or replacement leases;
- anticipated building improvements; and

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expected cash flows from financing and investing activities.

The decision to declare and pay dividends on the Common Stock in the future, as well as the timing, amount and composition of any such future dividends, will be at the sole discretion of the Company's board of directors. Any change in our dividend policy could have a material adverse effect on the market price of the Common Stock.

Cash distributions reduce the amount of cash that would otherwise be available for other business purposes, including funding debt maturities or future growth initiatives. For the Company to maintain its qualification as a REIT, it must annually distribute to its stockholders at least 90% of REIT taxable income, excluding net capital gains. In addition, although capital gains are not required to be distributed to maintain REIT status, capital gains, if any, that are generated as part of our capital recycling program are subject to federal and state income tax unless such gains are distributed to our stockholders. Cash distributions made to stockholders to maintain REIT status or to distribute otherwise taxable capital gains limit our ability to accumulate capital for other business purposes, including funding debt maturities or growth initiatives.

Because provisions contained in Maryland law, the Company's charter and the Company's bylaws may have an anti-takeover effect, stockholders may be prevented from receiving a "control premium" for the Common Stock. Provisions contained in the Company's charter and bylaws as well as Maryland general corporation law may have anti-takeover effects that delay, defer or prevent a takeover attempt, and thereby prevent our stockholders from receiving a "control premium" for their shares. For example, these provisions may defer or prevent tender offers for the Common Stock or purchases of large blocks of the Common Stock, thus limiting the opportunities for the Company's stockholders to receive a premium for their shares of Common Stock over then-prevailing market prices. These provisions include the following:

**Ownership limit.** The Company's charter prohibits direct, indirect or constructive ownership by any person or entity of more than 9.8% of the Company's outstanding capital stock. Any attempt to own or transfer shares of capital stock in excess of the ownership limit without the consent of the Company's board of directors will be void.

**Preferred Stock.** The Company's charter authorizes the board of directors to issue preferred stock in one or more classes and to establish the preferences and rights of any class of preferred stock issued. These actions can be taken without stockholder approval. The issuance of preferred stock could have the effect of delaying or preventing someone from taking control of the Company, even if a change in control were in our best interest.

**Business combinations.** Pursuant to the Company's charter and Maryland law, the Company cannot merge into or consolidate with another corporation or enter into a statutory share exchange transaction in which the Company is not the surviving entity or sell all or substantially all of its assets unless the board of directors adopts a resolution declaring the proposed transaction advisable and a majority of the stockholders voting together as a single class approve the transaction. Maryland law prohibits stockholders from taking action by written consent unless all stockholders consent in writing. The practical effect of this limitation is that any action required or permitted to be taken by the Company's stockholders may only be taken if it is properly brought before an annual or special meeting of stockholders. The Company's bylaws further provide that in order for a stockholder to properly bring any matter before a meeting, the stockholder must comply with requirements regarding advance notice. The foregoing provisions could have the effect of delaying until the next annual meeting stockholder actions that the holders of a majority of the Company's outstanding voting securities favor. These provisions may also discourage another person from making a tender offer for the Company's common stock, because such person or entity, even if it acquired a majority of the Company's outstanding voting securities, would likely be able to take action as a stockholder, such as electing new directors or approving a merger, only at a duly called stockholders meeting. Maryland law also establishes special requirements with respect to business combinations between Maryland corporations and interested stockholders unless exemptions apply. Among other things, the law prohibits for five years a merger and other similar transactions

between a company and an interested stockholder and requires a supermajority vote for such transactions after the end of the five-year period. The Company's charter contains a provision exempting the Company from the Maryland business combination statute. However, we cannot assure you that this charter provision will not be amended or repealed at any point in the future.

Control share acquisitions. Maryland general corporation law also provides that control shares of a Maryland corporation acquired in a control share acquisition have no voting rights except to the extent approved by a vote of two-thirds of the votes entitled to be cast on the matter, excluding shares owned by the acquirer or by officers or employee directors. The control share acquisition statute does not apply to shares acquired in a merger, consolidation or share exchange if the corporation is a party to the transaction, or to acquisitions approved or exempted by the corporation's charter or bylaws. The Company's bylaws contain a provision exempting from the control share acquisition statute any stock acquired by any person. However, we cannot assure you that this bylaw provision will not be amended or repealed at any point in the future.

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Maryland unsolicited takeover statute. Under Maryland law, the Company's board of directors could adopt various anti-takeover provisions without the consent of stockholders. The adoption of such measures could discourage offers for the Company or make an acquisition of the Company more difficult, even when an acquisition would be in the best interest of the Company's stockholders.

Anti takeover protections of operating partnership agreement. Upon a change in control of the Company, the partnership agreement of the Operating Partnership requires certain acquirers to maintain an umbrella partnership real estate investment trust structure with terms at least as favorable to the limited partners as are currently in place. For instance, the acquirer would be required to preserve the limited partner's right to continue to hold tax-deferred partnership interests that are redeemable for capital stock of the acquirer. Exceptions would require the approval of two-thirds of the limited partners of our Operating Partnership (other than the Company). These provisions may make a change of control transaction involving the Company more complicated and therefore might decrease the likelihood of such a transaction occurring, even if such a transaction would be in the best interest of the Company's stockholders.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

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## ITEM 2. PROPERTIES

## Wholly Owned Properties

The following table sets forth information about our Wholly Owned Properties:

	December 31, 2012		December 31, 2011		
	Rentable Square Feet	Percent Occupied/ Leased/ Pre-Leased	Rentable Square Feet	Percent Occupied/ Leased/ Pre-Leased	
In-Service (Occupied):					
Office	23,361,000	90.0	% 22,612,000	89.2	%
Industrial	5,474,000	93.2	5,827,000	91.6	
Retail	853,000	98.6	853,000	98.7	
Total or Weighted Average	29,688,000	90.9	% 29,292,000	90.0	%
Development (Leased/pre-leased):					
Completed—Not Stabilized (1)					
Office	—	—	% 117,000	100.0	%
Total or Weighted Average	—	—	% 117,000	100.0	%
In Process (1)					
Office	246,000	89.9	% 228,000	88.9	%
Total or Weighted Average	246,000	89.9	% 228,000	88.9	%
Total:					
Office	23,607,000		22,957,000		
Industrial	5,474,000		5,827,000		
Retail	853,000		853,000		
Total	29,934,000		29,637,000		

We consider a development project to be stabilized upon the earlier of the original projected stabilization date or (1) the date such project is generally more than 90% occupied. None of these properties qualified for development in process as reflected in our Consolidated Balance Sheets since substantial development activity is not underway.

The following table sets forth the net changes in square footage of our in-service Wholly Owned Properties:

	Year Ended December 31,		
	2012	2011	2010
	(rentable square feet in thousands)		
Office, Industrial and Retail Properties:			
Dispositions	(1,179	) (136	) (1,309
Developments Placed In-Service	116	208	413
Redevelopment/Other	23	(53	) (35
Acquisitions	1,436	2,091	336
Net Change in Square Footage of In-Service Wholly Owned Properties	396	2,110	(595



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The following table sets forth information about our in-service Wholly Owned Properties by segment and by geographic location at December 31, 2012:

Market	Rentable Square Feet	Occupancy	Percentage of Annualized Cash Rental Revenue (1)				Total	
			Office	Industrial	Retail	Total		
Raleigh	4,428,000	88.7	% 15.8	% —	% —	% 15.8	%	
Atlanta	6,439,000	89.0	12.0	2.5	—	14.5		
Tampa	2,912,000	91.5	12.7	—	—	12.7		
Nashville	2,610,000	95.6	11.4	—	—	11.4		
Kansas City	1,465,000	95.0	2.8	—	6.7	9.5		
Richmond	2,229,000	94.9	8.1	—	—	8.1		
Piedmont Triad	4,176,000	91.8	4.8	2.5	—	7.3		
Memphis	1,960,000	86.5						