CARRAMERICA REALTY CORP
Form 10-Q
May 07, 2003
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

FOR QUARTER ENDED March 31, 2003

COMMISSION FILE NO. 1-11706

CARRAMERICA REALTY CORPORATION

(Exact name of registrant as specified in its charter)

Maryland **(State or other jurisdiction of** **incorporation or organization)**	**52-1796339** **(I.R.S. Employer** **Identification Number)**

1850 K Street, N.W., Washington, D.C. 20006

(Address or principal executive office) (Zip code)

Registrant s telephone number, including area code (202) 729-1700

N/A

(Former name, former address and former fiscal year, if changed since last report)

Number of shares outstanding of each of the registrant s

classes of common stock, as of April 30, 2003:

Common Stock, par value $.01 per share: 51,877,080 shares

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 twelve (12) months (or such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past ninety (90) days. YES x NO ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). YES x NO ¨

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Part I

Item 1. Financial Information

The information furnished in our accompanying consolidated balance sheets, consolidated statements of operations and consolidated statements of cash flows reflects all adjustments which are, in our opinion, necessary for a fair presentation of the aforementioned financial statements for the interim periods.

The financial statements should be read in conjunction with the notes to the financial statements and Management s Discussion and Analysis of Financial Condition and Results of Operations. The results of operations for the three months ended March 31, 2003 are not necessarily indicative of the operating results to be expected for the full year.

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CARRAMERICA REALTY CORPORATION AND SUBSIDIARIES

Consolidated Balance Sheets As Of March 31, 2003 and December 31, 2002

(In thousands, except share and per share amounts)	**March 31, 2003** (unaudited)	**December 31, 2002**
Assets		
Rental property:		
Land	$ 669,034	$ 668,223
Buildings	1,976,611	1,967,496
Tenant improvements	371,176	369,901
Furniture, fixtures and equipment	4,264	4,262
	3,021,085	3,009,882
Less: Accumulated depreciation	(596,762)	(569,970)
Total rental property	2,424,323	2,439,912
Land held for development or sale	45,298	44,778
Construction in progress	6,574	12,732
Cash and cash equivalents	5,274	3,023
Restricted deposits	1,960	4,505
Accounts and notes receivable, net	16,444	20,391
Investments in unconsolidated entities	128,211	125,079
Accrued straight-line rents	77,037	74,884
Tenant leasing costs, net	43,421	42,170
Prepaid expenses and other assets, net	50,093	50,231
	$ 2,798,635	$ 2,817,705
Liabilities, Minority Interest, and Stockholders Equity		
Liabilities:		
Mortgages and notes payable, net	$ 1,672,713	$ 1,603,949
Accounts payable and accrued expenses	85,361	102,153
Rent received in advance and security deposits	37,189	35,590
Total liabilities	1,795,263	1,741,692
Minority interest	76,144	76,222
Stockholders equity:		
Preferred stock, $.01 par value, authorized 35,000,000 shares:Series B, C, and D Cumulative Redeemable Preferred Stock, at redemption value, issued and outstanding, 1,602,650 shares at March 31, 2003 and 3,622,589 shares at December 31, 2002	200,634	254,518
Common Stock, $.01 par value, authorized 180,000,000 shares: issued and outstanding 51,850,900 shares at March 31, 2003 and 51,835,647 shares at December 31, 2002.	519	518
Additional paid-in capital	946,804	951,281
Cumulative dividends in excess of net income	(220,729)	(208,526)

Total stockholders equity	927,228	997,791
Commitments and contingencies		
	$ 2,798,635	$ 2,815,705

See accompanying notes to consolidated financial statements.

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CARRAMERICA REALTY CORPORATION AND SUBSIDIARIES

Consolidated Statements of Operations

For the Three Months Ended March 31, 2003 and 2002

	Three Months Ended March 31,	
	2003	**2002**
(Unaudited and in thousands, except per share amounts)		
Operating revenues:		
Rental revenue:		
Base rent	$ 105,763	$ 105,124
Recoveries from tenants	16,052	16,158
Parking and other tenant charges	5,988	2,793
Total rental revenue	127,803	124,075
Real estate service revenue	5,555	6,127
Total operating revenues	133,358	130,202
Operating expenses:		
Property expenses:		
Operating expenses	32,374	30,837
Real estate taxes	12,000	11,733
Interest expense	25,537	24,388
General and administrative	10,286	11,041
Depreciation and amortization	32,010	32,740
Total operating expenses	112,207	110,739
Real estate operating income	21,151	19,463
Other income (expense):		
Interest income	98	194
Obligations under lease guarantees		(2,400)
Equity in earnings of unconsolidated entities	1,327	2,043
Total other income (expense)	1,425	(163)
Income from continuing operations before income taxes, minority interest, and loss on sale of assets and other provisions, net	22,576	19,300
Income taxes	(252)	(33)
Minority interest	(3,076)	(2,623)
Loss on sale of assets and other provisions, net	(277)	(860)

Income from continuing operations	18,971	15,784
Discontinued operations Net operations of sold property		1,716
Net income	$ 18,971	$ 17,500
Basic net income per common share:		
Continuing operations	$ 0.26	$ 0.14
Discontinued operations		0.03
Net income	$ 0.26	$ 0.17
Diluted net income per common share:		
Continuing operations	$ 0.26	$ 0.14
Discontinued operations		0.03
Net income	$ 0.26	$ 0.17

See accompanying notes to consolidated financial statements.

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CARRAMERICA REALTY CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows

For the Three Months Ended March 31, 2003 and 2002

(Unaudited and in thousands)	**2003**	**2002**
Cash flows from operating activities:		
Net income	$ 18,971	$ 17,500
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	32,010	34,116
Minority interest	3,076	2,623
Equity in earnings of unconsolidated entities	(1,327)	(2,043)
Loss on sale of assets and other provisions, net	277	860
Obligations under lease guarantees		2,400
Provision for uncollectible accounts	1,871	1,536
Stock-based compensation	1,171	1,064
Other	(188)	523
Changes in assets and liabilities:		
Decrease in accounts receivable	2,650	1,390
Increase in accrued straight-line rents	(2,153)	(2,903)
Additions to tenant leasing costs	(2,704)	(1,514)
Increase in prepaid expenses and other assets	(1,174)	(5,055)
Decrease in accounts payable and accrued expenses	(14,734)	(12,632)
Increase (decrease) in rent received in advance and security deposits	1,599	(1,441)
Total adjustments	20,374	18,924
Net cash provided by operating activities	39,345	36,424
Cash flows from investing activities:		
Acquisition and development of rental property	(7,972)	(7,552)
Additions to land held for development or sale	(520)	(339)
Additions to construction in progress	(3,777)	(1,703)
Issuance of notes receivable	(654)	
Distributions from unconsolidated entities	835	1,097
Investments in unconsolidated entities	(544)	(1,759)
Acquisition of minority interest	(220)	(3,371)
Decrease (increase) in restricted deposits	2,545	(140)
Proceeds from sales of properties	162	
Net cash used by investing activities	(10,145)	(13,767)
Cash flows from financing activities:		
Repurchase of common shares	(7,858)	
Repurchase of preferred shares	(53,953)	

Exercises of stock options	1,381	15,710
Proceeds from issuance of unsecured notes, net		394,496
Net borrowings (repayments) on unsecured credit facility	96,000	(383,000)
Deferred financing costs		(624)
Repayments of mortgages payable	(28,045)	(5,023)
Dividends and distributions to minority interests	(34,474)	(37,830)
Net cash used by financing activities	(26,949)	(16,271)
Increase in cash and cash equivalents	2,251	6,386
Cash and cash equivalents, beginning of the period	3,023	5,041
Cash and cash equivalents, end of the period	$ 5,274	$ 11,427
Supplemental disclosure of cash flow information:		
Cash paid for interest (net of capitalized interest of $424 and $872 for the three months ended March 31, 2003 and 2002, respectively)	$ 37,926	$ 20,419
Cash paid (refunds) for income taxes	$ (59)	$ 11

See accompanying notes to consolidated financial statements.

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CARRAMERICA REALTY CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

(1) Description of Business and Summary of Significant Accounting Policies

(a) Business

We are a fully integrated, self-administered and self-managed publicly traded real estate investment trust (REIT), organized as a corporation under the laws of Maryland. We focus on the acquisition, development, ownership and operation of office properties, located in selected markets across the United States.

(b) Basis of Presentation

The financial statements have been prepared using the accounting policies described in our 2002 annual report on Form 10-K except that, effective January 1, 2003, we began using the fair value method to account for employee stock compensation awards. The effect of the change on the financial statements was immaterial.

Our accounts and those of our controlled subsidiaries and affiliates are consolidated in the financial statements. We use the equity or cost methods, as appropriate in the circumstances, to account for our investments in and our share of the earnings or losses of unconsolidated entities. These entities are not controlled by us. If events or changes in circumstances indicated that the fair value of an investment accounted for using the equity method or cost method has declined below its carrying value and we consider the decline to be other than temporary, the investment is written down to fair value and an impairment loss is recognized.

Management has made a number of estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses in the financial statements, and the disclosure of contingent assets and liabilities. Estimates are required in order for us to prepare our financial statements in conformity with accounting principles generally accepted in the United States of America. Significant estimates are required in a number of areas, including the evaluation of impairment of long-lived assets and equity and cost method investments, assessing our probable liability under lease guarantees for HQ Global Workplaces, Inc. and the evaluation of the collectibility of accounts and notes receivable. Actual results could differ from these estimates.

(c) Interim Financial Statements

The financial statements reflect all adjustments, which are, in our opinion, necessary to reflect a fair presentation of the results for the interim periods, and all adjustments are of a normal, recurring nature.

(d) New Accounting Pronouncements

In November 2002, the Financial Accounting Standards Board (FASB) issued Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. The Interpretation requires recognition of liabilities at their fair value for newly issued guarantees. The Interpretation requires certain disclosures, which we have included in note 4. The adoption of Interpretation No. 45 on January 1, 2003 did not have a material effect on our financial statements.

CARRAMERICA REALTY CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based compensation and requires disclosure in both annual and interim financial statements about the method of accounting for stock-based compensation and the effect of the method used on reported results. Effective January 1, 2003, we adopted the fair value based method of accounting for stock-based compensation costs. We elected to use the prospective method of transition to the fair value method provided in SFAS No. 148 and, accordingly, the method is being applied for all employee stock compensation awards granted, modified or settled on or after January 1, 2003.

In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities. This Interpretation addresses the consolidation of variable interest entities (VIEs) in which the equity investors lack one or more of the essential characteristics of a controlling financial interest or where the equity investment at risk is not sufficient for the entity to finance its activities without subordinated financial support from other parties. The Interpretation applies to VIEs created after January 31, 2003 and to VIEs in which we acquire an interest after that date. Effective July 1, 2003, it also applies to VIEs in which we acquired an interest before February 1, 2003. We may apply the Interpretation prospectively, with a cumulative effect adjustment as of July 1, 2003, or by restating previously issued financial statements with a cumulative effect adjustment as of the beginning of the first year restated. We are in the process of evaluating the effects of applying Interpretation No. 46 in 2003. Based on our preliminary analysis, we believe that we may be required to consolidate certain of our unconsolidated real estate ventures that we have accounted for using the equity method; however, we do not expect that this will involve any cumulative effect adjustment. We also do not believe that this will have a material adverse effect on our financial condition.

(e) Earnings Per Share

The following table sets forth information relating to the computations of our basic and diluted earnings per share from continuing operations.

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CARRAMERICA REALTY CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

	Three Months Ended March 31, 2003			Three Months Ended March 31, 2002		
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
	(In thousands, except per share amounts)					
Basic EPS	$ 13,628	51,608	$ 0.26	$ 7,236	52,326	$ 0.14
Effect of Dilutive Securities						
Adjustment to dividends on unvested restricted stock	37					
Stock options		328			1,430	
Convertible preferred stock					12	
Diluted EPS	$ 13,665	51,936	$ 0.26	$ 7,236	53,768	$ 0.14

Income from continuing operations has been reduced by preferred stock dividends and dividends for unvested restricted stock of approximately $5,343,000 and $8,548,000 for the three months ended March 31, 2003 and 2002, respectively.

The effects of units in CarrAmerica Realty, L.P. and Carr Realty, L.P., that are redeemable for shares of our common stock, are not included in the computation of diluted earnings per share as their effect is antidilutive.

(f) Derivative Financial Instruments and Hedging

We manage our capital structure to reflect a long-term investment approach, generally seeking to match the stable return nature of our assets with a mix of equity and various debt instruments. We mainly use fixed rate debt instruments in order to match the returns from our real estate assets. We also utilize variable rate debt for short-term financing purposes or to protect against the risk, at certain times, that fixed rates may overstate our long-term costs of borrowing if assumed inflation or growth in the economy implicit in higher fixed interest rates do not materialize.

At times, our mix of variable and fixed rate debt may not suit our needs. At those times, we may use derivative financial instruments, including interest rate caps and swaps, forward interest rate options or interest rate options in order to assist us in managing our debt mix. We either will hedge our variable rate debt to give it a fixed interest rate or hedge fixed rate debt to give it a variable interest rate.

Under interest rate cap agreements, we make initial premium payments to the counterparties in exchange for the right to receive payments from them if interest rates exceed specified levels during the agreement period. Under interest rate swap agreements, we and the counterparties agree to exchange the difference between fixed rate and variable rate interest amounts calculated by reference to specified notional principal amounts during the agreement period. Notional principal amounts are used to express the volume of these transactions, but the cash requirements and amounts subject to credit risk are substantially less. Parties to interest rate cap and swap agreements are subject to market risk for changes in interest rates and credit risk in the event of nonperformance by the counterparty. We do not require any collateral under these agreements but deal only with highly rated institutional counterparties and do not expect that any counterparties will fail to meet their obligation.

Derivative financial instruments are recognized as either assets or liabilities on the balance sheet at their fair value. Subject to certain qualifying conditions, we may designate a derivative as either a hedge of the cash flows from a variable rate debt instrument or anticipated transaction (cash flow hedge) or a hedge of the fair value of a fixed rate debt instrument (fair value hedge). For those derivatives designated as a cash flow hedge, we report the fair value gains and losses in accumulated other comprehensive income in stockholders equity to the extent the hedge is effective. We recognize these fair value gains or losses in earnings during the period(s) in which the hedged item affects earnings. For a derivative qualifying as a fair value hedge, we report fair value gains and losses in earnings along with fair value gains or losses on

CARRAMERICA REALTY CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

the hedge item attributable to the risk being hedged. Most of our derivative financial instruments qualify as a fair value hedge. Derivatives that do not qualify for hedge accounting are marked to market through earnings. Amounts receivable or payable under interest rate cap and swap agreements are accounted for as adjustments to interest expense on the related debt.

On May 8, 2002, we entered into an interest rate swap agreements with JP Morgan Chase and Bank of America, N.A. hedging $150.0 million of senior unsecured notes due July 2004. We receive interest at a fixed rate of 7.2% and pay interest at a variable rate of six-month LIBOR in arrears plus 2.72%. The interest rate swaps mature at the same time the notes are due. The swaps qualify as fair value hedges for accounting purposes. The fair value of the interest rate swaps is recognized on our balance sheet and the carrying value of the senior unsecured notes is increased or decreased by an offsetting amount. As of March 31, 2003, the fair value of the interest rate swaps was approximately $4.9 million. We recognized a reduction in interest expense for the three months ended March 31, 2003 of approximately $1.2 million related to the swaps. As of March 31, 2003, taking into account the effect of the interest rate swaps, the effective interest rate on the notes was reduced to 3.9%.

On November 20, 2002, in conjunction with the issuance of $175.0 million of senior unsecured notes, we entered into interest rate swap agreements with JP Morgan Chase, Bank of America, N.A. and Goldman Sachs & Co. We receive interest at a fixed rate of 5.25% and pay interest at a variable rate of six-month LIBOR in arrears plus 1.405%. The interest rate swaps mature at the same time the notes are due. The swaps qualify as fair value hedges for accounting purposes. The fair value of the interest rate swaps is recognized on our balance sheet and the carrying value of the senior unsecured notes is increased or decreased by an offsetting amount. As of March 31, 2003, the fair value of the interest rate swaps was approximately $2.9 million. We recognized a reduction in interest expense for the three months ended March 31, 2003 of approximately $1.5 million related to the swaps. As of March 31, 2003, taking into account the effect of the interest rate swaps, the effective interest rate on the notes was reduced to 2.6%.

As part of the assumption of $63.5 million of debt associated with the purchase of two operating properties in August 2002, we purchased interest rate caps with a notional amount of $97.0 million and LIBOR capped at 6.75%. As of March 31, 2003, the fair market value of these interest rate caps was not material.

(g) Stock/Unit Compensation Plans

Through 2002, we applied the intrinsic value method of accounting prescribed by Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations to account for our stock/unit compensation plans. Under this method, we recorded compensation expense for awards of stock, options or units to employees only if the market price of the unit or stock on the grant date exceeded the amount the employee was required to pay to acquire the unit or stock. Effective January 1, 2003, we adopted the fair value based method of accounting for stock-based compensation costs. We elected to use the prospective method of transition to the fair value method provided in SFAS No. 148 and, accordingly, the method is being applied for all employee stock compensation awards granted, modified or settled on or after January 1, 2003.

The following table summarizes pro forma effects on net income and earnings per share if the fair value method had been used to account for all stock-based compensation awards made between 1997 and 2002.

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CARRAMERICA REALTY CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

	Three Months Ended March 31,	
	2003	**2002**
(In thousands, except per share data)		
Net income as reported	$ 18,971	$ 17,500
Stock-based compensation cost from stock option plans included in net income	19	
Stock-based compensation cost from restricted unit plan included in net income	1,152	1,064
Fair value of stock-based compensation	(1,760)	(1,877)
Pro forma net income	$ 18,382	$ 16,687
Earnings per share as reported:		
Basic	$ 0.26	$ 0.17
Diluted	0.26	0.17
Earnings per share, pro forma:		
Basic	$ 0.25	$ 0.16
Diluted	0.25	0.15

(h) Reclassifications

Certain reclassifications of prior period amounts have been made to conform to the current period s presentation.

(2) HQ Global Workplaces, Inc.

In 1997, we began making investments in HQ Global Workplaces, Inc. (HQ Global), a provider of executive office suites. On June 1, 2000, we, along with HQ Global, VANTAS Incorporated (VANTAS) and FrontLine Capital Group (FrontLine), consummated several transactions including (i) the merger of VANTAS with and into HQ Global, (ii) the acquisition by FrontLine of shares of HQ Global common stock from us and other stockholders of HQ Global, and (iii) the acquisition by VANTAS of our debt and equity interests in OmniOffices (UK) Limited and OmniOffices LUX 1929 Holding Company S.A. We received $377.3 million in cash in connection with these transactions. In addition, $140.5 million of debt which we had guaranteed was repaid with a portion of the cash proceeds. Following the transaction, we owned approximately 16% of the equity of HQ Global on a diluted basis and our investment had a carrying value of $42.2 million. In 2001, based on a number of considerations, we recorded an impairment charge that reduced the carrying value of our remaining investment in HQ Global to zero.

On March 13, 2002, HQ Global filed for bankruptcy protection under Chapter 11 of the federal bankruptcy laws. During 1997 and 1998, to assist HQ Global as it grew its business, we provided guarantees of HQ Global s performance under four office leases. To our knowledge, all monthly rent payments were made by HQ Global under two of these leases through January 2002, and rental payments under the other two leases were made through February 2002.

In the course of its bankruptcy proceedings, HQ Global has filed motions to reject two of these four leases. One lease was for approximately 22,000 square feet of space at two adjacent buildings in San Jose, California. Our liability under this guarantee was limited to approximately $2.0 million. We reached an agreement with the landlord of this lease under which we paid $1.75 million in full satisfaction of the guarantee in January 2003. We recognized this expense in 2002.

The second lease that was rejected by HQ Global is a sublease for space in downtown Manhattan. This lease is for approximately 26,000 square feet of space and runs through March 2008, with total aggregate remaining lease payments as of February 1, 2002 of approximately $5.4 million. In June 2002, we received a demand for payment of the full amount of the guarantee. However, we believe that we have defenses to payment under this guarantee available to us and joined with HQ Global in filing suit on July 24, 2002 in HQ Global s bankruptcy proceedings asking the bankruptcy court to declare that the lease was terminated by the landlord of the sublease not later than February 28, 2002. On July 26, 2002, the landlord under the sublease filed suit in federal court in New York seeking payment from us under this guarantee. In light of our defenses and these proceedings, we have not

CARRAMERICA REALTY CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

accrued any expense relating to this guarantee; however, there can be no assurance as to the outcome of the pending litigation or that we will not incur expense or be required to make cash payments relating to this guarantee up to the full amount of the guarantee. As of March 31, 2003, we had not made any payments under this guarantee.

HQ Global has not filed a motion seeking to reject the remaining two leases that we have guaranteed, although it could do so in the future. Even if the leases are not rejected, we may ultimately be liable to the lessors for payments due under the leases. In one case, the lease is for approximately 25,000 square feet of space in midtown Manhattan, and our liability is currently capped at approximately $0.5 million, which liability reduces over the life of the lease until its expiration in September 2007. As of March 31, 2003, we have not accrued any expense related to or made any payments under this guarantee.

The remaining lease is for space in San Mateo, California. This lease is for approximately 19,000 square feet of space and runs through January 2013, with total aggregate remaining lease payments as of March 1, 2002 of approximately $10.4 million. We initially recognized an expense of $0.4 million under this guarantee in the first quarter of 2002 based on a tentative agreement with HQ Global