WASHINGTON REAL ESTATE INVESTMENT TRUST
Form 10-Q
October 31, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For quarterly period ended September 30, 2014

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

COMMISSION FILE NO. 1-6622

WASHINGTON REAL ESTATE
INVESTMENT TRUST
(Exact name of registrant as specified in its charter)

MARYLAND	53-0261100
(State of incorporation)	(IRS Employer Identification Number)

6110 EXECUTIVE BOULEVARD, SUITE 800, ROCKVILLE, MARYLAND 20852
(Address of principal executive office) (Zip code)
Registrant’s telephone number, including area code: (301) 984-9400

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

Title of Each Class	Name of exchange on which registered
Shares of Beneficial Interest	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

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 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 o

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

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

Large accelerated filer	x	Accelerated filer	o
Non-accelerated filer	o	Smaller reporting company	o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES o NO x

As of October 28, 2014, 66,661,627 common shares were outstanding.

WASHINGTON REAL ESTATE INVESTMENT TRUST
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PART I
FINANCIAL INFORMATION

ITEM 1: FINANCIAL STATEMENTS

The information furnished in the accompanying unaudited Consolidated Balance Sheets, Condensed Consolidated Statements of Income, Consolidated Statement of Shareholders' Equity and Consolidated Statements of Cash Flows reflects all adjustments, consisting of normal recurring items, which are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations and cash flows for the interim periods. The accompanying financial statements and notes thereto should be read in conjunction with the financial statements and notes for the three years ended December 31, 2013 included in Washington Real Estate Investment Trust’s 2013 Annual Report on Form 10-K.

WASHINGTON REAL ESTATE INVESTMENT TRUST AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT PER SHARE DATA)

	September 30, 2014 (Unaudited)	December 31, 2013
Assets		
Land	$519,859	$426,575
Income producing property	1,867,752	1,675,652
	2,387,611	2,102,227
Accumulated depreciation and amortization	(620,279)	(565,342)
Net income producing property	1,767,332	1,536,885
Properties under development or held for future development	99,500	61,315
Total real estate held for investment, net	1,866,832	1,598,200
Investment in real estate sold or held for sale, net	—	79,901
Cash and cash equivalents	8,571	130,343
Restricted cash	9,496	9,189
Rents and other receivables, net of allowance for doubtful accounts of $5,519 and $6,783, respectively	58,135	48,756
Prepaid expenses and other assets	116,345	105,004
Other assets related to properties sold or held for sale	—	4,100
Total assets	$2,059,379	$1,975,493
Liabilities		
Notes payable	$747,082	$846,703
Mortgage notes payable	413,330	294,671
Lines of credit	5,000	—
Accounts payable and other liabilities	64,153	51,742
Advance rents	12,211	13,529
Tenant security deposits	8,625	7,869
Liabilities related to properties sold or held for sale	—	1,533
Total liabilities	1,250,401	1,216,047
Equity		
Shareholders' equity		
Preferred shares; $0.01 par value; 10,000 shares authorized; no shares issued or outstanding	—	—
Shares of beneficial interest; $0.01 par value; 100,000 shares authorized: 66,663 and 66,531 shares issued and outstanding at September 30, 2014 and December 31, 2013, respectively	667	665
Additional paid in capital	1,153,344	1,151,174
Distributions in excess of net income	(347,724)	(396,880)
Total shareholders' equity	806,287	754,959
Noncontrolling interests in subsidiaries	2,691	4,487
Total equity	808,978	759,446
Total liabilities and equity	$2,059,379	$1,975,493

See accompanying notes to the consolidated financial statements.

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WASHINGTON REAL ESTATE INVESTMENT TRUST AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(IN THOUSANDS, EXCEPT PER SHARE DATA)
(UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Revenue				
Real estate rental revenue	$73,413	$65,828	$214,278	$196,303
Expenses				
Real estate expenses	25,914	23,243	77,784	69,467
Depreciation and amortization	24,354	21,168	71,508	63,328
Acquisition costs	69	148	5,047	448
General and administrative	4,523	3,850	13,780	11,717
	54,860	48,409	168,119	144,960
Other operating income				
Gain on sale of real estate	—	—	570	—
Real estate operating income	18,553	17,419	46,729	51,343
Other income (expense)				
Interest expense	(15,087)	(15,930)	(44,602)	(47,944)
Other income	192	220	634	705
	(14,895)	(15,710)	(43,968)	(47,239)
Income from continuing operations	3,658	1,709	2,761	4,104
Discontinued operations:				
Income from operations of properties sold or held for sale	—	4,131	546	11,139
Gain on sale of real estate	—	—	105,985	3,195
Net income	3,658	5,840	109,292	18,438
Less: Net loss attributable to noncontrolling interests in subsidiaries	10	—	17	—
Net income attributable to the controlling interests	$3,668	$5,840	$109,309	$18,438
Basic net income per share:				
Continuing operations	$0.05	$0.03	$0.04	$0.06
Discontinued operations	—	0.06	1.59	0.21
Net income per share	$0.05	$0.09	$1.63	$0.27
Diluted net income per share:				
Continuing operations	$0.05	$0.03	$0.04	$0.06
Discontinued operations	—	0.06	1.59	0.21
Net income per share	$0.05	$0.09	$1.63	$0.27
Weighted average shares outstanding – basic	66,738	66,410	66,725	66,403
Weighted average shares outstanding – diluted	66,790	66,561	66,760	66,545
Dividends declared per share	$0.3000	$0.3000	$0.9000	$0.9000

See accompanying notes to the consolidated financial statements.

WASHINGTON REAL ESTATE INVESTMENT TRUST AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
(IN THOUSANDS)
(UNAUDITED)

	Shares Outstanding	Shares of Beneficial Interest at Par Value	Additional Paid in Capital	Distributions in Excess of Net Income Attributable to the Controlling Interests	Total Shareholders' Equity	Noncontrolling Interests in Subsidiaries	Total Equity
Balance, December 31, 2013	66,531	$ 665	$1,151,174	$ (396,880)	$ 754,959	$ 4,487	$759,446
Net income attributable to the controlling interests	—	—	—	109,309	109,309	—	109,309
Net loss attributable to the noncontrolling interests	—	—	—	—	—	(17)	(17)
Distributions to noncontrolling interests	—	—	—	—	—	(1,784)	(1,784)
Contributions from noncontrolling interests	—	—	—	—	—	5	5
Dividends	—	—	—	(60,153)	(60,153)	—	(60,153)
Share grants, net of share grant amortization and forfeitures	132	2	2,170	—	2,172	—	2,172
Balance, September 30, 2014	66,663	$ 667	$1,153,344	$ (347,724)	$ 806,287	$ 2,691	$808,978

See accompanying notes to the consolidated financial statements.

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WASHINGTON REAL ESTATE INVESTMENT TRUST AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)
(UNAUDITED)

	Nine Months Ended September 30,	
	2014	2013
Cash flows from operating activities		
Net income	$109,292	$18,438
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization, including amounts in discontinued operations	71,508	75,489
Provision for losses on accounts receivable	1,335	3,012
Gain on sale of real estate	(106,555)	(3,195)
Amortization of share grants, net	3,835	3,615
Amortization of debt premiums, discounts and related financing costs	2,730	2,980
Changes in operating other assets	(16,255)	(8,856)
Changes in operating other liabilities	(3,013)	2,002
Net cash provided by operating activities	62,877	93,485
Cash flows from investing activities		
Real estate acquisitions, net	(154,126)	—
Net cash received for sale of real estate	190,864	15,161
Capital improvements to real estate	(41,945)	(39,348)
Development in progress	(28,363)	(9,385)
Real estate deposits, net	(2,500)	(6,800)
Cash held in replacement reserve escrows	(550)	—
Non-real estate capital improvements	(44)	(125)
Net cash used in investing activities	(36,664)	(40,497)
Cash flows from financing activities		
Line of credit borrowings, net	5,000	85,000
Dividends paid	(60,153)	(60,132)
Contributions from noncontrolling interests	5	390
Distributions to noncontrolling interests	(3,454)	—
Payment of financing costs	(660)	—
Principal payments – mortgage notes payable	(2,860)	(32,461)
Borrowings under construction loan	14,137	3,033
Notes payable repayments	(100,000)	(60,000)
Net cash used in financing activities	(147,985)	(64,170)
Net decrease in cash and cash equivalents	(121,772)	(11,182)
Cash and cash equivalents at beginning of period	130,343	19,105
Cash and cash equivalents at end of period	$8,571	$7,923
Supplemental disclosure of cash flow information:		
Cash paid for interest, net of amounts capitalized	$36,770	$42,075
Cash paid for income taxes, net of refunds	156	—
Decrease in accrued capital improvements and development costs	10,860	2,978
Mortgage notes payable assumed in connection with the acquisition of real estate	100,861	—

See accompanying notes to the consolidated financial statements.

WASHINGTON REAL ESTATE INVESTMENT TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2014
(UNAUDITED)

NOTE 1: NATURE OF BUSINESS

Washington Real Estate Investment Trust (“Washington REIT”), a Maryland real estate investment trust, is a self-administered, self-managed equity real estate investment trust, successor to a trust organized in 1960. Our business consists of the ownership and operation of income-producing real estate properties in the greater Washington metro region. We own a diversified portfolio of office buildings, multifamily buildings and retail centers.

Federal Income Taxes

We believe that we qualify as a real estate investment trust (“REIT”) under Sections 856-860 of the Internal Revenue Code and intend to continue to qualify as such. To maintain our status as a REIT, we are required to distribute 90% of our ordinary taxable income to our shareholders. When selling properties, we have the option of (a) reinvesting the sales proceeds of properties sold, allowing for a deferral of income taxes on the sale, (b) paying out capital gains to the shareholders with no tax to Washington REIT or (c) treating the capital gains as having been distributed to the shareholders, paying the tax on the gain deemed distributed and allocating the tax paid as a credit to the shareholders. During the first quarter of 2014, we closed on Transactions III (for the sale of Woodburn Medical Park I and II) and IV (for the sale of Prosperity Medical Center I, II and III) of the Medical Office Portfolio sale for an aggregate contract sales price of $193.6 million. We have reinvested a portion of the Medical Office Portfolio sales proceeds in replacement properties through deferred tax exchanges.

Generally, and subject to our ongoing qualification as a REIT, no provisions for income taxes are necessary except for taxes on undistributed REIT taxable income and taxes on the income generated by our taxable REIT subsidiaries (“TRSs”). Our TRSs are subject to corporate federal and state income tax on their taxable income at regular statutory rates or as calculated under the alternative minimum tax, as appropriate. There were no material income tax provisions or material net deferred income tax items for our TRSs for the three and nine months ended September 30, 2014 and 2013.

NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND BASIS OF PRESENTATION

Significant Accounting Policies

We have prepared our consolidated financial statements using the accounting policies described in our Annual Report on Form 10-K for the year ended December 31, 2013.

New Accounting Pronouncements

In April 2014, the Financial Accounting Standards Board ("FASB") issued ASU No. 2014-08, Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity, which changes the requirements for reporting discontinued operations. Specifically, under this ASU only those disposals of components of an entity that represent a strategic shift that has (or will have) a major effect on an entity’s operations and financial results will be reported as discontinued operations in the financial statements. The primary impact of this ASU is that we are no longer required to report the disposal of every operating property in discontinued operations. Adoption of this ASU is required for all disposals (or classifications as held for sale) of components of an entity that occur within annual periods beginning on or after after December 15, 2014, and interim periods within those years. Early adoption is permitted, but only for disposals (or classifications as held for sale) that have not been reported in financial statements previously issued or available for issuance. We early adopted this ASU effective for the first quarter of 2014.

In June 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, which creates a single source of revenue guidance. The new standard provides accounting guidance for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other U.S. generally accepted accounting principles (“GAAP”) requirements, such as the leasing literature). The guidance also provides a model for the measurement and recognition of gains and losses on the sale of certain nonfinancial assets, such as property and equipment, including real estate. The new standard is effective for public entities for fiscal years beginning after December 15, 2016 and for interim periods therein. Early adoption is not permitted for public entities. We are currently evaluating the impact the new standard may have on Washington REIT.

Principles of Consolidation and Basis of Presentation

The accompanying unaudited consolidated financial statements include the consolidated accounts of Washington REIT, our majority-owned subsidiaries and entities in which Washington REIT has a controlling interest, including where Washington REIT has been determined to be a primary beneficiary of a variable interest entity (“VIE”). See note 3 for additional information on the properties for which there is a noncontrolling interest. All intercompany balances and transactions have been eliminated in consolidation.

We have prepared the accompanying unaudited financial statements pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in annual financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to those rules and regulations, although we believe that the disclosures made are adequate to make the information presented not misleading. In addition, in the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the results for the periods presented have been included. These unaudited financial statements should be read in conjunction with the financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2013.

Within these notes to the financial statements, we refer to the three months ended September 30, 2014 and September 30, 2013 as the “2014 Quarter” and the “2013 Quarter,” respectively, and the nine months ended September 30, 2014 and September 30, 2013 as the “2014 Period” and the “2013 Period,” respectively.

Use of Estimates in the Financial Statements

The preparation of financial statements in conformity with GAAP requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

NOTE 3: REAL ESTATE

Acquisitions

Washington REIT acquired the following properties during the 2014 Period:

Acquisition Date	Property Name	Type	Rentable Square Feet	Contract Purchase Price (in thousands)
February 21, 2014	Yale West (216 units)	Multifamily	N/A	$73,000
March 26, 2014	The Army Navy Club Building	Office	108,000	79,000
May 1, 2014	1775 Eye Street, NW	Office	185,000	104,500
			293,000	$256,500

The results of operations from the acquired operating properties are included in the consolidated statements of income as of their acquisition dates.

The revenue and earnings of our 2014 acquisitions are as follows (amounts in thousands):

	Three Months Ended September 30, 2014	Nine Months Ended September 30, 2014
Real estate rental revenue	$5,089	$10,444
Net loss	(640)	(2,752)

We record the acquired physical assets (land, building and tenant improvements), and in-place leases (absorption, tenant origination costs, leasing commissions and net lease intangible assets/liabilities), and any other assets or liabilities at their fair values.

We have recorded the total purchase price of the above acquisitions as follows (in thousands):

Land	$93,567
Buildings	141,456
Tenant origination costs	8,354
Leasing commissions/absorption costs	12,847
Net lease intangible assets	7,331
Net lease intangible liabilities	(2,122)
Fair value of assumed mortgages	(107,125)
Furniture fixtures and equipment	932
Total	$155,240

The weighted remaining average life for the 2014 acquisition components above, other than land and building, are 71 months for tenant origination costs, 54 months for leasing commissions/absorption costs, 72 months for net lease intangible assets and 82 months for net lease intangible liabilities.

The difference in the total contract purchase price of $256.5 million for the 2014 acquisitions and the acquisition cost per the consolidated statement of cash flows of $154.1 million is primarily due to the assumption of two mortgage notes secured by Yale West and The Army Navy Club Building for an aggregate $100.9 million and the payment of a $3.6 million deposit for Yale West in 2013, partially offset by a credit to the seller for building renovations at 1775 Eye Street, NW for $1.9 million.

The following unaudited pro-forma combined condensed statements of operations are for the 2014 and 2013 Quarters and Periods as if the above described acquisitions had occurred at the beginning of the period of acquisition and the same period in the year prior to acquisition. The unaudited pro-forma information does not purport to be indicative of the results that actually would have occurred if the acquisitions had been in effect for the 2014 and 2013 Quarters and Periods. The unaudited data presented is in thousands, except per share data.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Real estate rental revenue	$73,413	$71,004	$219,192	$211,662
Income from continuing operations	3,668	477	1,960	449
Net income	3,668	4,608	108,492	14,783
Diluted earnings per share	0.05	0.07	1.62	0.22

Redevelopment

In the office segment, we have an active redevelopment project to renovate 7900 Westpark Drive. Our total investment in the renovation at 7900 Westpark Drive is expected to be $35.0 million. As of September 30, 2014 and December 31, 2013, we had invested $18.4 million and $3.6 million, respectively, in the renovation. We anticipate completion during the first quarter of 2015.

Variable Interest Entities

In June 2011, we executed a joint venture operating agreement with a real estate development company to develop The Maxwell, a mid-rise multifamily property at 650 North Glebe Road in Arlington, Virginia. We estimate the total cost of the project to be $49.9 million. During the first quarter of 2013, we secured third-party debt financing for approximately 70% of the project's cost. Washington REIT is the 90% owner of the joint venture and will have management and leasing responsibilities when the project is completed and stabilized (defined as 90% of the residential units leased). The real estate development company owns 10% of the joint venture and is responsible for the development and construction of the property. The joint venture currently expects to complete this development project during the fourth quarter of 2014.

In November 2011, we executed a joint venture operating agreement with a real estate development company to develop a high-rise multifamily property at 1225 First Street (formerly 1219 First Street) in Alexandria, Virginia. We estimate the total cost of the project to be $95.3 million, with approximately 70% of the project financed with debt. Washington REIT is the 95% owner of the joint venture and will have management and leasing responsibilities if the project is completed and stabilized. The real estate development company owns 5% of the joint venture and is responsible for the development and construction of the property. In the first quarter of 2013, we decided to delay commencement of construction due to market conditions and concerns of oversupply. We continue to reassess this project on a periodic basis going forward.

We have determined that The Maxwell and 1225 First Street joint ventures are VIE's primarily based on the fact that the equity investment at risk is not sufficient to permit either entity to finance its activities without additional financial support. We expect that 70% of the total development costs for each project would be financed through debt. We have also determined that Washington REIT is the primary beneficiary of each VIE due to the fact that Washington REIT is providing 90% to 95% of the equity contributions and will manage each property after stabilization.

We include the joint venture land acquisitions on our consolidated balance sheets in properties under development or held for future development. As of September 30, 2014 and December 31, 2013, the land and capitalized development costs are as follows (in thousands):

	September 30, 2014	December 31, 2013
The Maxwell	$47,084	$27,343
1225 First Street	20,807	20,788

As of September 30, 2014 and December 31, 2013, the accounts payable and accrued liabilities related to the joint ventures are as follows (in thousands):

	September 30, 2014	December 31, 2013
The Maxwell	$6,253	$1,785
1225 First Street	76	39

On February 21, 2013, Washington REIT, through its consolidated joint venture to develop The Maxwell, entered into a construction loan agreement with Citizens Bank for $33.0 million. The loan bears interest at LIBOR plus 2.15%, which decreases to LIBOR plus 2.0% upon completion of construction and the joint venture not being in default. The loan matures on February 21, 2016, with two one year extension options exercisable by the joint venture, subject to fees and compliance with certain provisions in the loan agreement. As of September 30, 2014 and December 31, 2013, the consolidated joint venture had $21.4 million and $7.3 million, respectively, outstanding on this construction loan agreement.

Discontinued Operations

We dispose of assets that no longer meet our long-term strategy or return objectives and where market conditions for sale are favorable. The proceeds from the sales may be reinvested into other properties, used to fund development operations or to support other corporate needs, or distributed to our shareholders. Properties are considered held for sale when they meet the criteria specified (see "Discontinued Operations" in note 2 of the consolidated financial statements included in Washington REIT's Annual Report on Form 10-K for the year ended December 31, 2013). Depreciation on these properties is discontinued at that time, but operating revenues, other operating expenses and interest continue to be recognized until the date of sale.

In September 2013, we entered into four separate purchase and sale agreements to effectuate the sale of our entire medical office segment (including land held for development at 4661 Kenmore Avenue) and two office buildings (Woodholme Center and 6565 Arlington Boulevard) for an aggregate purchase price of $500.8 million. The sale was structured as four transactions. Transactions I and II closed in November 2013 and Transactions III and IV closed in January 2014.

The results of our medical office segment are summarized as follows (amounts in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013

Real estate rental revenue	$—	$10,889	$892	$32,928
Net income	—	3,820	546	10,080
Basic net income per share	—	0.06	0.01	0.15
Diluted net income per share	—	0.06	0.01	0.15

We sold the following properties in 2014 and 2013:

Property Name	Segment	Rentable Square Feet	Contract Purchase Price (in thousands)	Gain on Sale (in thousands)
Medical Office Portfolio Transactions III & IV (1)	Medical Office	427,000	$193,561	$105,985
5740 Columbia Road (2)	Retail	3,000	1,600	570
	Total 2014	430,000	$195,161	$106,555
Atrium Building	Office	79,000	$15,750	$3,195
Medical Office Portfolio Transactions I & II (3)	Medical Office / Office	1,093,000	307,189	18,949
	Total 2013	1,172,000	$322,939	$22,144

(1) Woodburn Medical Park I and II and Prosperity Medical Center I, II and III.

(2) This property is classified as continuing operations in accordance with ASU No. 2014-08 (see note 2).

(3) 2440 M Street, 15001 Shady Grove Road, 15505 Shady Grove Road, 19500 at Riverside Park (formerly Lansdowne Medical Office Building), 9707 Medical Center Drive, CentreMed I and II, 8301 Arlington Boulevard, Sterling Medical Office Building, Shady Grove Medical Village II, Alexandria Professional Center, Ashburn Farm Office Park I, Ashburn Farm Office Park II, Ashburn Farm Office Park III, Woodholme Medical Office Building, two office properties (6565 Arlington Boulevard and Woodholme Center) and undeveloped land at 4661 Kenmore Avenue.

As of September 30, 2014 and December 31, 2013, investment in real estate for properties sold or held for sale, all of which were in the medical office segment, was as follows (in thousands):

	September 30, 2014	December 31, 2013
Investment in real estate sold or held for sale	$—	$125,967
Less accumulated depreciation	—	(46,066)
Investment in real estate sold or held for sale, net	$—	$79,901

Income from operations of properties sold or held for sale for the three and nine months ended September 30, 2014 and 2013 was as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Real estate rental revenue	$—	$12,073	$892	$37,141
Real estate expenses	—	(4,398)	(346)	(12,856)
Depreciation and amortization	—	(3,215)	—	(12,161)
Interest expense	—	(329)	—	(985)
Income from operations of properties sold or held for sale	$—	$4,131	$546	$11,139

Income from operations of properties sold or held for sale by property for the three and nine months ended September 30, 2014 and 2013 was as follows (in thousands):

		Three Months Ended September 30,		Nine Months Ended September 30,	
Property	Segment	2014	2013	2014	2013
Atrium Building	Office	$—	$—	$—	$185
Medical Office Portfolio	Medical Office / Office	—	4,131	546	10,954
		$—	$4,131	$546	$11,139

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NOTE 4: MORTGAGE NOTES PAYABLE

In February 2014, we assumed a $48.2 million mortgage note as partial consideration for the acquisition of Yale West. This mortgage note bears interest at 5.55% per annum. The fair value interest rate on this mortgage note is 3.75% based on quotes obtained for similar loans. We recorded the mortgage note at its estimated fair value of $54.0 million. Principal and interest are payable monthly until January 1, 2052, at which time all unpaid principal and interest are payable in full. The loan may be prepaid, without penalty, on January 31, 2022 or thereafter on the last business day of the month until maturity, with thirty days prior written notice to the lender.

In March 2014, we assumed a $52.7 million mortgage note as partial consideration for acquisition of The Army Navy Club Building. This mortgage note bears interest at 3.45% per annum. The fair value interest rate on this mortgage note is 3.18% based on quotes obtained for similar loans. We recorded the mortgage at its estimated fair value of $53.2 million. Principal and interest are payable monthly until May 1, 2017, at which time all unpaid principal and interest are payable in full.

NOTE 5: UNSECURED LINES OF CREDIT PAYABLE

As of September 30, 2014, we maintained a $100.0 million unsecured line of credit maturing in June 2015 ("Credit Facility No. 1") and a $400.0 million unsecured line of credit maturing in July 2016 ("Credit Facility No. 2"). Credit Facilities No. 1 and No. 2 have accordion features that allow us to increase the facilities to $200.0 million and $600.0 million, respectively, subject to additional lender commitments.

The amounts of these lines of credit unused and available at September 30, 2014 are as follows (in thousands):

	Credit Facility No. 1	Credit Facility No. 2
Committed capacity	$100,000	$400,000
Borrowings outstanding	(5,000)	—
Unused and available	$95,000	$400,000

We executed borrowings on the unsecured lines of credit during the 2014 Period as follows (in thousands):

	Credit Facility No. 1
Balance at December 31, 2013	$—
Borrowings	5,000
Balance at September 30, 2014	$5,000

NOTE 6: NOTES PAYABLE

We repaid without penalty $100.0 million of our 5.25% unsecured notes on their due date of January 15, 2014, using proceeds from the sale of the Medical Office Portfolio.

NOTE 7: STOCK BASED COMPENSATION

Washington REIT maintains short-term ("STIP") and long-term ("LTIP") incentive plans that allow for stock-based awards to officers and non-officer employees. Stock based awards are provided to officers and non-officer employees, as well as trustees, under the Washington Real Estate Investment Trust 2007 Omnibus Long-Term Incentive Plan which allows for awards in the form of restricted shares, restricted share units, options and other awards up to an aggregate of 2,000,000 shares over the ten year period in which the plan will be in effect. Restricted share units are converted into shares of our stock upon full vesting through the issuance of new shares.

During the 2014 Period, the Board of Trustees adopted a new STIP and new LTIP for executive officers. Regarding the new STIP, the changes from the prior STIP primarily removed the 15% service-only component of the award, maintaining an award payable 50% in cash and 50% in stock. The new LTIP is based entirely on total shareholder return during a defined three-year period. The LTIP was also converted from a single three-year plan structure to a “rolling” structure in which a new three-year plan is commenced each year. The vesting at the end of the performance period was modified to be 75% at the end of the performance period and 25% one year thereafter. In addition, during the transition period to the new LTIP, the Board of Trustees awarded similar transition awards with defined performance periods of one and two years and modified vesting to account for the transition.

Total Compensation Expense

Total compensation expense recognized in the consolidated financial statements for all outstanding share based awards was $1.3 million and $1.2 million for the 2014 and 2013 Quarters, respectively, and $3.8 million and $3.6 million for the 2014 and 2013 Periods, respectively.

Restricted Share Awards

The total fair values of restricted share awards vested was $1.0 million and $0.7 million for the 2014 and 2013 Periods, respectively.

The total unvested restricted share awards at September 30, 2014 was 207,082 shares, which had a weighted average grant date fair value of $25.37 per share. As of September 30, 2014, the total compensation cost related to unvested restricted share awards was $1.7 million, which we expect to recognize over a weighted average period of 17 months.

NOTE 8: FAIR VALUE DISCLOSURES

Assets and Liabilities Measured at Fair Value

For assets and liabilities measured at fair value on a recurring basis, quantitative disclosures about the fair value measurements are required to be disclosed separately for each major category of assets and liabilities, as follows:

Level 1: Quoted prices in active markets for identical assets

Level 2: Significant other observable inputs

Level 3: Significant unobservable inputs

The only assets or liabilities we had at September 30, 2014 and December 31, 2013 that are recorded at fair value on a recurring basis are the assets held in the Supplemental Executive Retirement Program (“SERP”). We base the valuations related to this asset on the observable market values of the investments that comprise the SERP (Level 2 inputs).

The fair values of these assets at September 30, 2014 and December 31, 2013 were as follows (in thousands):

	September 30, 2014				December 31, 2013			
	Fair Value	Level 1	Level 2	Level 3	Fair Value	Level 1	Level 2	Level 3
Assets:								
SERP	$2,616	$—	$2,616	$—	$3,290	$—	$3,290	$—

Financial Assets and Liabilities Not Measured at Fair Value

The following disclosures of estimated fair value were determined by management using available market information and established valuation methodologies, including discounted cash flow. Many of these estimates involve significant judgment. The estimated fair value disclosed may not necessarily be indicative of the amounts we could realize on disposition of the financial instruments. The use of different market assumptions or estimation methodologies could have an effect on the estimated fair value amounts. In addition, fair value estimates are made at a point in time and thus, estimates of fair value subsequent to September 30, 2014 may differ significantly from the amounts presented.

Following is a summary of significant methodologies used in estimating fair values and a schedule of fair values at September 30, 2014.

Cash and Cash Equivalents and Restricted Cash

Cash and cash equivalents and restricted cash include cash and commercial paper with original maturities of less than 90 days, which are valued at the carrying value, which approximates fair value due to the short maturity of these instruments (Level 1 inputs).

Notes Receivable

We acquired a note receivable ("2445 M Street note") in 2008 with the purchase of 2445 M Street. We estimate the fair value of the 2445 M Street note based on a discounted cash flow methodology using market discount rates (Level 3 inputs).

Debt

Mortgage notes payable consist of instruments in which certain of our real estate assets are used for collateral. We estimate the fair value of the mortgage notes payable by discounting the contractual cash flows at a rate equal to the relevant treasury rates (with respect to the timing of each cash flow) plus credit spreads estimated through independent comparisons to real estate assets or loans with similar characteristics. Lines of credit payable consist of bank facilities which we use for various purposes including working capital, acquisition funding or capital improvements. The lines of credit advances are priced at a specified rate plus a spread. We estimate the market value based on a comparison of the spreads of the advances to market given the adjustable base rate. We estimate the fair value of the notes payable by discounting the contractual cash flows at a rate equal to the relevant treasury rates (with respect to the timing of each cash flow) plus credit spreads derived using the relevant securities' market prices. We classify these fair value measurements as Level 3 as we use significant unobservable inputs and management judgment due to the absence of quoted market prices.

As of September 30, 2014 and December 31, 2013, the carrying values and estimated fair values of our financial instruments were as follows (in thousands):

	September 30, 2014		December 31, 2013	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Cash and cash equivalents	$8,571	$8,571	$130,343	$130,343
Restricted cash	9,496	9,496	9,189	9,189
2445 M Street note	5,556	6,755	6,070	6,803
Mortgage notes payable	413,330	429,957	294,671	313,476
Lines of credit	5,000	5,000	—	—
Notes payable	747,082	782,450	846,703	856,171

NOTE 9: EARNINGS PER COMMON SHARE

We determine "Basic earnings per share" using the two-class method as our unvested restricted share awards and units have non-forfeitable rights to dividends and are therefore considered participating securities. We compute basic earnings per share by dividing net income attributable to the controlling interest less the allocation of earnings to unvested restricted share awards and units by the weighted-average number of common shares outstanding for the period.

We also determine "Diluted earnings per share" under the two-class method with respect to the unvested restricted share awards. We further evaluate any other potentially dilutive securities at the end of the period and adjust the basic earnings per share calculation for the impact of those securities that are dilutive. Our dilutive earnings per share calculation includes the dilutive impact of employee stock options based on the treasury stock method and our incentive share awards with performance or market conditions under the contingently issuable method. The diluted earnings per share calculation also considers operating partnership units (if any) under the if-converted method.

The computations of basic and diluted earnings per share for the three and nine months ended September 30, 2014 and 2013 were as follows (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Numerator:				
Income from continuing operations	$3,658	$1,709	$2,761	$4,104
Net loss attributable to noncontrolling interests	10	—	17	—
Allocation of earnings to unvested restricted share awards	(44)	(32)	11	(83)
Adjusted income from continuing operations attributable to the controlling interests	3,624	1,677	2,789	4,021
Income from discontinued operations, including gain on sale of real estate, net of taxes	—	4,131	106,531	14,334
Allocation of earnings to unvested restricted share awards	—	(77)	(335)	(288)
Adjusted income from discontinuing operations attributable to the controlling interests	—	4,054	106,196	14,046
Adjusted net income attributable to the controlling interests	$3,624	$5,731	$108,985	$18,067
Denominator:				
Weighted average shares outstanding – basic	66,738	66,410	66,725	66,403
Effect of dilutive securities:				
Operating partnership units	—	117	—	117
Employee stock options and restricted share awards	52	34	35	25
Weighted average shares outstanding – diluted	66,790	66,561	66,760	66,545
Earnings per common share, basic:				
Continuing operations	$0.05	$0.03	$0.04	$0.06
Discontinued operations	—	0.06	1.59	0.21
	$0.05	$0.09	$1.63	$0.27
Earnings per common share, diluted:				
Continuing operations	$0.05	$0.03	$0.04	$0.06
Discontinued operations	—	0.06	1.59	0.21
	$0.05	$0.09	$1.63	$0.27

NOTE 10: SEGMENT INFORMATION

We have three reportable segments: office, retail and multifamily. Office buildings provide office space for various types of businesses and professions. Retail shopping centers are typically grocery store anchored neighborhood centers that include other small shop tenants or regional power centers with several junior box tenants. Multifamily properties provide rental housing for individuals and families throughout the Washington metropolitan area. During the 2014 Period, we completed the sale of our medical office segment (see note 3).

We evaluate performance based upon operating income from the combined properties in each segment. Our reportable operating segments are consolidations of similar properties. GAAP requires that segment disclosures present the measure(s) used by the chief operating decision maker for purposes of assessing segments' performance. Net operating income is a key measurement of our segment profit and loss. Net operating income is defined as segment real estate rental revenue less segment real estate expenses.

The following tables present revenues, net operating income, capital expenditures and total assets for the 2014 and 2013 Quarters and Periods from these segments, and reconciles net operating income of reportable segments to net income attributable to the controlling interests as reported (in thousands):

	Three Months Ended September 30, 2014				
	Office	Retail	Multifamily	Corporate and Other	Consolidated
Real estate rental revenue	$42,628	$14,825	$15,960	$—	$73,413
Real estate expenses	16,066	3,204	6,644	—	25,914
Net operating income	$26,562	$11,621	$9,316	$—	$47,499
Depreciation and amortization					(24,354)
General and administrative					(4,523)
Acquisition costs					(69)
Interest expense					(15,087)
Other income					192
Net income					3,658
Less: Net loss attributable to noncontrolling interests in subsidiaries					10
Net income attributable to the controlling interests					$3,668
Capital expenditures	$7,804	$3,037	$2,157	$3	$13,001
Total assets	$1,277,131	$341,728	$404,596	$35,924	$2,059,379

	Three Months Ended September 30, 2013					
	Office	Medical Office	Retail	Multifamily	Corporate and Other	Consolidated
Real estate rental revenue	$38,221	$—	$13,990	$13,617	$—	$65,828
Real estate expenses	14,517	—	3,207	5,519	—	23,243
Net operating income	$23,704	$—	$10,783	$8,098	$—	$42,585
Depreciation and amortization						(21,168)
Acquisition costs						(148)
General and administrative						(3,850)
Interest expense						(15,930)
Other income						220
Discontinued operations:						
Income from operations of properties sold or held for sale						4,131
Net income						5,840
Less: Net income attributable to noncontrolling interests in subsidiaries						—
Net income attributable to the controlling interests						$5,840
Capital expenditures	$9,535	$505	$198	$4,041	$16	$14,295
Total assets	$1,116,087	$319,928	$348,490	$258,027	$45,823	$2,088,355

	Nine Months Ended September 30, 2014				
	Office	Retail	Multifamily	Corporate and Other	Consolidated
Real estate rental revenue	$123,568	$44,209	$46,501	—	$214,278
Real estate expenses	47,579	10,672	19,533	—	77,784
Net operating income	$75,989	$33,537	$26,968	—	$136,494
Depreciation and amortization					(71,508)
General and administrative					(13,780)
Acquisition costs					(5,047)
Interest expense					(44,602)
Other income					634
Gain on sale of real estate (classified as continuing operations)					570
Discontinued operations:					
Income from operations of properties sold or held for sale					546
Gain on sale of real estate					105,985
Net income					109,292
Less: Net loss attributable to noncontrolling interests in subsidiaries					17
Net income attributable to the controlling interests					109,309
Capital expenditures	$30,974	$4,157	$6,814	$44	$41,989

	Nine Months Ended September 30, 2013					
	Office	Medical Office	Retail	Multifamily	Corporate and Other	Consolidated
Real estate rental revenue	$113,849	$—	$42,105	$40,349	$—	$196,303
Real estate expenses	42,697	—	10,355	16,415	—	69,467
Net operating income	$71,152	$—	$31,750	$23,934	$—	$126,836
Depreciation and amortization						(63,328)
Acquisition costs						(448)
General and administrative						(11,717)
Interest expense						(47,944)
Other income						705
Discontinued operations:						
Income from operations of properties sold or held for sale						11,139
Gain on sale of real estate						3,195
Net income						18,438
Less: Net income attributable to noncontrolling interests in subsidiaries						—
Net income attributable to the controlling interests						$18,438
Capital expenditures	$26,773	$3,035	$2,732	$6,808	$125	$39,473

NOTE 11: SUBSEQUENT EVENTS

On October 1, 2014, we closed on the purchase of Spring Valley Retail Center, a 75,000 square foot retail property in Washington, DC, for $40.5 million. We funded this acquisition with borrowings on our unsecured lines of credit. The initial accounting for the acquisition is incomplete due to the timing of the acquisition relative to the filing date of this report and, therefore, purchase price accounting and pro forma disclosures are not included.

ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our consolidated financial statements and the notes thereto appearing in Item 1 of this report and the more detailed information contained in our Annual Report on Form 10-K for the year ended December 31, 2013 filed with the Securities and Exchange Commission on March 3, 2014.

We refer to the three months ended September 30, 2014 and September 30, 2013 as the "2014 Quarter" and the "2013 Quarter," respectively, and the nine months ended September 30, 2014 and September 30, 2013 as the "2014 Period" and the "2013 Period," respectively.

Forward-Looking Statements

This Form 10-Q contains forward-looking statements which involve risks and uncertainties. Forward-looking statements include statements in this report preceded by, followed by or that include the words "believe," "expect," "intend," "anticipate," "potential," "project," "will" and other similar expressions. We claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 for these statements.

The following important factors, in addition to those discussed elsewhere in this Form 10-Q, could affect our future results and could cause those results to differ materially from those expressed in the forward-looking statements: (a) the effect of credit and financial market conditions; (b) the availability and cost of capital; (c) fluctuations in interest rates; (d) the economic health of our tenants; (e) the timing and pricing of lease transactions; (f) the economic health of the greater Washington metro region, or other markets we may enter; (g) the effects of changes in Federal government spending; (h) the supply of competing properties; (i) consumer confidence; (j) unemployment rates; (k) consumer tastes and preferences; (l) our future capital requirements; (m) inflation; (n) compliance with applicable laws, including those concerning the environment and access by persons with disabilities; (o) governmental or regulatory actions and initiatives; (p) changes in general economic and business conditions; (q) terrorist attacks or actions; (r) acts of war; (s) weather conditions; (t) the effects of changes in capital available to the technology and biotechnology sectors of the economy, and (u) other factors discussed under the caption "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2013 filed with the Securities and Exchange Commission on March 3, 2014. We undertake no obligation to update our forward-looking statements or risk factors to reflect new information, future events, or otherwise.

General

Introductory Matters

We provide our Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") in addition to the accompanying consolidated financial statements and notes to assist readers in understanding our results of operations and financial condition. We organize the MD&A as follows:

- Overview. Discussion of our business, operating results, investment activity and capital requirements, and summary of our significant transactions to provide context for the remainder of MD&A.
- Results of Operations. Discussion of our financial results comparing the 2014 Quarter to the 2013 Quarter and the 2014 Period to the 2013 Period.
- Liquidity and Capital Resources. Discussion of our financial condition and analysis of changes in our capital structure and cash flows.
- Critical Accounting Policies and Estimates. Descriptions of accounting policies that reflect significant judgments and estimates used in the preparation of our consolidated financial statements.

When evaluating our financial condition and operating performance, we focus on the following financial and non-financial indicators:

- Net operating income ("NOI"), calculated as real estate rental revenue less real estate expenses excluding depreciation and amortization and general and administrative expenses. NOI is a non-GAAP supplemental measure to net income;
- Funds From Operations ("FFO"), calculated as set forth below under the caption "Funds from Operations." FFO is a non-GAAP supplemental measure to net income;
- Occupancy, calculated as occupied square footage as a percentage of total square footage as of the last day of that period;
- Leased percentage, calculated as the percentage of available physical net rentable area leased for our commercial segments and percentage of apartments leased for our multifamily segment;

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- Rental rates; and
- Leasing activity, including new leases, renewals and expirations.

For purposes of evaluating comparative operating performance, we categorize our properties as “same-store”, “non-same-store” or discontinued operations. A "same-store" property is one that was owned for the entirety of the periods being evaluated and excludes properties under redevelopment or development and properties purchased or sold at any time during the periods being compared. A "non-same-store" property is one that was acquired, under redevelopment or development, or placed into service during either of the periods being evaluated. We define redevelopment properties as those for which we expect to spend significant development and construction costs on existing or acquired buildings pursuant to a formal plan which has a current impact on operating results, occupancy and the ability to lease space with the intended result of a higher economic return on the property. Properties under redevelopment or development are included within the non-same-store properties beginning in the period during which redevelopment or development activities commence. Redevelopment and development properties are included in the same-store pool upon completion of the redevelopment or development, and the earlier of achieving 90% occupancy or two years after completion.

Overview

Business

Our revenues are derived primarily from the ownership and operation of income-producing properties in the greater Washington metro region. As of September 30, 2014, we owned a diversified portfolio of 54 properties, totaling approximately 7.3 million square feet of commercial space and 2,890 multifamily units, and land held for development. These 54 properties consisted of 25 office properties, 16 retail centers and 13 multifamily properties.

Operating Results

Real estate rental revenue, NOI, net income attributable to the controlling interests and FFO for the three months ended September 30, 2014 and 2013 were as follows (in thousands):

	Three Months Ended September 30,			
	2014	2013	$ Change	% Change
Real estate rental revenue	$73,413	$65,828	$7,585	11.5 %
NOI [1]	$47,499	$42,585	$4,914	11.5 %
Net income attributable to the controlling interests	$3,668	$5,840	$(2,172)	(37.2)%
FFO [2]	$28,022	$30,223	$(2,201)	(7.3)%

[1] See page 25 of the MD&A for reconciliations of NOI to net income.
[2] See page 35 of the MD&A for reconciliations of FFO to net income.

The increases in real estate rental revenue and NOI are primarily due to acquisitions ($4.7 million and $2.1 million, respectively)and higher real estate rental revenue and NOI from same-store properties primarily due to higher occupancy and rental rates ($2.3 million and $0.5 million, respectively). Same-store occupancy increased to 93.2% from 89.8% one year ago, with increases in all segments.

The decreases in net income attributable to the controlling interests and FFO are primarily due to the loss of income from the properties included in the Medical Office Portfolio, which was sold in stages during the fourth quarter of 2013 and the first quarter of 2014.

Investment Activity

Subsequent to the end of the 2014 Quarter, we acquired Spring Valley Retail Center, a 75,000 square foot retail property in Washington, DC, for $40.5 million and incurred acquisition costs of approximately $0.8 million. We funded the purchase price with borrowings on our unsecured lines of credit. This acquisition is consistent with our current strategy of focusing on properties inside the Washington metro region's Beltway, near major transportation nodes and in areas of strong employment drivers and superior growth demographics.

Capital Requirements

There are no debt maturities for the remainder of 2014, though we will continue to make recurring principal amortization payments. As of September 30, 2014, our unsecured lines of credit had $5.0 million in borrowings outstanding, leaving a remaining borrowing capacity of $495.0 million. Subsequent to the end of the 2014 Quarter, we executed borrowings on the unsecured lines of credit for an additional $50.0 million for the acquisition of Spring Valley Retail Center and for general corporate purposes.

Significant Transactions

Our significant transactions during the 2014 and 2013 Periods are summarized as follows:

2014 Period

- The disposition of the Woodburn Medical Park I and II and Prosperity Medical Center I, II and III medical office buildings with a combined 427,000 square feet, for a contract sales price of $193.6 million, resulting in a gain on sale of $106.0 million. These sales transactions completed the disposition of the Medical Office Portfolio.
- The acquisition of Yale West, a 216-unit multifamily property in Washington, DC, for a contract purchase price of $73.0 million. We assumed a $48.2 million mortgage with this acquisition. We incurred $1.8 million of acquisition costs related to this transaction.
- The acquisition of The Army Navy Club Building, a 108,000 square foot office property in Washington, DC, for a contract purchase price of $79.0 million. We assumed a $52.7 million mortgage with this acquisition. We incurred $1.3 million of acquisition costs with this transaction.
- The acquisition of 1775 Eye Street, NW, a 185,000 square foot office property in Washington, DC, for a contract purchase price of $104.5 million. We incurred $1.7 million of acquisition costs with this transaction.
- The execution of new leases for 0.6 million square feet of commercial space with an average rental rate increase of 12.4% over expiring leases.

2013 Period

- The execution of four separate contracts with a single buyer for the sale of the entire medical office segment, consisting of 17 medical office assets, and two office assets, 6565 Arlington Boulevard and Woodholme Center (both of which have significant medical office tenancy), encompassing in total approximately 1.5 million square feet. The assets sold also include land held for development at 4661 Kenmore Avenue. The sales prices under the four agreements aggregated to $500.8 million. Purchase and Sale Agreement #1 ($303.4 million of the aggregate sales price) and Purchase and Sale Agreement #2 ($3.8 million of the aggregate sales price) closed in November 2013, resulting in a gain on sale of real estate of $18.9 million. Purchase and Sale Agreement #3 ($79.0 million of the aggregate sales price) and Purchase and Sale Agreement #4 ($114.6 million of the aggregate sales price) closed in January 2014, resulting in a gain on sale of real estate of $106.0 million.
- The disposition of the Atrium Building, a 80,000 square foot office building, for a contract sales price of $15.8 million, resulting in a gain on sale of $3.2 million.
- The execution of new leases for 1.2 million square feet of commercial space, excluding leases at properties classified as sold or held for sale, with an average rental rate increase of 9.3% over expiring leases.

Results of Operations

The discussion that follows is based on our consolidated results of operations for the 2014 and 2013 Quarters and Periods. The ability to compare one period to another may be significantly affected by acquisitions completed and dispositions made during those periods. To provide more insight into our operating results, we divide our discussion into two main sections:

- Consolidated Results of Operations: Overview analysis of results on a consolidated basis.
- Net Operating Income: Detailed analysis of same-store and non-same-store NOI results by segment.

Consolidated Results of Operations

Real Estate Rental Revenue

Real estate rental revenue for properties classified as continuing operations for the three and nine months ended September 30, 2014 and 2013 were as follows (in thousands):

	Three Months Ended September 30,		Change		Nine Months Ended September 30,		Cha
	2014	2013	$	%	2014	2013	$
Minimum base rent	$62,595	$56,762	$5,833	10.3 %	$181,588	$169,373	$ 1
Recoveries from tenants	7,861	6,576	1,285	19.5 %	23,496	20,159	3,3
Provisions for doubtful accounts	(459)	(813)	354	43.5 %	(1,594)	(2,725)	1,1
Lease termination fees	24	53	(29)	(54.7)%			

				3.94 %		
ARM	9,377	208	9,585	(257)	9,328	3.08%
Hybrid ARM	128,763	6,027	134,790	(353)	134,437	4.98%
Total Agency	772,949	40,419	813,368	3,536	816,904	5.32%
MBS-CMO	23,411	739	24,150	575	24,725	6.33%
Non-Agency MBS	613,798	(241,270)	372,528	6,804	379,332	3.80%
CMBS	209,512	(1,861)	207,651	7,393	215,044	5.07%
Total	1,619,670	(201,973)	1,417,697	18,308	1,436,005	4.72%

(1) Net weighted average coupon is presented net of servicing and other fees.

(2) Average yield incorporates future prepayment assumptions.

The following table summarizes certain characteristics of our investment portfolio, at fair value, according to their estimated weighted average life classifications as of March 31, 2010:

$ in thousands	March 31, 2010
Less than one year	1,382
Greater than one year and less than five years	813,500
Greater than or equal to five years	621,123
Total	1,436,005

The following table presents certain information about the carrying value of our available for sale MBS at March 31, 2010:

$ in thousands	March 31, 2010
Principal balance	1,619,670
Unamortized premium	43,549
Unamortized discount	(245,522)
Gross unrealized gains	28,133

Gross unrealized losses	(9,825)
Carrying value/estimated fair value	1,436,005

Financing and Other Liabilities. We enter into repurchase agreements to finance the majority of our Agency RMBS, Non-Agency RMBS and some CMBS. These agreements are secured by our Agency RMBS, Non-Agency RMBS and CMBS and bear interest at rates that have historically moved in close relationship to the London Interbank Offer Rate (“LIBOR”). As of March 31, 2010, we had entered into repurchase agreements totaling $961.2 million. In addition, we funded most of our CMBS portfolio with borrowings of $151.8 million under the TALF. The TALF loans are non-recourse and mature in February 2013, July 2014, August 2014, December 2014 and January 2015. Finally, we committed to invest up to $100.0 million in the Invesco PPIP fund, which, in turn, invests in our target assets. As of March 31, 2010, $28.4 million of our commitment to the Invesco Fund has been called.

Hedging Instruments. We generally hedge as much of our interest rate risk as we deem prudent in light of market conditions. No assurance can be given that our hedging activities will have the desired beneficial impact on our results of operations or financial condition. Our investment policies do not contain specific requirements as to the percentages or amount of interest rate risk that we are required to hedge.

Interest rate hedging may fail to protect or could adversely affect us because, among other things:

- available interest rate hedging may not correspond directly with the interest rate risk for which protection is sought;
- the duration of the hedge may not match the duration of the related liability;
- the party owing money in the hedging transaction may default on its obligation to pay;
- the credit quality of the party owing money on the hedge may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and
- the value of derivatives used for hedging may be adjusted from time to time in accordance with accounting rules to reflect changes in fair value. Downward adjustments ("mark-to-market losses") would reduce our shareholders' equity.

As of March 31, 2010, we have entered into interest rate swap agreements designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements. These swap agreements provide for fixed interest rates indexed off of one-month LIBOR and effectively fix the floating interest rates on $675.0 million of borrowings under our repurchase agreements as of March 31, 2010. We intend to continue to add interest rate hedge positions according to our hedging strategy.

The following table summarizes our hedging activity as of March 31, 2010:

Counterparty	Notional Amount $ - in thousands	Maturity Date	Fixed Interest Rate in Contract
The Bank of New York Mellon	175,000	8/5/2012	2.07 %
SunTrust Bank	100,000	7/15/2014	2.79 %
Credit Suisse International	100,000	2/24/2015	3.26 %
Credit Suisse International	100,000	3/24/2015	2.76 %
The Bank of New York Mellon	100,000	5/24/2013	1.83 %
Wells Fargo Bank, N.A.	100,000	7/15/2015	2.85 %
Total/Weighted Average	675,000		2.54 %

Book Value per Share

Our book value was $20.26 and $20.39 as of March 31, 2010 and December 31, 2009, respectively, on a fully diluted basis after giving effect to our units of limited partnership interest in our operating partnership, which may be converted to common shares at the sole election of the Company.

Critical Accounting Policies

Our consolidated financial statements are prepared in accordance with US GAAP, which requires the use of estimates and assumptions that involve the exercise of judgment and use of assumptions as to future uncertainties. Our most critical accounting policies involve decisions and assessments that could affect our reported assets and liabilities, as well as our reported revenues and expenses. We believe that all of the decisions and assessments upon which our consolidated financial statements are based are reasonable at the time made and based upon information available to us at that time. We rely upon independent pricing of our assets at each quarter's end to arrive at what we believe to be reasonable estimates of fair market value. The complete listing of our Critical Accounting Policies was disclosed in our 2009 annual report on Form 10-K, as filed with the SEC on March 24, 2010, as amended, and there have been no material changes to our Critical Accounting Policies as disclosed therein.

Results of Operations

The table below presents certain information from our Consolidated Statement of Operations for the three month periods ending March 31, 2010 and March 31, 2009:

	For the Three Months Ended	
$ in thousands, except per share data	March 31, 2010 (unaudited)	March 31, 2009
Revenues		
Interest income	18,010	—
Interest expense	3,652	—
Net interest income	14,358	—
Other income (loss)		
Gain on sale of investments	733	—
Equity in earnings and fair value change in unconsolidated limited partnerships	446	—
Loss on other-than-temporarily impaired securities	(124)	—
Unrealized loss on interest rate swaps	(25)	—
Total other income	1,030	—
Expenses		
Management fee – related party	1,284	—
General and administrative	182	45
Insurance	346	—
Professional Fees	409	3
Total expenses	2,221	48
Net income (loss)	13,167	(48)
Net income loss attributable to non-controlling interest	1,118	—
Net income attributable to common shareholders	12,049	(48)
Earnings per share:		
Net income attributable to (basic/diluted)	0.77	NM
Dividends declared per common share	0.78	—
Weighted average number of shares of common stock:		
Basic	15,685	NM
Diluted	17,111	NM

NM = not meaningful

Net Income Summary

For the three months ended March 31, 2010, our net income was $13.2 million or $0.77 basic income per weighted average share available to common shareholders compared to $10.5 million or $1.02 basic income per weighted average share available to common shareholders for the three months ended December 31, 2009. The increase to net income is primarily attributable to the growth in our income portfolio resulting from our follow-on public offering in January 2010.

Interest Income and Average Earning Asset Yield

Our primary source of income is interest earned on our portfolio of mortgage-backed securities. We had average earning assets of $1.2 billion and $861.9 million and earned interest income of $18.0 million and $12.6 million for the three months ended March 31, 2010 and three months ended December 31, 2009, respectively. The yield on our average investment portfolio was 5.88% and 5.82% for the respective periods. The change in our average assets and the portfolio yield was primarily the result of the increase in our investment portfolio after our January follow-on common stock offering.

The constant prepayment rate ("CPR") of our portfolio impacts the amount of premium and discount on the purchase of securities that is recognized into income. Our agency and non-agency RMBS had a weighted average CPR of 12.7 and 15.7 for the 3 months ended March 31, 2010 and December 31, 2009, respectively. The table below shows the three month CPR for our MBS compared to bonds with similar characteristics ("Cohorts"):

	March 31, 2010		December 31, 2009	
	Company	Cohort	Company	Cohort
15 year Agency RMBS	10.7	19.5	15.0	21.8
30 year Agency RMBS	14.8	38.2	22.7	27.3
Agency Hybrid ARM RMBS	23.7	N/A	19.5	N/A
Non-Agency RMBS	15.0	N/A	16.0	N/A
Overall	12.7	N/A	15.7	N/A

On February 10, 2010, Fannie Mae and Freddie Mac announced their intention to purchase delinquent loans from certain mortgage pools guaranteed by them. For purposes of these purchases, delinquent loans are those that are 120 days or greater delinquent as of the measurement date. Freddie Mac stated that it would purchase substantially all of the delinquent loans. Fannie Mae purchased 220,000 delinquent loans in March 2010 and expects to purchase a significant portion of their current delinquent population within a few months, subject to market, servicer capacity and other constraints. The impact of the increased buy-outs would accelerate the amortization of premium paid for these agency RMBS, which would reduce our interest income. In the fourth quarter of 2009, the Company correctly anticipated the increased buy-outs and sold several agency RMBS that were at risk. For the three month period ended March 31, 2010, the Company's estimates the increased buy-outs reduced interest income by less than $1.0 million as a result of higher premium amortization. For the agency RMBS held in the portfolio as of March 31, 2010, the Company estimates that the completion of this buy-out program will have no significant effect on future periods.

Interest Expense and the Cost of Funds

Our largest expense is the interest expense on borrowed funds. We had average borrowed funds of $826.3 million and $666.2 million and total interest expense of $3.7 million and $2.6 million for the three months ended March 31, 2010 and three months ended December 31, 2009, respectively. The increase in average borrowed funds and interest expense was primarily the result of increasing our investment portfolio with the proceeds of our January 2010 follow-on public offering.

Our average cost of funds was 1.60% and 1.54% for the three months ended March 31, 2010 and three months ended December 31, 2009, respectively. Since a substantial portion of our repurchase agreements are short term, changes in market rates are directly reflected in our interest expense. Interest expense includes borrowing costs under repurchase agreements, the TALF borrowing, as well as any hedging costs for our cash flow hedges.

Net Interest Income

Our net interest income, which equals interest income less interest expense, totaled $14.3 million and $10.0 million for the three months ended March 31, 2010 and three months ended December 31, 2009, respectively. Our net interest rate margin, which equals the yield on our average assets for the period less the average cost of funds for the period, was 4.28% and 4.28% for the three months ended March 31, 2010 and three months ended December 31, 2009, respectively. The increase in net interest income was primarily the result of increasing our investment portfolio with the proceeds of our January 2010 follow-on public offering.

Gain on Sale of Investments

As part of our credit process, all of our MBS are reviewed on a monthly basis to determine if they continue to meet our risk and return targets. This process involves looking at changing market assumptions and the impact those assumptions will have on the individual securities. During the fourth quarter of 2009 we anticipated the government sponsored entities ("GSEs") would accelerate the required buy out of delinquent loans in the agency RMBS. As a result of our change in market assumptions, we sold securities and recognized gains of approximately $733,000 and $2.0 million for the three month periods ended March 31, 2010 and December 31, 2009, respectively.

Loss on Other-Than Temporary Impaired Securities

During the three months ended March 31, 2010, the trustees of certain non-Agency RMBS notified us that due to the deterioration of the underlying collateral in these securitizations, a portion of the principal of these securities had no value. Accordingly, we recognized a $124,000 loss on other-than-temporarily impaired securities in the consolidated statement of operations for the three months ended March 31, 2010, which had been included in accumulated other comprehensive income. No loss on other-than-temporary impairment on investments was recorded for the three months ended December 31, 2009.

Equity in Earnings and Change in Fair Value of Unconsolidated Limited Partnerships

For the three months ended March 31, 2010 and three months ended December 31, 2009, we recognized equity in earnings of $230,000 and $63,000, respectively, and unrealized income on the change in fair value of our investment in the Invesco PPIP Fund of approximately $216,000 and $8,000, respectively. The increase in each case was primarily the result of our increased commitment from $25.0 million to $100.0 million and an increase in our capital contributed to the Invesco PPIP Fund.

Other Income (Loss)

Our other income (loss) relates to the unrealized loss on interest rate swaps of approximately $25,000, which represents the ineffective portion of the change in fair value of our interest rate swaps which is recognized directly in earnings for the three months ended March 31, 2010. No unrealized loss on interest rate swap ineffectiveness was recorded for the three months ended December 31, 2009.

Expenses

We incurred management fees of $1.3 million and $760,000 for the three months ended March 31, 2010, and three months ended December 31, 2009, respectively, which are payable to our Manager under our management agreement. The increase in management fees is attributed to an increase in shareholders' equity resulting from our follow-on public offering in January 2010. This management fee and the relationship between the Company and the Manager are discussed further in our discussion of related party relationships.

Our general and administrative expense of $182,000 and $150,000 for the three ended March 31, 2010 and three months ended December 31, 2009, respectively, includes the salary and the estimated bonus of our CFO, amortization of equity based compensation related to anticipated quarterly grants of our stock to the Company's independent directors, payable subsequent to each calendar quarter, amortization of equity based compensation related to restricted stock grants to our executive officers who are employees of the Manager, cash based payments to our Company's independent directors, derivative transaction fees, software licensing, industry memberships, filing fees, travel and entertainment and other miscellaneous general and administrative costs. The increase in general and administrative expenses between the three months ended March 31, 2010 and three month ended December 31, 2009 is primarily attributable to an increase in salary and estimated bonus of our CFO.

Our insurance expense of $346,000 and $354,000 for the three months ended March 31, 2010 and three months ended December 31, 2009, respectively, represents the cost of liability insurance to indemnify our directors and officers.

Our professional fees of $409,000 and $341,000 for the three months ended March 31, 2010 and the three months ended December 31, 2009, respectively, represents the cost of legal, accounting, auditing and consulting services provided to us by third party service providers. The increase in professional fees between the three months ended March 31, 2010 and three months ended December 31, 2009 is primarily attributable to an increase in accounting and legal costs.

Net Income and Return on Average Equity

Our net income was $13.2 million and $10.5 million for the three months ended March 31, 2010 and the three months ended December 31, 2009, respectively. Our annualized return on average equity was 15.68% and 19.35% for the three months ended March 31, 2010 and three months ended December 31, 2009, respectively. The increase in net income was primarily the result of increasing our investment portfolio with the proceeds of our January 2010 public offering. The decrease in return on average equity is primarily a result of greater average shares outstanding resulting from our January 2010 public offering and a lower gain on sale of investments between the two periods.

Liquidity and Capital Resources

Liquidity is a measurement of our ability to meet potential cash requirements, including ongoing commitments to pay dividends, fund investments and other general business needs. Our primary sources of funds for liquidity consists of the net proceeds from our common equity offerings, net cash provided by operating activities, cash from repurchase agreements and other financing arrangements and future issuances of equity and/or debt securities. We also have financed, and may continue to finance our assets under, and may otherwise participate in, programs established by the U.S. government.

We currently believe that we have sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on borrowings and the payment of cash dividends as required for continued qualification as a REIT. We generally maintain liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage our long-term investment capital. Because the level of these borrowings can be adjusted on a daily basis, the level of cash and cash equivalents carried on the balance sheet is significantly less important than our potential liquidity available under borrowing arrangements.

We allocate our equity to each of our target assets and apply leverage to obtain our net interest income. We invest in assets that provide attractive returns with an aggregate debt-to-equity ratio of 3 to 5 times. To obtain this total leverage we lever agency RMBS 6 to 8 times, non-agency RMBS 1 to 2 times and CMBS 3 to 4 times. The table below shows the allocation of our equity and debt-to-equity ratio as of March 31, 2010.

$ in thousands	Agency	Non-Agency	CMBS	PPIF	Total
Borrowings	773,490	169,534	169,958	—	1,112,982
Equity allocation	98,459	211,496	45,695	16,326	371,976
Debt / Equity Ratio	7.9	0.8	3.7	—	3.0
% of Total Equity	26.4 %	56.9 %	12.3 %	4.4 %	100.0 %

We enter into repurchase agreements with various counterparties to fund our purchase of MBS. The following table summarizes our total borrowings by type of investment for the period ended March 31, 2010 and December 31, 2009:

$ in thousands	March 31, 2010		December 31, 2009	
Repurchase Agreements	Amount Outstanding	Weighted Average	Amount Outstanding	Weighted Average
Agency RMBS	773,490	0.24 %	545,975	0.26 %
Non-Agency RBS	169,534	1.49 %	—	—
CMBS	18,139	1.05 %	—	—
Total Repurchase agreements	961,163	0.47 %	545,975	0.26 %

CMBS under TALF	151,819	3.56	%	80,377	3.82	%
Total Borrowings	1,112,982	0.90	%	626,352	0.72	%

As of March 31, 2010, the weighted average margin requirement, or the percentage amount by which the collateral value must exceed the loan amount, which we also refer to as the "haircut," under our repurchase agreements for Agency RMBS was approximately 5.0% (weighted by borrowing amount) and under our repurchase agreements for Non-Agency RMBS was approximately 29.7%. Across our repurchase facilities for Agency RMBS, the haircuts range from a low of 3% to a high of 8% and for Non-Agency RMBS range from a low of 12% to a high of 50%. Declines in the value of our securities portfolio can trigger margin calls by our lenders under our repurchase agreements. An event of default or termination event would give some of our counterparties the option to terminate all repurchase transactions existing with us and require any amount due by us to the counterparties to be payable immediately.

As discussed above under “Market Conditions,” the residential mortgage market in the United States has experienced difficult economic conditions including:

- increased volatility of many financial assets, including agency securities and other high-quality RMBS assets, due to news of potential security liquidations;

- increased volatility and deterioration in the broader residential mortgage and RMBS markets; and

- significant disruption in financing of RMBS.

If these conditions persist, then our lenders may be forced to exit the repurchase market, become insolvent or further tighten lending standards or increase the amount of required equity capital or haircut, any of which could make it more difficult or costly for us to obtain financing.

Effects of Margin Requirements, Leverage and Credit Spreads

Our securities have values that fluctuate according to market conditions and, as discussed above, the market value of our securities will decrease as prevailing interest rates or credit spreads increase. When the value of the securities pledged to secure a repurchase loan decreases to the point where the positive difference between the collateral value and the loan amount is less than the haircut, our lenders may issue a “margin call,” which means that the lender will require us to pay the margin call in cash or pledge additional collateral to meet that margin call. Under our repurchase facilities, our lenders have full discretion to determine the value of the securities we pledge to them. Most of our lenders will value securities based on recent trades in the market. Lenders also issue margin calls as the published current principal balance factors change on the pool of mortgages underlying the securities pledged as collateral when scheduled and unscheduled paydowns are announced monthly.

We experience margin calls in the ordinary course of our business. In seeking to effectively manage the margin requirements established by our lenders, we maintain a position of cash and unpledged securities. We refer to this position as our “liquidity.” The level of liquidity we have available to meet margin calls is directly affected by our leverage levels, our haircuts and the price changes on our securities. If interest rates increase as a result of a yield curve shift or for another reason or if credit spreads widen, then the prices of our collateral (and our unpledged assets that constitute our liquidity) will decline, we will experience margin calls, and we will use our liquidity to meet the margin calls. There can be no assurance that we will maintain sufficient levels of liquidity to meet any margin calls. If our haircuts increase, our liquidity will proportionately decrease. In addition, if we increase our borrowings, our liquidity will decrease by the amount of additional haircut on the increased level of indebtedness.

We intend to maintain a level of liquidity in relation to our assets that enables us to meet reasonably anticipated margin calls but that also allows us to be substantially invested in securities. We may misjudge the appropriate amount of our liquidity by maintaining excessive liquidity, which would lower our investment returns, or by maintaining insufficient liquidity, which would force us to liquidate assets into unfavorable market conditions and harm our results of operations and financial condition.

Forward-Looking Statements Regarding Liquidity

Based upon our current portfolio, leverage rate and available borrowing arrangements, we believe that the net proceeds of our common equity offerings and private placements, combined with cash flow from operations and available borrowing capacity, will be sufficient to enable us to meet anticipated short-term (one year or less) liquidity requirements to fund our investment activities, pay fees under our management agreement, fund our distributions to shareholders and for other general corporate expenses.

Our ability to meet our long-term (greater than one year) liquidity and capital resource requirements will be subject to obtaining additional debt financing and equity capital. We may increase our capital resources by obtaining long-term credit facilities or making public or private offerings of equity or debt securities, possibly including classes of preferred stock, common stock, and senior or subordinated notes. Such financing will depend on market conditions for capital raises and for the investment of any proceeds. If we are unable to renew, replace or expand our sources of financing on substantially similar terms, it may have an adverse effect on our business and results of operations.

Contractual Obligations

On July 1, 2009, we entered into an agreement with our Manager pursuant to which our Manager is entitled to receive a management fee and the reimbursement of certain expenses. The management fee will be calculated and payable quarterly in arrears in an amount equal to 1.50% of our shareholders' equity, per annum, calculated and payable quarterly in arrears. Our Manager will use the proceeds from its management fee in part to pay compensation to its officers and personnel who, notwithstanding that certain of those individuals are also our officers, will receive no cash compensation directly from us. We are required to reimburse our Manager for operating expenses related to us incurred by our Manager, including certain salary expenses and other expenses relating to legal, accounting, due diligence and other services. Expense reimbursements to our Manager are made in cash on a monthly basis following the end of each month. Our reimbursement obligation is not subject to any dollar limitation.

Contractual Commitments

As of March 31, 2010, we had the following contractual commitments and commercial obligations:

	Payments Due by Period				
$ in thousands	Total	Less than 1 year	1-3 years	3-5 years	After 5 years
Repurchase agreements	961,163	961,163	—	—	—
TALF financing	151,819	—	—	151,819	—
Invesco PPIP Fund investment	71,572	—	71,572	—	—
Total contractual obligations	1,184,554	961,163	71,572	151,819	—

As of March 31, 2010 we have approximately $177,000 and $24.4 million in contractual interest payments related to our repurchase agreements and TALF financings respectively.

Off-Balance Sheet Arrangements

We committed to invest up to $100.0 million in the Invesco PPIP Fund, which, in turn, invests in our target assets. As of March 31, 2010, approximately $28.4 million of the commitment has been called.

Shareholders' Equity

On January 15, 2010, we completed a follow-on public offering of 7,000,000 shares of common stock and an issuance of an additional 1,050,000 shares of common stock pursuant to the underwriters' full exercise of their over-allotment option at $21.25 per share. The net proceeds to us were $162.6 million, net of issuance costs of approximately $8.5 million.

Unrealized Gains and Losses

Unrealized fluctuations in market values of assets do not impact our US GAAP income but rather are reflected on our balance sheet by changing the carrying value of the asset and shareholders' equity under "Accumulated Other

Comprehensive Income (Loss),” we account for our investment securities as “available-for-sale.” In addition, unrealized fluctuations in market values of our cash flow hedges that qualify for hedge accounting are also reflected in “Accumulated Other Comprehensive Income (Loss).”

As a result of this mark-to-market accounting treatment, our book value and book value per share are likely to fluctuate far more than if we used historical amortized cost accounting. As a result, comparisons with companies that use historical cost accounting for some or all of their balance sheet may not be meaningful.

Dividends

We intend to continue to make regular quarterly distributions to holders of our common stock. U.S. federal income tax law generally requires that a REIT distribute annually at least 90% of its REIT taxable income, determined without regard to the deduction for dividends paid and excluding net capital gains, and that it pay tax at regular corporate rates to the extent that it annually distributes less than 100% of its net taxable income. We intend to pay regular quarterly dividends to our shareholders in an amount equal at least 90% of our net taxable income. Before we pay any dividend, whether for U.S. federal income tax purposes or otherwise, we must first meet both our operating requirements and debt service on our repurchase agreements and other debt payable. If our cash available for distribution is less than our net taxable income, we could be required to sell assets or borrow funds to make cash distributions, or we may make a portion of the required distribution in the form of a taxable stock distribution or distribution of debt securities.

On March 17, 2010, the Company declared a dividend of $0.78 per share of common stock. The dividend was paid on April 22, 2010 to shareholders of record as of the close of business on March 31, 2010.

Inflation

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance far more than inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates.

Other Matters

We calculate that at least 75% of our assets were qualified REIT assets, as defined in the Internal Revenue Code of 1986, as amended (the "Code") for the quarter ended March 31, 2010. We also calculate that our revenue qualifies for the 75% source of income test and for the 95% source of income test rules for the quarter ended March 31, 2010. Consequently, we met the REIT income and asset test as of March 31, 2010. We also met all REIT requirements regarding the ownership of our common stock and the distribution of our net income as of March 31, 2010. Therefore, as of March 31, 2010, we believe that we qualified as a REIT under the Code.

We at all times intend to conduct our business so as not to become required to register as an investment company under the 1940 Act. If we were to become required to register as an investment company, then our use of leverage would be substantially reduced. Because we are a holding company that conducts our business through the operating partnership and the wholly-owned or majority owned subsidiaries of the operating partnership, the securities issued by these subsidiaries that are excepted from the definition of "investment company" under Section 3(c)(1) or Section 3(c)(7) of the 1940 Act, together with any other investment securities the operating partnership may own, may not have a combined value in excess of 40% of the value of the operating partnership's total assets (exclusive of U.S. government securities and cash) on an unconsolidated basis, which we refer to as the 40% test. This requirement limits the types of businesses in which we may engage through our subsidiaries. In addition, we believe neither the company nor the operating partnership are considered an investment company under Section 3(a)(1)(A) of the 1940 Act because they do not engage primarily or hold themselves out as being engaged primarily in the business of investing, reinvesting or trading in securities. Rather, through the operating partnership's wholly owned or majority-owned subsidiaries, the company and the operating partnership are primarily engaged in the non-investment company businesses of these subsidiaries. IAS Asset I LLC and certain of the operating partnership's other subsidiaries that we may form in the future rely upon the exclusion from the definition of "investment company" under the 1940 Act provided by Section 3(c)(5)(C) of the 1940 Act, which is available for entities "primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." This exclusion generally requires that at least 55% of each of our subsidiaries' portfolios be comprised of qualifying assets and at least 80% of each of their portfolios be comprised of qualifying assets and real estate-related assets (and no more than 20% comprised of miscellaneous assets). Qualifying assets for this purpose include mortgage loans fully secured by real estate and other assets, such as whole pool Agency and non-Agency RMBS, that the Securities and Exchange Commission, or SEC, or its staff in various no-action letters has determined are the functional equivalent of mortgage loans fully secured by real estate. We treat as real estate-related assets CMBS, debt and equity securities of companies primarily engaged in real estate businesses, agency partial pool certificates and securities issued by pass-through entities of which substantially all of the assets consist of qualifying assets and/or real estate-related assets. Additionally, unless certain mortgage securities represent all the certificates issued with respect to an underlying pool of mortgages, the MBS may be treated as securities separate from the underlying mortgage loans and, thus, may not be considered qualifying interests for purposes of the 55% requirement. We calculate that as of March 31, 2010, we were in compliance with this requirement.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

The primary components of our market risk are related to interest rate, prepayment and market value. While we do not seek to avoid risk completely, we believe the risk can be quantified from historical experience and seek to actively manage that risk, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

Interest Rate Risk

Interest rate risk is highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations, and other factors beyond our control. We are subject to interest rate risk in connection with our investments and our repurchase agreements. Our repurchase agreements are typically of limited duration and will be periodically refinanced at current market rates. We mitigate this risk through utilization of derivative contracts, primarily interest rate swap agreements, interest rate caps and interest rate floors.

Interest Rate Effect on Net Interest Income

Our operating results depend in large part upon differences between the yields earned on our investments and our cost of borrowing and interest rate hedging activities. Most of our repurchase agreements provide financing based on a floating rate of interest calculated on a fixed spread over LIBOR. The fixed spread will vary depending on the type of underlying asset which collateralizes the financing. Accordingly, the portion of our portfolio which consists of floating interest rate assets are match-funded utilizing our expected sources of short-term financing, while our fixed interest rate assets are not match-funded. During periods of rising interest rates, the borrowing costs associated with our investments tend to increase while the income earned on our fixed interest rate investments may remain substantially unchanged. This increase in borrowing costs results in the narrowing of the net interest spread between the related assets and borrowings and may even result in losses. Further, during this portion of the interest rate and credit cycles, defaults could increase and result in credit losses to us, which could adversely affect our liquidity and operating results. Such delinquencies or defaults could also have an adverse effect on the spread between interest-earning assets and interest-bearing liabilities.

Hedging techniques are partly based on assumed levels of prepayments of our RMBS. If prepayments are slower or faster than assumed, the life of the RMBS will be longer or shorter, which would reduce the effectiveness of any hedging strategies we may use and may cause losses on such transactions. Hedging strategies involving the use of derivative securities are highly complex and may produce volatile returns.

Interest Rate Effects on Fair Value

Another component of interest rate risk is the effect that changes in interest rates will have on the market value of the assets that we acquire. We face the risk that the market value of our assets will increase or decrease at different rates than those of our liabilities, including our hedging instruments.

We primarily assess our interest rate risk by estimating the duration of our assets and the duration of our liabilities. Duration measures the market price volatility of financial instruments as interest rates change. We generally calculate duration using various financial models and empirical data. Different models and methodologies can produce different duration numbers for the same securities.

It is important to note that the impact of changing interest rates on fair value can change significantly when interest rates change materially. Therefore, the volatility in the fair value of our assets could increase significantly when interest rates change materially. In addition, other factors impact the fair value of our interest rate-sensitive investments and hedging instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, changes in actual interest rates may have a material adverse effect on us.

Prepayment Risk

As we receive prepayments of principal on our investments, premiums paid on these investments are amortized against interest income. In general, an increase in prepayment rates will accelerate the amortization of purchase premiums, thereby reducing the interest income earned on the investments. Conversely, discounts on such investments are accreted into interest income. In general, an increase in prepayment rates will accelerate the accretion of purchase discounts, thereby increasing the interest income earned on the investments.

Extension Risk

We compute the projected weighted-average life of our investments based upon assumptions regarding the rate at which the borrowers will prepay the underlying mortgages. In general, when a fixed-rate or hybrid adjustable-rate security is acquired with borrowings, we may, but are not required to, enter into an interest rate swap agreement or other hedging instrument that effectively fixes our borrowing costs for a period close to the anticipated average life of the fixed-rate portion of the related assets. This strategy is designed to protect us from rising interest rates, because the borrowing costs are fixed for the duration of the fixed-rate portion of the related target asset.

However, if prepayment rates decrease in a rising interest rate environment, then the life of the fixed-rate portion of the related assets could extend beyond the term of the swap agreement or other hedging instrument. This could have a negative impact on our results from operations, as borrowing costs would no longer be fixed after the end of the hedging instrument, while the income earned on the hybrid adjustable-rate assets would remain fixed. This situation may also cause the market value of our hybrid adjustable-rate assets to decline, with little or no offsetting gain from the related hedging transactions. In extreme situations, we may be forced to sell assets to maintain adequate liquidity, which could cause us to incur losses.

Market Risk

Market Value Risk

Our available-for-sale securities are reflected at their estimated fair value with unrealized gains and losses excluded from earnings and reported in other comprehensive income pursuant to ASC Topic 320. The estimated fair value of these securities fluctuates primarily due to changes in interest rates and other factors. Generally, in a rising interest rate environment, the estimated fair value of these securities would be expected to decrease; conversely, in a decreasing interest rate environment, the estimated fair value of these securities would be expected to increase.

The sensitivity analysis table presented below shows the estimated impact of an instantaneous parallel shift in the yield curve, up and down 50 and 100 basis points, on the market value of our interest rate-sensitive investments and net interest income, at March 31, 2010, assuming a static portfolio. When evaluating the impact of changes in interest rates, prepayment assumptions and principal reinvestment rates are adjusted based on our Manager's expectations. The analysis presented utilized assumptions, models and estimates of our Manager based on our Manager's judgment and experience.

Change in Interest Rates	Percentage Change in Projected Net Interest Income	Percentage Change in Projected Portfolio Value
+1.00%	15.32%	(1.31)%
+0.50%	7.00%	(0.60)%
-0.50%	(6.98)%	0.37%

-1.00%	(15.04)%	0.41%

Real Estate Risk

Residential and commercial property values are subject to volatility and may be affected adversely by a number of factors, including, but not limited to: national, regional and local economic conditions (which may be adversely affected by industry slowdowns and other factors); local real estate conditions (such as the supply of housing stock); changes or continued weakness in specific industry segments; construction quality, age and design; demographic factors; and retroactive changes to building or similar codes. In addition, decreases in property values reduce the value of the collateral and the potential proceeds available to a borrower to repay our loans, which could also cause us to suffer losses.

Credit Risk

We believe that our investment strategy will generally keep our credit losses and financing costs low. However, we retain the risk of potential credit losses on all of the residential and commercial mortgage loans, as well as the loans underlying the Non-Agency RMBS and CMBS in our portfolio. We seek to manage this risk through our pre-acquisition due diligence process and through the use of non-recourse financing, which limits our exposure to credit losses to the specific pool of mortgages that are subject to the non-recourse financing. In addition, with respect to any particular asset, our Manager's investment team evaluates, among other things, relative valuation, supply and demand trends, shape of yield curves, prepayment rates, delinquency and default rates, recovery of various sectors and vintage of collateral.

Risk Management

To the extent consistent with maintaining our REIT qualification, we seek to manage risk exposure to protect our investment portfolio against the effects of major interest rate changes. We generally seek to manage this risk by:

- monitoring and adjusting, if necessary, the reset index and interest rate related to our target assets and our financings;

- attempting to structure our financing agreements to have a range of different maturities, terms, amortizations and interest rate adjustment periods;

- using hedging instruments, primarily interest rate swap agreements but also financial futures, options, interest rate cap agreements, floors and forward sales to adjust the interest rate sensitivity of our target assets and our borrowings; and

- actively managing, on an aggregate basis, the interest rate indices, interest rate adjustment periods, and gross reset margins of our target assets and the interest rate indices and adjustment periods of our financings.

ITEM 4T. CONTROLS AND PROCEDURES.

Our management is responsible for establishing and maintaining disclosure controls and procedures that are designed to ensure that information we are required to disclose in the reports that we file or submit under the Securities Exchange Act of 1934, as amended (the "Exchange Act") is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include controls and procedures designed to ensure that the required information is accumulated or communicated to our management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure.

We have evaluated, with the participation of our principal executive officer and principal financial officer, the effectiveness of our disclosure controls and procedures as of March 31, 2010. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon our evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the applicable rules and forms, and that it is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

No change occurred in our internal control over financial reporting (as defined in Rule13a-15(f) and 15d-15(f) of the Exchange Act) during the three months ended March 31, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

From time to time, we may be involved in various claims and legal actions arising in the ordinary course of business. As of March 31, 2010, we were not involved in any such legal proceedings.

ITEM 1A. RISK FACTORS.

There were no material changes during the period covered by this report to the risk factors previously disclosed in our annual report on Form 10-K filed on March 24, 2010.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

ITEM 4. RESERVED

ITEM 5. OTHER INFORMATION.

None.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

INVESCO MORTGAGE CAPITAL INC.

May 14, 2010	By:	/s/ Richard J. King Richard J. King President and Chief Executive Officer
May 14, 2010	By:	/s/ Donald R. Ramon Donald R. Ramon Chief Financial Officer

EXHIBIT INDEX

Item 6. Exhibits

Exhibit No.	Description
3.1	Articles of Amendment and Restatement of Invesco Mortgage Capital Inc., incorporated by reference to Exhibit 3.1 to our Quarterly Report on Form 10-Q, filed with the Securities and Exchange Commission on August 12, 2009.
3.2	Amended and Restated Bylaws of Invesco Mortgage Capital Inc., incorporated by reference to Exhibit 3.2 to Amendment No. 8 to our Registration Statement on Form S-11, filed with the Securities and Exchange Commission on June 18, 2009.
31.1	Certification of Richard J. King pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Donald R. Ramon pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Richard J. King pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Donald R. Ramon pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.