

PS BUSINESS PARKS INC/CA

Form 10-Q

August 01, 2014

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**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 the quarterly period ended June 30, 2014**

**or**

.. **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number 1-10709**

**PS BUSINESS PARKS, INC.**

**(Exact name of registrant as specified in its charter)**

**California**  
**(State or Other Jurisdiction of**

**95-4300881**  
**(I.R.S. Employer**

**Incorporation)**

**Identification Number)**

**701 Western Avenue, Glendale, California 91201-2397**

**(Address of principal executive offices) (Zip Code)**

**Registrant's telephone number, including area code: (818) 244-8080**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

As of July 28, 2014, the number of shares of the registrant's common stock, \$0.01 par value per share, outstanding was 26,912,436.

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**PS BUSINESS PARKS, INC.**  
**CONSOLIDATED BALANCE SHEETS**

(In thousands, except share data)

|   | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013 |
|---|---------------------------------|----------------------|
| <b>ASSETS</b>   |                                 |                      |
| Cash and cash equivalents   | \$ 62,523                       | \$ 31,481            |
| Real estate facilities, at cost:  |                                 |                      |
| Land  | 790,346                         | 790,346              |
| Buildings and improvements  | 2,209,513                       | 2,191,829            |
|   | 2,999,859                       | 2,982,175            |
| Accumulated depreciation  | (992,793)                       | (942,959)            |
|   | 2,007,066                       | 2,039,216            |
| Properties held for disposition, net  | 99,438                          | 101,184              |
| Land and building held for development  | 23,472                          | 22,253               |
|   | 2,129,976                       | 2,162,653            |
| Rent receivable   | 4,468                           | 5,248                |
| Deferred rent receivable  | 27,475                          | 25,903               |
| Other assets  | 7,034                           | 13,274               |
| Total assets  | \$ 2,231,476                    | \$ 2,238,559         |
| <b>LIABILITIES AND EQUITY</b>   |                                 |                      |
| Accrued and other liabilities   | \$ 69,813                       | \$ 73,919            |
| Mortgage note payable   | 250,000                         | 250,000              |
| Total liabilities   | 319,813                         | 323,919              |
| Commitments and contingencies   |                                 |                      |
| Equity:   |                                 |                      |
| PS Business Parks, Inc. s shareholders equity:  |                                 |                      |
| Preferred stock, \$0.01 par value, 50,000,000 shares authorized, 39,800 shares issued and outstanding at June 30, 2014 and December 31, 2013                                | 995,000                         | 995,000              |
| Common stock, \$0.01 par value, 100,000,000 shares authorized, 26,904,436 and 26,849,822 shares issued and outstanding at June 30, 2014 and December 31, 2013, respectively | 268                             | 267                  |
| Paid-in capital   | 704,343                         | 699,314              |
| Cumulative net income   | 1,121,054                       | 1,070,975            |
| Cumulative distributions  | (1,104,752)                     | (1,047,615)          |

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|   |              |              |
|---|--------------|--------------|
| Total PS Business Parks, Inc. s shareholders equity | 1,715,913    | 1,717,941    |
| Noncontrolling interests:                           |              |              |
| Common units  | 195,750      | 196,699      |
| Total noncontrolling interests                      | 195,750      | 196,699      |
| Total equity  | 1,911,663    | 1,914,640    |
| Total liabilities and equity                        | \$ 2,231,476 | \$ 2,238,559 |

See accompanying notes.

**Table of Contents****PS BUSINESS PARKS, INC.****CONSOLIDATED STATEMENTS OF INCOME****(Unaudited, in thousands, except per share data)**

|   | <b>For The Three Months<br/>Ended June 30,</b> |                  | <b>For The Six Months<br/>Ended June 30,</b> |                  |
|---|--|------------------|--|------------------|
|   | <b>2014</b>                                    | <b>2013</b>      | <b>2014</b>                                  | <b>2013</b>      |
| <b>Revenues:</b>  |  |                  |  |                  |
| Rental income   | \$ 93,986                                      | \$ 87,930        | \$ 189,307                                   | \$ 176,050       |
| Facility management fees                                      | 165  | 157              | 331  | 315              |
| <b>Total operating revenues</b>                               | <b>94,151</b>                                  | <b>88,087</b>    | <b>189,638</b>                               | <b>176,365</b>   |
| <b>Expenses:</b>  |  |                  |  |                  |
| Cost of operations  | 31,535   | 28,720           | 64,979                                       | 58,104           |
| Depreciation and amortization                                 | 28,295   | 26,629           | 56,736                                       | 53,590           |
| General and administrative                                    | 3,363  | 2,370            | 5,850  | 4,769            |
| <b>Total operating expenses</b>                               | <b>63,193</b>                                  | <b>57,719</b>    | <b>127,565</b>                               | <b>116,463</b>   |
| <b>Other income and (expense):</b>                            |  |                  |  |                  |
| Interest and other income                                     | 95   | 69               | 157  | 112              |
| Interest and other expense                                    | (3,403)  | (3,961)          | (6,779)                                      | (8,549)          |
| <b>Total other income and (expense)</b>                       | <b>(3,308)</b>                                 | <b>(3,892)</b>   | <b>(6,622)</b>                               | <b>(8,437)</b>   |
| <b>Net income</b>   | <b>\$ 27,650</b>                               | <b>\$ 26,476</b> | <b>\$ 55,451</b>                             | <b>\$ 51,465</b> |
| <b>Net income allocation:</b>                                 |  |                  |  |                  |
| <b>Net income allocable to noncontrolling interests:</b>      |  |                  |  |                  |
| Noncontrolling interests common units                         | \$ 2,669                                       | \$ 2,613         | \$ 5,372                                     | \$ 5,179         |
| <b>Total net income allocable to noncontrolling interests</b> | <b>2,669</b>                                   | <b>2,613</b>     | <b>5,372</b>                                 | <b>5,179</b>     |
| <b>Net income allocable to PS Business Parks, Inc.:</b>       |  |                  |  |                  |
| Preferred shareholders  | 15,122   | 15,122           | 30,244                                       | 28,972           |
| Restricted stock unit holders                                 | 33   | 30               | 69   | 63               |
| Common shareholders   | 9,826  | 8,711            | 19,766                                       | 17,251           |
| <b>Total net income allocable to PS Business Parks, Inc.</b>  | <b>24,981</b>                                  | <b>23,863</b>    | <b>50,079</b>                                | <b>46,286</b>    |
| <b>Net income</b>   | <b>\$ 27,650</b>                               | <b>\$ 26,476</b> | <b>\$ 55,451</b>                             | <b>\$ 51,465</b> |
| <b>Net income per common share:</b>                           |  |                  |  |                  |

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|   |         |         |         |         |
|---|---------|---------|---------|---------|
| Basic                                       | \$ 0.37 | \$ 0.36 | \$ 0.74 | \$ 0.71 |
| Diluted                                     | \$ 0.36 | \$ 0.36 | \$ 0.73 | \$ 0.71 |
| Weighted average common shares outstanding: |         |         |         |         |
| Basic                                       | 26,899  | 24,358  | 26,881  | 24,333  |
| Diluted                                     | 26,999  | 24,470  | 26,981  | 24,441  |
| Dividends declared per common share         | \$ 0.50 | \$ 0.44 | \$ 1.00 | \$ 0.88 |

See accompanying notes.

Table of Contents**PS BUSINESS PARKS, INC.****CONSOLIDATED STATEMENT OF EQUITY****FOR THE SIX MONTHS ENDED JUNE 30, 2014**

(Unaudited, in thousands, except share data)

|                          | Preferred Stock |            | Common Stock |        | Paid-in    | Cumulative   | Cumulative    | Total PS     |                |
|--------------------------|-----------------|------------|--------------|--------|------------|--------------|---------------|--------------|----------------|
|                          | Shares          | Amount     | Shares       | Amount | Capital    | Net          |               | Shareholder  | Noncontrolling |
|                          |                 |            |              |        |            | Income       | Distributions | Equity       | Interests      |
| <b>December 31, 2013</b> | 39,800          | \$ 995,000 | 26,849,822   | \$ 267 | \$ 699,314 | \$ 1,070,975 | \$(1,047,615) | \$ 1,717,941 | \$ 196,699     |
| Stock options            |                 |            | 49,273       | 1      | 2,442      |              |               | 2,443        |                |
| Issuance, net            |                 |            | 5,341        |        | 3,571      |              |               | 3,571        |                |
|                          |                 |            |              |        |            | 50,079       |               | 50,079       | 5,372          |
|                          |                 |            |              |        |            |              | (30,244)      | (30,244)     |                |
|                          |                 |            |              |        |            |              | (26,893)      | (26,893)     |                |
| Noncontrolling interests |                 |            |              |        |            |              |               |              | (7,305)        |
| Underlying operating     |                 |            |              |        |            |              |               | (984)        | 984            |
| <b>June 30, 2014</b>     | 39,800          | \$ 995,000 | 26,904,436   | \$ 268 | \$ 704,343 | \$ 1,121,054 | \$(1,104,752) | \$ 1,715,913 | \$ 195,750     |

See accompanying notes.



Table of Contents**PS BUSINESS PARKS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited, in thousands)**

|   | <b>For The Six Months<br/>Ended June 30,</b> |             |
|---|--|-------------|
|   | <b>2014</b>                                  | <b>2013</b> |
| <b>Cash flows from operating activities:</b>                                      |  |             |
| Net income  | \$ 55,451                                    | \$ 51,465   |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |             |
| Depreciation and amortization expense   | 56,736                                       | 53,590      |
| In-place lease adjustment   | (441)  | 121         |
| Tenant improvement reimbursements net of lease incentives                         | (839)  | (625)       |
| Stock compensation  | 3,898  | 2,628       |
| Decrease in receivables and other assets  | 4,664  | 1,816       |
| Decrease in accrued and other liabilities   | (2,959)                                      | (3,386)     |
| Total adjustments   | 61,059                                       | 54,144      |
| Net cash provided by operating activities   | 116,510                                      | 105,609     |
| <b>Cash flows from investing activities:</b>                                      |  |             |
| Capital improvements to real estate facilities                                    | (22,250)                                     | (24,722)    |
| Capital improvements to land and building held for development                    | (1,219)                                      | (53)        |
| Net cash used in investing activities   | (23,469)                                     | (24,775)    |
| <b>Cash flows from financing activities:</b>                                      |  |             |
| Repayment of borrowings on term loan debt   |  | (110,000)   |
| Principal payments on mortgage notes payable                                      |  | (47)        |
| Repayment of mortgage notes payable   |  | (18,055)    |
| Net proceeds from the issuance of preferred stock                                 |  | 106,311     |
| Proceeds from the exercise of stock options                                       | 2,443  | 3,659       |
| Distributions paid to preferred shareholders                                      | (30,244)                                     | (28,972)    |
| Distributions paid to noncontrolling interests - common units                     | (7,305)                                      | (6,428)     |
| Distributions paid to common shareholders   | (26,893)                                     | (21,423)    |
| Net cash used in financing activities   | (61,999)                                     | (74,955)    |
| Net increase in cash and cash equivalents   | 31,042                                       | 5,879       |
| Cash and cash equivalents at the beginning of the period                          | 31,481                                       | 12,883      |
| Cash and cash equivalents at the end of the period                                | \$ 62,523                                    | \$ 18,762   |

**Supplemental schedule of non-cash investing and financing activities:**

|   |          |             |
|---|----------|-------------|
| Adjustment to noncontrolling interests in underlying operating partnership: |          |             |
| Noncontrolling interests common units                                       | \$ 984   | \$ 103      |
| Paid-in capital   | \$ (984) | \$ (103)    |
| Transfer to land and building held for development:                         |          |             |
| Land  | \$       | \$ (5,927)  |
| Buildings and improvements  | \$       | \$ (10,323) |
| Accumulated depreciation  | \$       | \$ 778      |
| Land and building held for development                                      | \$       | \$ 15,472   |

See accompanying notes.

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**PS BUSINESS PARKS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2014**

**1. Organization and description of business**

PS Business Parks, Inc. ( PSB ) was incorporated in the state of California in 1990. As of June 30, 2014, PSB owned 77.8% of the common partnership units of PS Business Parks, L.P. (the Operating Partnership ). The remaining common partnership units are owned by Public Storage ( PS ). Assuming issuance of the Company s common stock upon redemption of its partnership units, PS would own 42.3% of the outstanding shares of the Company s common stock. PSB, as the sole general partner of the Operating Partnership, has full, exclusive and complete responsibility and discretion in managing and controlling the Operating Partnership. PSB and its subsidiaries, including the Operating Partnership are collectively referred to as the Company.

The Company is a fully-integrated, self-advised and self-managed real estate investment trust ( REIT ) that owns, operates, acquires and develops commercial properties, primarily multi-tenant flex, office and industrial space. As of June 30, 2014, the Company owned and operated 29.7 million rentable square feet of commercial space located in eight states. The Company also manages 1.2 million rentable square feet on behalf of PS.

References to the number of properties or square footage are unaudited and outside the scope of the Company s independent registered public accounting firm s review of the Company s financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States).

**2. Summary of significant accounting policies**

*Basis of presentation*

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ( GAAP ) for interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2014 are not necessarily indicative of the results that may be expected for the year ended December 31, 2014. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2013.

The accompanying consolidated financial statements include the accounts of PSB and the Operating Partnership. All significant inter-company balances and transactions have been eliminated in the consolidated financial statements.

*Noncontrolling Interests*

The Company s noncontrolling interests are reported as a component of equity separate from the parent s equity. Purchases or sales of equity interests that do not result in a change in control are accounted for as equity transactions. In addition, net income attributable to the noncontrolling interests is included in consolidated net income on the face of the income statement and, upon a gain or loss of control, the interests purchased or sold, as well as any interests retained, are recorded at fair value with any gain or loss recognized in earnings. At the end of each reporting period,

the Company determines the amount of equity (book value of net assets) which is allocable to the noncontrolling interests based upon the ownership interest, and an adjustment is made to the noncontrolling interests, with a corresponding adjustment to paid-in capital, to reflect the noncontrolling interests equity interest in the Company.

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The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from these estimates.

*Allowance for doubtful accounts*

The Company monitors the collectability of its receivable balances including the deferred rent receivable on an ongoing basis. Based on these reviews, the Company maintains an allowance for doubtful accounts for estimated losses resulting from the possible inability of tenants to make contractual rent payments to the Company. A provision for doubtful accounts is recorded during each period. The allowance for doubtful accounts, which represents the cumulative allowances less write-offs of uncollectible rent, is netted against tenant and other receivables on the consolidated balance sheets. Tenant receivables are net of an allowance for uncollectible accounts totaling \$400,000 at June 30, 2014 and December 31, 2013. Deferred rent receivable is net of an allowance for uncollectible accounts totaling \$834,000 and \$940,000 at June 30, 2014 and December 31, 2013, respectively.

*Financial instruments*

The methods and assumptions used to estimate the fair value of financial instruments are described below. The Company has estimated the fair value of financial instruments using available market information and appropriate valuation methodologies. Considerable judgment is required in interpreting market data to develop estimates of market value. Accordingly, estimated fair values are not necessarily indicative of the amounts that could be realized in current market exchanges. The Company determines the estimated fair value of financial assets and liabilities utilizing a hierarchy of valuation techniques based on whether the inputs to a fair value measurement are considered to be observable or unobservable in a marketplace. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect market assumptions. This hierarchy requires the use of observable market data when available. The following is the fair value hierarchy:

*Level 1* quoted prices for identical instruments in active markets;

*Level 2* quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which significant inputs and significant value drivers are observable in active markets; and

*Level 3* fair value measurements derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable

Financial assets that are exposed to credit risk consist primarily of cash and cash equivalents and receivables. The Company considers all highly liquid investments with a remaining maturity of three months or less at the date of purchase to be cash equivalents. Cash and cash equivalents, which consist primarily of money market investments, are only invested in entities with an investment grade rating. Receivables are comprised of balances due from a large number of customers. Balances that the Company expects to become uncollectible are reserved for or written off. Due to the short period to maturity of the Company's cash and cash equivalents, accounts receivable, other assets and accrued and other liabilities, the carrying values as presented on the consolidated balance sheets are reasonable

estimates of fair value.

Carrying values of the Company's mortgage notes payable, unsecured credit facility and term loan approximate fair value. The characteristics of these financial instruments, market data and other comparative metrics utilized in determining these fair values are Level 2 inputs.

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### *Real estate facilities*

Real estate facilities are recorded at cost. Costs related to the renovation or improvement of the properties are capitalized. Expenditures for repairs and maintenance are expensed as incurred. Expenditures that are expected to benefit a period greater than two years and exceed \$2,000 are capitalized and depreciated over their estimated useful life. Buildings and improvements are depreciated using the straight-line method over their estimated useful lives, which generally range from five to 30 years. Transaction costs, which include tenant improvements and lease commissions, in excess of \$1,000 for leases with terms greater than one year are capitalized and depreciated over their estimated useful lives. Transaction costs less than \$1,000 or for leases of one year or less are expensed as incurred.

### *Land and building held for development*

Property taxes, insurance, interest and costs essential to the development of property for its intended use are capitalized during the period of development. Upon classification of an asset as held for development, depreciation of the asset is ceased.

### *Properties held for disposition*

An asset is classified as an asset held for disposition when it meets certain requirements, which include, among other criteria, the approval of the sale of the asset, the marketing of the asset for sale and the expectation by the Company that the sale will likely occur within the next 12 months. Upon classification of an asset as held for disposition, depreciation of the asset is ceased, and the net book value of the asset is included on the balance sheet as properties held for disposition.

### *Intangible assets/liabilities*

Intangible assets and liabilities include above-market and below-market in-place lease values of acquired properties based on the present value (using an interest rate which reflects the risks associated with the leases acquired) of the difference between (i) the contractual amounts to be paid pursuant to the in-place leases and (ii) management's estimate of fair market lease rates for the corresponding in-place leases, measured over a period equal to the remaining non-cancelable term of the lease. The capitalized above-market and below-market lease values (included in other assets and accrued liabilities in the accompanying consolidated balance sheets) are amortized to rental income over the remaining non-cancelable terms of the respective leases.

The Company recorded net increases in rental income of \$244,000 and \$441,000 for the three and six months ended June 30, 2014, respectively, due to the amortization of net intangible liabilities resulting from the above-market and below-market lease values. The Company recorded net reductions to rental income of \$49,000 and \$121,000 for the three and six months ended June 30, 2013, respectively, due to the amortization of net intangible assets resulting from the above-market and below-market lease values.

As of June 30, 2014, the value of in-place leases resulted in net intangible assets of \$3.0 million, net of \$7.2 million of accumulated amortization with a weighted average amortization period of 7.5 years, and net intangible liabilities of \$4.2 million, net of \$5.9 million of accumulated amortization with a weighted average amortization period of 4.6 years. As of December 31, 2013, the value of in-place leases resulted in net intangible assets of \$3.7 million, net of \$6.6 million of accumulated amortization and net intangible liabilities of \$5.4 million, net of \$4.8 million of accumulated amortization.





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### *Evaluation of asset impairment*

The Company evaluates its assets used in operations for impairment by identifying indicators of impairment and by comparing the sum of the estimated undiscounted future cash flows for each asset to the asset's carrying value. When indicators of impairment are present and the sum of the estimated undiscounted future cash flows is less than the carrying value of such asset, an impairment loss is recorded equal to the difference between the asset's current carrying value and its value based on discounting its estimated future cash flows. In addition, the Company evaluates its assets held for disposition for impairment. Assets held for disposition are reported at the lower of their carrying value or fair value, less cost of disposition. At June 30, 2014, the Company did not consider any assets to be impaired.

### *Stock compensation*

All share-based payments to employees, including grants of employee stock options, are recognized as stock compensation in the Company's income statement based on their grant date fair values. See Note 11.

### *Revenue and expense recognition*

The Company must meet four basic criteria before revenue can be recognized: persuasive evidence of an arrangement exists; the delivery has occurred or services have been rendered; the fee is fixed or determinable; and collectability is reasonably assured. All leases are classified as operating leases. Rental income is recognized on a straight-line basis over the terms of the leases. Straight-line rent is recognized for all tenants with contractual fixed increases in rent that are not included on the Company's credit watch list. Deferred rent receivable represents rental revenue recognized on a straight-line basis in excess of billed rents. Reimbursements from tenants for real estate taxes and other recoverable operating expenses are recognized as rental income in the period the applicable costs are incurred. Property management fees are recognized in the period earned.

Costs incurred in connection with leasing (primarily tenant improvements and lease commissions) are capitalized and amortized over the lease period.

### *Gains from sales of real estate facilities*

The Company recognizes gains from sales of real estate facilities at the time of sale using the full accrual method, provided that various criteria related to the terms of the transactions and any subsequent involvement by the Company with the properties sold are met. If the criteria are not met, the Company defers the gains and recognizes them when the criteria are met or uses the installment or cost recovery methods as appropriate under the circumstances.

### *General and administrative expenses*

General and administrative expenses include executive and other compensation, office expenses, professional fees, acquisition transaction costs, state income taxes and other such administrative items.

### *Income taxes*

The Company has qualified and intends to continue to qualify as a REIT, as defined in Section 856 of the Internal Revenue Code of 1986, as amended. As a REIT, the Company is not subject to federal income tax to the extent that it distributes its REIT taxable income to its shareholders. A REIT must distribute at least 90% of its taxable income each year. In addition, REITs are subject to a number of organizational and operating requirements. The Company may be subject to certain state and local taxes on its income and property and to federal income and excise taxes on its

undistributed taxable income. The Company believes it met all organization and operating requirements to maintain its REIT status during 2013 and intends to continue to meet such requirements for 2014. Accordingly, no provision for income taxes has been made in the accompanying consolidated financial statements.

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The Company can recognize a tax benefit only if it is more likely than not that a particular tax position will be sustained upon examination or audit. To the extent that the more likely than not standard has been satisfied, the benefit associated with a position is measured as the largest amount that is greater than 50% likely of being recognized upon settlement. As of June 30, 2014, the Company did not recognize any tax benefit for uncertain tax positions.

*Accounting for preferred equity issuance costs*

The Company records issuance costs as a reduction to paid-in capital on its balance sheet at the time the preferred securities are issued and reflects the carrying value of the preferred equity at the stated value. Such issuance costs are recorded as non-cash preferred equity distributions at the time the Company notifies the holders of preferred stock or units of its intent to redeem such shares or units.

*Net income allocation*

Net income was allocated as follows (*in thousands*):

|   | <b>For The Three<br/>Months<br/>Ended June 30,</b> |                  | <b>For The Six<br/>Months<br/>Ended June 30,</b> |                  |
|---|--|------------------|--|------------------|
|   | <b>2014</b>  | <b>2013</b>      | <b>2014</b>                                      | <b>2013</b>      |
| Net income allocable to noncontrolling interests:             |  |                  |  |                  |
| Noncontrolling interests – common units                       | \$ 2,669   | \$ 2,613         | \$ 5,372   | \$ 5,179         |
| <b>Total net income allocable to noncontrolling interests</b> | <b>2,669</b>                                       | <b>2,613</b>     | <b>5,372</b>                                     | <b>5,179</b>     |
| Net income allocable to PS Business Parks, Inc.:              |  |                  |  |                  |
| Preferred shareholders  | 15,122   | 15,122           | 30,244   | 28,972           |
| Restricted stock unit holders                                 | 33   | 30               | 69   | 63               |
| Common shareholders   | 9,826  | 8,711            | 19,766   | 17,251           |
| <b>Total net income allocable to PS Business Parks, Inc.</b>  | <b>24,981</b>                                      | <b>23,863</b>    | <b>50,079</b>                                    | <b>46,286</b>    |
| <b>Net income</b>   | <b>\$ 27,650</b>                                   | <b>\$ 26,476</b> | <b>\$ 55,451</b>                                 | <b>\$ 51,465</b> |

*Net income per common share*

Per share amounts are computed using the number of weighted average common shares outstanding. Diluted weighted average common shares outstanding includes the dilutive effect of stock options and restricted stock units under the treasury stock method. Basic weighted average common shares outstanding excludes such effect. The Company's restricted stock units are participating securities and are included in the computation of basic and diluted weighted average common shares outstanding. The Company's restricted stock unit holders are paid non-forfeitable dividends in excess of the expense recorded which results in a reduction in net income allocable to common shareholders and unit holders. Earnings per share has been calculated as follows (*in thousands, except per share amounts*):

|   | <b>For The Three<br/>Months<br/>Ended June 30,</b> |             | <b>For The Six Months<br/>Ended June 30,</b> |             |
|---|--|-------------|--|-------------|
|   | <b>2014</b>  | <b>2013</b> | <b>2014</b>                                  | <b>2013</b> |
| Net income allocable to common shareholders   | \$ 9,826   | \$ 8,711    | \$ 19,766                                    | \$ 17,251   |
| Weighted average common shares outstanding:   |  |             |  |             |
| Basic weighted average common shares outstanding  | 26,899   | 24,358      | 26,881                                       | 24,333      |
| Net effect of dilutive stock compensation based on treasury stock method using average market price | 100  | 112         | 100  | 108         |
| Diluted weighted average common shares outstanding  | 26,999   | 24,470      | 26,981                                       | 24,441      |
| Net income per common share Basic   | \$ 0.37  | \$ 0.36     | \$ 0.74                                      | \$ 0.71     |
| Net income per common share Diluted   | \$ 0.36  | \$ 0.36     | \$ 0.73                                      | \$ 0.71     |

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Options to purchase 16,000 and 14,000 shares for the three and six months ended June 30, 2014 and 2013, respectively, were not included in the computation of diluted net income per share because such options were considered anti-dilutive.

*Segment reporting*

The Company views its operations as one segment.

*Reclassifications*

Certain reclassifications have been made to the consolidated financial statements for 2013 in order to conform to the 2014 presentation.

*Recently Issued Accounting Standards*

In April, 2014, the Financial Accounting Standard Board ( FASB ) issued amendments to guidance for reporting discontinued operations and disposals of components of an entity. The amended guidance requires that a disposal representing a strategic shift that has (or will have) a major effect on an entity's financial results or a business activity classified as held for sale should be reported as discontinued operations. The amendments also expand the disclosure requirements for discontinued operations and add new disclosures for individually significant dispositions that do not qualify as discontinued operations. The amendments are effective prospectively for fiscal years, and interim reporting periods within those years, beginning after December 15, 2014 (early adoption is permitted only for disposals that have not been previously reported). During the first quarter of 2014, the Company early adopted the amended guidance, which did not have a material impact on the consolidated financial position or results of operations.

In May, 2014, the FASB issued new accounting guidance which amended the existing accounting standards for revenue recognition. The new accounting guidance establishes principles for recognizing revenue upon the transfer of promised goods or services to customers, in an amount that reflects the expected consideration received in exchange for those goods or services. This guidance is effective for the Company's fiscal year beginning October 1, 2017. Early adoption is not permitted. The amendments may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of initial application. The Company is currently in the process of evaluating the impact of adoption of the new accounting guidance on its consolidated financial statements.

**3. Real estate facilities**

The activity in real estate facilities for the six months ended June 30, 2014 is as follows (*in thousands*):

|   | <b>Land</b> | <b>Buildings<br/>and<br/>Improvements</b> | <b>Accumulated<br/>Depreciation</b> | <b>Total</b> |
|---|-------------|---|-------------------------------------|--------------|
| Balances at December 31, 2013               | \$ 790,346  | \$ 2,191,829                              | \$ (942,959)                        | \$ 2,039,216 |
| Capital improvements, net                   |             | 22,840                                    |                                     | 22,840       |
| Disposals                                   |             | (4,106)                                   | 4,106                               |              |
| Depreciation and amortization               |             |   | (56,736)                            | (56,736)     |
| Transfer to properties held for disposition |             | (1,050)                                   | 2,796                               | 1,746        |

|                           |            |              |              |              |
|---------------------------|------------|--------------|--------------|--------------|
| Balances at June 30, 2014 | \$ 790,346 | \$ 2,209,513 | \$ (992,793) | \$ 2,007,066 |
|---------------------------|------------|--------------|--------------|--------------|

The purchase price of acquired properties is recorded to land, buildings and improvements and intangible assets and liabilities associated with in-place leases (including tenant improvements, unamortized lease commissions, value of above-market and below-market leases, acquired in-place lease values, and tenant relationships, if any) based on their respective estimated fair values. Acquisition-related costs are expensed as incurred.

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In determining the fair value of the tangible assets of the acquired properties, management considers the value of the properties as if vacant as of the acquisition date. Management must make significant assumptions in determining the value of assets acquired and liabilities assumed. Using different assumptions in the recording of the purchase cost of the acquired properties would affect the timing of recognition of the related revenue and expenses. Amounts recorded to land are derived from comparable sales of land within the same region. Amounts recorded to buildings and improvements, tenant improvements and unamortized lease commissions are based on current market replacement costs and other market information. The amount recorded to acquired in-place leases is determined based on management's assessment of current market conditions and the estimated lease-up periods for the respective spaces.

On July 24, 2014, the Company acquired a 149,000 square foot building in Miami, Florida, for \$12.7 million. The building, which is currently vacant, is a free standing building located within the Company's 3.3 million square foot Miami Industrial Commerce Center, which is currently 98.1% leased.

On July 28, 2014, the Company acquired a 19,000 square foot building in Dallas, Texas, for \$1.1 million. The flex building, which is 100.0% occupied, is located in the Company's 389,000 square foot Araphao Business Park.

On December 20, 2013, the Company acquired Bayshore Corporate Commons, an eight-building, 340,000 square foot office park in San Mateo, California, for \$60.5 million. On November 8, 2013, the Company acquired nine multi-tenant flex buildings in the Valwood submarket of Dallas, Texas, aggregating 245,000 square feet for \$12.4 million. On October 15, 2013, the Company acquired four multi-tenant flex parks along with a four-acre parcel of land aggregating 559,000 square feet of single-story flex buildings located in Dallas, Texas, for a purchase price of \$27.9 million. On July 26, 2013, the Company acquired a 389,000 square foot multi-tenant flex park consisting of 18 single-story buildings located in Dallas, Texas, for a purchase price of \$14.8 million.

The Company owns three business parks, aggregating 1.3 million square feet, and 11.5 acres of land in Oregon that it is in the process of selling and therefore has classified such assets as properties held for disposition at June 30, 2014 and December 31, 2013. The Company anticipates the sale of such assets to be completed during the fourth quarter of 2014.

At the beginning of 2013, the Company reclassified a 125,000 square foot building located in Northern Virginia to land and building held for development as the Company intends to redevelop the property. In conjunction with the reclassification, the Company ceased depreciation of the asset. In July, 2013, the Company entered into a joint venture agreement with a real estate development company to pursue a multifamily development on the property. During the entitlement phase, all costs related to the pre-development will be split evenly between the Company and its joint venture partner. The Company will contribute the property to the joint venture upon completion of the entitlement phase. The asset and capitalized development costs were \$17.4 million and \$16.2 million at June 30, 2014 and December 31, 2013, respectively. For the six months ended June 30, 2014, the Company capitalized costs of \$1.2 million related to this development, of which \$457,000 related to capitalized interest costs.

**4. Leasing activity**

The Company leases space in its real estate facilities to tenants primarily under non-cancelable leases generally ranging from one to 10 years. Future minimum rental revenues, excluding recovery of operating expenses under these leases, are as follows as of June 30, 2014 (*in thousands*):

|      |            |
|------|------------|
| 2014 | \$ 138,507 |
|------|------------|

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|              |                   |
|--------------|-------------------|
| 2015         | 226,747           |
| 2016         | 160,385           |
| 2017         | 110,246           |
| 2018         | 76,573            |
| Thereafter   | 143,080           |
| <b>Total</b> | <b>\$ 855,538</b> |



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In addition to minimum rental payments, certain tenants reimburse the Company for their pro rata share of specified operating expenses. Such reimbursements amounted to \$19.8 million and \$18.7 million for the three months ended June 30, 2014 and 2013, respectively, and \$40.8 million and \$36.9 million for the six months ended June 30, 2014 and 2013, respectively. These amounts are included as rental income in the accompanying consolidated statements of income.

Leases accounting for 3.6% of total leased square footage are subject to termination options which include leases accounting for 1.2% of total leased square footage having termination options exercisable through December 31, 2014. In general, these leases provide for termination payments should the termination options be exercised. The future minimum rental revenues in the above table assume such options are not exercised.

**5. Bank loans**

On April 28, 2014, the Company modified and extended the terms of its line of credit (the *Credit Facility*) with Wells Fargo Bank, National Association (*Wells Fargo*). The expiration of the Credit Facility was extended from August 1, 2015 to May 1, 2019. The Credit Facility has a borrowing limit of \$250.0 million. The rate of interest charged on borrowings was modified to a rate ranging from the London Interbank Offered Rate (*LIBOR*) plus 0.875% to LIBOR plus 1.70% depending on the Company's credit ratings. Currently, the Company's rate under the Credit Facility is LIBOR plus 0.925%. In addition, the Company is required to pay an annual facility fee ranging from 0.125% to 0.30% of the borrowing limit depending on the Company's credit ratings (currently 0.15%). The Company had no balance outstanding on the Credit Facility at June 30, 2014 and December 31, 2013. The Company had \$1.1 million and \$485,000 of unamortized commitment fees as of June 30, 2014 and December 31, 2013, respectively. The Credit Facility requires the Company to meet certain covenants, with all of which the Company was in compliance as of June 30, 2014. Interest on outstanding borrowings is payable monthly.

The Company had a term loan with Wells Fargo (the *Term Loan*). Pursuant to the Term Loan, the Company borrowed \$250.0 million for a three year term maturing December 31, 2014. The Term Loan was repaid in full in November, 2013. Interest on the amounts borrowed under the Term Loan was accrued based on an applicable rate ranging from LIBOR plus 1.15% to LIBOR plus 2.25% depending on the Company's credit ratings. During 2013, the Company's rate under the Term Loan was LIBOR plus 1.20%.

**6. Mortgage note payable**

The Company has one mortgage note payable with a fixed interest rate of 5.45%, secured by 4.8 million square feet of commercial properties with a net book value of \$432.6 million. The interest is payable monthly, and the mortgage note payable has a maturity date of December, 2016. The Company had \$250.0 million outstanding on the mortgage note payable as of June 30, 2014 and December 31, 2013.

In January, 2013, the Company repaid two mortgage notes payable totaling \$18.1 million with a combined stated interest rate of 5.60%.

**7. Noncontrolling interests**

As described in Note 2, the Company reports noncontrolling interests within equity in the consolidated financial statements, but separate from the Company's shareholders' equity. In addition, net income allocable to noncontrolling interests is shown as a reduction from net income in calculating net income allocable to common shareholders.

*Common partnership units*

The Company presents the accounts of PSB and the Operating Partnership on a consolidated basis. Ownership interests in the Operating Partnership that can be redeemed for common stock, other than PSB's interest, are classified as noncontrolling interests common units in the consolidated financial statements. Net income allocable to noncontrolling interests common units consists of the common units share of the consolidated operating results after allocation to preferred units and shares. Beginning one year from the date of admission as a limited partner (common units) and subject to certain limitations described below, each limited partner other than PSB has the right to require the redemption of its partnership interest.

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A limited partner (common units) that exercises its redemption right will receive cash from the Operating Partnership in an amount equal to the market value (as defined in the Operating Partnership Agreement) of the partnership interests redeemed. In lieu of the Operating Partnership redeeming the common units for cash, PSB, as general partner, has the right to elect to acquire the partnership interest directly from a limited partner exercising its redemption right, in exchange for cash in the amount specified above or by issuance of one share of PSB common stock for each unit of limited partnership interest redeemed.

A limited partner (common units) cannot exercise its redemption right if delivery of shares of PSB common stock would be prohibited under the applicable articles of incorporation, or if the general partner believes that there is a risk that delivery of shares of common stock would cause the general partner to no longer qualify as a REIT, would cause a violation of the applicable securities laws, or would result in the Operating Partnership no longer being treated as a partnership for federal income tax purposes.

At June 30, 2014, there were 7,305,355 common units owned by PS, which are accounted for as noncontrolling interests. Combined with PS's existing common stock ownership, on a fully converted basis, PS has a combined ownership of 42.3% of the Company's common equity.

### *Preferred partnership units*

The Company had no preferred units outstanding through the Operating Partnership as of June 30, 2014 and December 31, 2013.

## **8. Related party transactions**

The Operating Partnership manages industrial, office and retail facilities for PS. These facilities, all located in the United States, operate under the "Public Storage" or "PS Business Parks" names. The PS Business Parks name and logo is owned by PS and licensed to the Company under a non-exclusive, royalty-free license agreement. The license can be terminated by either party for any reason with six months written notice.

Under the property management contract with PS, the Operating Partnership is compensated based on a percentage of the gross revenues of the facilities managed. Under the supervision of the property owners, the Operating Partnership coordinates rental policies, rent collections, marketing activities, the purchase of equipment and supplies, maintenance activities, and the selection and engagement of vendors, suppliers and independent contractors. In addition, the Operating Partnership assists and advises the property owners in establishing policies for the hire, discharge and supervision of employees for the operation of these facilities, including property managers and leasing, billing and maintenance personnel.

The property management contract with PS is for a seven-year term with the agreement automatically extending for an additional one-year period upon each one-year anniversary of its commencement (unless cancelled by either party). Either party can give notice of its intent to cancel the agreement upon expiration of its current term. Management fee revenues under this contract were \$165,000 and \$157,000 for the three months ended June 30, 2014 and 2013, respectively, and \$331,000 and \$315,000 for the six months ended June 30, 2014 and 2013, respectively.

PS also provides property management services for the self-storage component of two assets owned by the Company. These self-storage facilities, located in Palm Beach County, Florida, operate under the "Public Storage" name.



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Under the property management contract, PS is compensated based on a percentage of the gross revenues of the facilities managed. Under the supervision of the Company, PS coordinates rental policies, rent collections, marketing activities, the purchase of equipment and supplies, maintenance activities, and the selection and engagement of vendors, suppliers and independent contractors. In addition, PS is responsible for establishing the policies for the hire, discharge and supervision of employees for the operation of these facilities, including on-site managers, assistant managers and associate managers.

Either the Company or PS can cancel the property management contract upon 60 days notice. Management fee expenses under the contract were \$17,000 and \$14,000 for the three months ended June 30, 2014 and 2013, respectively, and \$33,000 and \$28,000 for the six months ended June 30, 2014 and 2013, respectively.

Pursuant to a cost sharing and administrative services agreement, the Company shares costs with PS for certain administrative services and rental of corporate office space, which are allocated to PS in accordance with a methodology intended to fairly allocate those costs. These costs totaled \$118,000 and \$108,000 for the three months ended June 30, 2014 and 2013, respectively, and \$226,000 and \$216,000 for the six months ended June 30, 2014 and 2013, respectively.

The Company had net amounts due to PS of \$294,000 and \$181,000 at June 30, 2014 and December 31, 2013, respectively, for these contracts, as well as for certain operating expenses paid by the Company on behalf of PS.

**9. Shareholders equity***Preferred stock*

As of June 30, 2014 and December 31, 2013, the Company had the following series of preferred stock outstanding:

| Series   | Issuance Date   | Earliest Potential Redemption Date | Dividend Rate | Shares Outstanding (in thousands) | Amount     |
|----------|-----------------|------------------------------------|---------------|-----------------------------------|------------|
| Series R | October, 2010   | October, 2015                      | 6.875%        | 3,000                             | \$ 75,000  |
| Series S | January, 2012   | January, 2017                      | 6.450%        | 9,200                             | 230,000    |
| Series T | May, 2012       | May, 2017                          | 6.000%        | 14,000                            | 350,000    |
| Series U | September, 2012 | September, 2017                    | 5.750%        | 9,200                             | 230,000    |
| Series V | March, 2013     | March, 2018                        | 5.700%        | 4,400                             | 110,000    |
| Total    |                 |                                    |               | 39,800                            | \$ 995,000 |

On March 14, 2013, the Company issued \$110.0 million or 4.4 million depository shares, each representing 1/1,000 of a share of the 5.70% Cumulative Preferred Stock, Series V, at \$25.00 per depository share.

The Company paid \$15.1 million in distributions to its preferred shareholders for the three months ended June 30, 2014 and 2013. The Company paid \$30.2 million and \$29.0 million in distributions to its preferred shareholders for the six months ended June 30, 2014 and 2013, respectively.

Holders of the Company's preferred stock will not be entitled to vote on most matters, except under certain conditions. In the event of a cumulative arrearage equal to six quarterly dividends, the holders of the preferred stock will have the right to elect two additional members to serve on the Company's Board of Directors until all events of default have been cured. At June 30, 2014, there were no dividends in arrears.

Except under certain conditions relating to the Company's qualification as a REIT, the preferred stock is not redeemable prior to the previously noted redemption dates. On or after the respective redemption dates, the respective series of preferred stock will be redeemable, at the option of the Company, in whole or in part, at \$25.00 per depositary share, plus any accrued and unpaid dividends. The Company had \$31.8 million of deferred costs in connection with the issuance of preferred stock as of June 30, 2014 and December 31, 2013, which the Company will report as additional non-cash distributions upon notice of its intent to redeem such shares.

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### *Common stock*

On November 7, 2013, the Company sold 1,495,000 shares of common stock in a public offering and concurrently sold 950,000 shares of common stock at the public offering price to PS. The aggregate net proceeds were \$192.3 million.

No shares of common stock were repurchased under the board approved common stock repurchase program during the six months ended June 30, 2014 and 2013.

The Company paid \$13.5 million (\$0.50 per common share) and \$10.7 million (\$0.44 per common share) in distributions to its common shareholders for the three months ended June 30, 2014 and 2013, respectively, and \$26.9 million (\$1.00 per common share) and \$21.4 million (\$0.88 per common share) for the six months ended June 30, 2014 and 2013, respectively.

### *Equity stock*

In addition to common and preferred stock, the Company is authorized to issue 100.0 million shares of Equity Stock. The Articles of Incorporation provide that the Equity Stock may be issued from time to time in one or more series and give the Board of Directors broad authority to fix the dividend and distribution rights, conversion and voting rights, redemption provisions and liquidation rights of each series of Equity Stock.

## **10. Commitments and contingencies**

The Company currently is neither subject to any other material litigation nor, to management's knowledge, is any material litigation currently threatened against the Company other than routine litigation and administrative proceedings arising in the ordinary course of business.

## **11. Stock compensation**

PSB has a 2003 Stock Option and Incentive Plan (the "2003 Plan") and a 2012 Equity and Performance-Based Incentive Compensation Plan (the "2012 Plan") covering 1.5 million and 1.0 million shares of PSB's common stock, respectively. Under the 2003 Plan and 2012 Plan, PSB has granted non-qualified options to certain directors, officers and key employees to purchase shares of PSB's common stock at a price not less than the fair market value of the common stock at the date of grant. Additionally, under the 2003 Plan and 2012 Plan, PSB has granted restricted shares of common stock to certain directors and restricted stock units to officers and key employees.

The weighted average grant date fair value of options granted during the six months ended June 30, 2014 and 2013 was \$10.95 per share and \$8.81 per share, respectively. The Company has calculated the fair value of each option grant on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants during the six months ended June 30, 2014 and 2013, respectively: a dividend yield of 2.3% and 2.2% expected volatility of 17.7% and 16.7% expected life of five years; and risk-free interest rates of 1.7% and 0.7%.

No restricted stock units were granted during the six months ended June 30, 2014 and 2013.

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At June 30, 2014, there was a combined total of 935,000 options and restricted stock units authorized to be granted. Information with respect to outstanding options and nonvested restricted stock units granted under the 2003 Plan and 2012 Plan is as follows:

| <b>Options:</b>                  | <b>Number of<br/>Options</b> | <b>Weighted<br/>Average<br/>Exercise Price</b> | <b>Weighted<br/>Average<br/>Remaining<br/>Contract Life</b> | <b>Aggregate<br/>Intrinsic<br/>Value<br/>(in thousands)</b> |
|----------------------------------|------------------------------|--|---|---|
| Outstanding at December 31, 2013 | 380,773                      | \$ 56.45                                       |   |   |
| Granted                          | 16,000                       | \$ 85.53                                       |   |   |
| Exercised                        | (49,273)                     | \$ 49.58                                       |   |   |
| Forfeited                        | (4,000)                      | \$ 52.35                                       |   |   |
| Outstanding at June 30, 2014     | 343,500                      | \$ 58.84                                       | 6.02 Years  | \$ 8,502  |
| Exercisable at June 30, 2014     | 224,900                      | \$ 55.55                                       | 5.31 Years  | \$ 6,284  |

| <b>Restricted Stock Units:</b> | <b>Number of<br/>Units</b> | <b>Weighted<br/>Average<br/>Grant<br/>Date Fair Value</b> |
|--------------------------------|----------------------------|---|
| Nonvested at December 31, 2013 | 45,100                     | \$ 60.07  |
| Granted                        |                            | \$  |
| Vested                         | (8,430)                    | \$ 51.73  |
| Forfeited                      | (1,740)                    | \$ 67.28  |
| Nonvested at June 30, 2014     | 34,930                     | \$ 61.72  |

Effective March, 2014, the Company entered into a performance-based restricted stock unit program, the Senior Management Long-Term Equity Incentive Program for 2014-2017 ( LTEIP ), with selected employees of the Company. Under the LTEIP, the Company established three levels of targeted restricted stock unit awards for selected employees, which would be earned only if the Company achieved one of three defined targets during 2014 to 2017. The first type of award is an annual award following the end of each of the four years in the program, with the award subject to and based on the achievement of one of three defined targets during the previous year. The second type of award is an award based on achieving one of three defined targets during the cumulative four-year period 2014-2017. In the event the minimum defined target is not achieved for an annual award, the shares allocated to be awarded for such year are added to the shares that may be received if the four-year target is achieved. Both types of restricted stock unit awards vest in four equal annual installments beginning from the date of award. Up to approximately 83,657 restricted stock units would be granted for each of the four years assuming achievement was met and up to approximately 83,657 restricted stock units would be granted for the cumulative four-year period assuming achievement was met. Compensation expense is recognized based on the shares expected to be awarded based on the target level that is expected to be achieved. Net compensation expense of \$2.4 million and \$3.2 million related to the LTEIP was recognized during the three and six months ended June 30, 2014, respectively.



Effective January 1, 2012, the Company entered into a performance-based restricted stock unit program, the Senior Management Long-Term Equity Incentive Program for 2012-2015 ( 2012 LTEIP ), with selected employees of the Company. The targets for 2012 and 2013 were not achieved and management determined in 2013 that it was not probable that the targets under the 2012 LTEIP will be met. As such, the Company stopped recording amortization as of September 30, 2013. Net compensation of \$917,000 and \$2.0 million related to the 2012 LTEIP was recognized during the three and six months ended June 30, 2013, respectively, and was reversed during the three months ended December 31, 2013.

Included in the Company's consolidated statements of income for the three months ended June 30, 2014 and 2013, was \$108,000 and \$103,000, respectively, in net compensation expense related to stock options. Net compensation expense of \$230,000 and \$218,000 related to stock options was recognized during the six months ended June 30, 2014 and 2013, respectively. Excluding the LTEIP amortization of \$2.4 million and \$917,000, respectively, net compensation expense of \$108,000 and \$117,000 related to restricted stock units was recognized during the three months ended June 30, 2014 and 2013, respectively. Excluding the LTEIP amortization of \$3.2 million and \$2.0 million, respectively, net compensation of \$284,000 and \$312,000 related to restricted stock units was recognized during the six months ended June 30, 2014 and 2013, respectively.

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As of June 30, 2014, there was \$695,000 of unamortized compensation expense related to stock options expected to be recognized over a weighted average period of 2.9 years. As of June 30, 2014, there was \$33.3 million (includes \$31.7 million from the LTEIP) of unamortized compensation expense related to restricted stock units expected to be recognized over a weighted average period of 5.4 years.

Cash received from 49,273 stock options exercised during the six months ended June 30, 2014 was \$2.4 million. Cash received from 76,300 stock options exercised during the six months ended June 30, 2013 was \$3.7 million. The aggregate intrinsic value of the stock options exercised was \$1.7 million and \$2.5 million during the six months ended June 30, 2014 and 2013, respectively.

During the six months ended June 30, 2014, 8,430 restricted stock units vested; in settlement of these units, 5,341 shares were issued, net of shares applied to payroll taxes. The aggregate fair value of the shares vested for the six months ended June 30, 2014 was \$708,000. During the six months ended June 30, 2013, 9,110 restricted stock units vested; in settlement of these units, 5,796 shares were issued, net of shares applied to payroll taxes. The aggregate fair value of the shares vested for the six months ended June 30, 2013 was \$695,000.

In May of 2004, the shareholders of the Company approved the issuance of up to 70,000 shares of common stock under the Retirement Plan for Non-Employee Directors (the Director Plan). Under the Director Plan, the Company grants 1,000 shares of common stock for each year served as a director up to a maximum of 5,000 shares issued upon retirement. In December of 2011, the Director Plan was amended to increase the maximum shares from 5,000 shares to 7,000 shares, 1,000 shares of common stock for each year served as a director. The Company recognizes compensation expense with regards to grants to be issued in the future under the Director Plan. As a result, included in the Company's consolidated statements of income was \$77,000 and \$67,000 in compensation expense for the three months ended June 30, 2014 and 2013, respectively and \$153,000 and \$134,000 for the six months ended June 30, 2014 and 2013, respectively. As of June 30, 2014 and 2013, there was \$1.3 million and \$1.0 million, respectively, of unamortized compensation expense related to these shares. No shares were issued during the six months ended June 30, 2014 and 2013.

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**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Forward-Looking Statements:** Forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995, are made throughout this Quarterly Report on Form 10-Q. For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, the words may, believes, anticipates, plans, expects, seeks, estimates, intends, and other similar expressions are intended to identify forward-looking statements. There are a number of important factors that could cause the results of the Company to differ materially from those indicated by such forward-looking statements, including but not limited to: (a) changes in general economic and business conditions; (b) decreases in rental rates or increases in vacancy rates/failure to renew or replace expiring leases; (c) tenant defaults; (d) the effect of the recent credit and financial market conditions; (e) our failure to maintain our status as a real estate investment trust ( REIT ); (f) the economic health of our tenants; (g) increases in operating costs; (h) casualties to our properties not covered by insurance; (i) the availability and cost of capital; (j) increases in interest rates and its effect on our stock price; (k) other factors discussed under the heading Part I, Item 1A. Risk Factors in our annual report on Form 10-K for the year ended December 31, 2013. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by us or any other person that our objectives and plans will be achieved. Moreover, we assume no obligation to update these forward-looking statements to reflect actual results, changes in assumptions or changes in other factors affecting such forward-looking statements, except as required by law.

**Overview**

As of June 30, 2014, the Company owned and operated 29.7 million rentable square feet of multi-tenant flex, industrial and office properties located in eight states.

The Company focuses on increasing profitability and cash flow aimed at maximizing shareholder value. The Company strives to maintain high occupancy levels while increasing rental rates when market conditions allow, although the Company may decrease rental rates in markets where conditions require. The Company also acquires properties it believes will create long-term value, and from time to time disposes of properties which no longer fit within the Company's strategic objectives. Operating results are driven primarily by income from rental operations and are therefore substantially influenced by rental demand for space within our properties and our markets, which impacts occupancy and rental rates.

During the first six months of 2014, the Company executed leases comprising 4.5 million square feet of space including 2.8 million square feet of renewals of existing leases and 1.7 million square feet of new leases. Overall, the change in rental rates for the Company continued to improve. The Company experienced an increase in rental rates when comparing new rental rates to outgoing rental rates of 1.1% and 0.2% for the three and six months ended June 30, 2014, respectively, compared to a decrease of 1.3% for the six months ended June 30, 2013. See further discussion of operating results below.

**Critical Accounting Policies and Estimates:**

Our accounting policies are described in Note 2 to the consolidated financial statements included in this Form 10-Q. We believe our most critical accounting policies relate to revenue recognition, property acquisitions, allowance for doubtful accounts, impairment of long-lived assets, depreciation, accruals of operating expenses and accruals for contingencies, each of which are more fully described in Part I, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations in our annual report on Form 10-K for the year ended December 31,

2013.

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**Effect of Economic Conditions on the Company's Operations:** During the first six months of 2014, most markets reflected signs of improving occupancy and rental rates, overall new rental rates for the Company experienced a modest increase over expiring rental rates on executed leases as economic conditions continue to improve. Current and future economic conditions and competition may continue to have a significant impact on the Company, potentially resulting in further reductions in occupancy and rental rates.

The Company historically has experienced a low level of write-offs of uncollectable rents, but there is inherent uncertainty in a tenant's ability to continue paying rent and meet its full lease obligation. The table below summarizes the impact to the Company from tenants' inability to pay rent or continue to meet their lease obligations (*in thousands*):

|   | <b>For The Six Months<br/>Ended June 30,</b> |             |
|---|--|-------------|
|   | <b>2014</b>                                  | <b>2013</b> |
| Write-offs of uncollectible rent  | \$ 559                                       | \$ 565      |
| Write-offs as a percentage of rental income   | 0.3%   | 0.3%        |
| Square footage of leases terminated prior to their scheduled expiration due to business failures/bankruptcies                                 | 144  | 201         |
| Accelerated depreciation and amortization related to unamortized tenant improvements and lease commissions associated with early terminations | \$ 286                                       | \$ 1,312    |

As of July 28, 2014, the Company had 16,000 square feet of leased space occupied by tenants that are protected by Chapter 11 of the U.S. Bankruptcy Code. From time to time, tenants contact us, requesting early termination of their lease, a reduction in space under lease, or rent deferment or abatement. At this time, the Company cannot anticipate what impact, if any, the ultimate outcome of these discussions will have on our future operating results.

**Company Performance and Effect of Economic Conditions on Primary Markets:** The Company's operations are substantially concentrated in 10 regions. During the six months ended June 30, 2014, initial rental rates on new and renewed leases within the Company's total portfolio increased 0.2% over expiring rents, with the increase in the three months ended June 30, 2014 being 1.1%. The Company's Same Park (defined below) occupancy rate at June 30, 2014 was 92.8%, compared to 91.4% at June 30, 2013. The Company's total portfolio occupancy rate at June 30, 2014 was 91.5%, compared to 90.3% at June 30, 2013. Each of the 10 regions in which the Company owns assets is subject to its own unique market influences. See Supplemental Property Data and Trends below for more information on regional operating data.

**Effect of Acquisitions and Dispositions of Properties on the Company's Operations:** The Company is focused on growing its operations by looking for opportunities to expand its presence in existing and new markets through strategic acquisitions that meet the Company's focus on multi-tenant flex, industrial and office parks in markets where it has or may obtain a substantial market presence. The Company may from time to time dispose of assets based on market conditions.

On July 24, 2014, the Company acquired a 149,000 square foot building in Miami, Florida, for \$12.7 million. The building, which is currently vacant, is a free standing building located within the Company's 3.3 million square foot Miami Industrial Commerce Center, which is currently 98.1% leased.

On July 28, 2014, the Company acquired a 19,000 square foot building in Dallas, Texas, for \$1.1 million. The flex building, which is 100.0% occupied, is located in the Company's 389,000 square foot Araphao Business Park.

The Company is pursuing the sale of its portfolio in the Portland, Phoenix and Sacramento markets. The assets owned in these markets comprise an aggregate 2.4 million square feet and accounted for 7.3% of the Company's net operating income (see page 22 for definition) in 2013. The Company anticipates closing on the sale of the assets in Portland in the fourth quarter of 2014. The ultimate timing and probability of the sale of the Phoenix and Sacramento markets are uncertain at this time as the marketing process is still underway.

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On December 20, 2013, the Company acquired Bayshore Corporate Commons, an eight-building, 340,000 square foot office park in San Mateo, California, for \$60.5 million. On November 8, 2013, the Company acquired nine multi-tenant flex buildings in the Valwood submarket of Dallas, Texas, aggregating 245,000 square feet for \$12.4 million. On October 15, 2013, the Company acquired four multi-tenant flex parks along with a four-acre parcel of land aggregating 559,000 square feet of single-story flex buildings located in Dallas, Texas, for a purchase price of \$27.9 million. On July 26, 2013, the Company acquired a 389,000 square foot multi-tenant flex park consisting of 18 single-story buildings located in Dallas, Texas, for a purchase price of \$14.8 million.

As of June 30, 2014, the blended occupancy rate of the six assets acquired from 2012 to 2013 was 78.4% compared to a blended occupancy rate of 67.7% at the time of acquisition. As of June 30, 2014, the Company had 587,000 square feet of vacancy spread over these six acquisitions which we believe provides the Company with considerable opportunity to generate additional rental income given that the Company's Same Park assets in these same submarkets have a weighted occupancy of 93.7% at June 30, 2014. The table below contains the assets acquired from 2012 to 2013 (*in thousands*):

| Property                   | Date Acquired  | Location                | Purchase Price    | Square Feet  | Occupancy at Acquisition | Occupancy at June 30, 2014 |
|----------------------------|----------------|-------------------------|-------------------|--------------|--------------------------|----------------------------|
| Bayshore Corporate Commons | December, 2013 | San Mateo, California   | \$ 60,500         | 340          | 81.8%                    | 77.3%                      |
| Valwood Business Park      | November, 2013 | Dallas, Texas           | 12,425            | 245          | 83.5%                    | 89.0%                      |
| Dallas Flex Portfolio      | October, 2013  | Dallas, Texas           | 27,900            | 559          | 72.1%                    | 68.7%                      |
| Arapaho Business Park      | July, 2013     | Dallas, Texas           | 14,800            | 389          | 66.5%                    | 76.2%                      |
| Austin Flex Buildings      | December, 2012 | Austin, Texas           | 14,900            | 226          | 86.1%                    | 100.0%                     |
| 212th Business Park        | July, 2012     | Kent Valley, Washington | 37,550            | 958          | 52.3%                    | 77.4%                      |
| <b>Total</b>               |                |                         | <b>\$ 168,075</b> | <b>2,717</b> | <b>67.7%</b>             | <b>78.4%</b>               |

At the beginning of 2013, the Company reclassified a 125,000 square foot building located in Northern Virginia to land and building held for development as the Company intends to redevelop the property. In conjunction with the reclassification, the Company ceased depreciation of the asset. In July, 2013, the Company entered into a joint venture agreement with a real estate development company to pursue a multifamily development of this property. During the entitlement phase, all costs related to the pre-development will be split evenly between the Company and its joint venture partner. The Company will contribute the property to the joint venture upon completion of the entitlement phase. The asset and capitalized development costs were \$17.4 million and \$16.2 million at June 30, 2014 and December 31, 2013, respectively. For the six months ended June 30, 2014, the Company capitalized costs of \$1.2 million related to this development, of which \$457,000 related to capitalized interest costs.

**Scheduled Lease Expirations:** In addition to the 2.5 million square feet, or 8.4%, of space available in our total portfolio as of June 30, 2014, 1,163 leases representing 13.1% of the leased square footage of our total portfolio or

12.2% of annualized rental income are scheduled to expire during the remainder of 2014. Our ability to re-lease available space will depend upon market conditions in the specific submarkets in which our properties are located. As a result, we cannot predict with certainty the rate at which expiring leases will be re-leased.

**Impact of Inflation:** Although inflation has not been significant in recent years, it remains a potential factor in our economy, and the Company continues to seek ways to mitigate its potential impact. A substantial portion of the Company's leases require tenants to pay operating expenses, including real estate taxes, utilities, and insurance, as well as increases in common area expenses, partially reducing the Company's exposure to inflation.

Rental income, cost of operations and rental income less cost of operations, excluding depreciation and amortization, or net operating income (defined as NOI for purposes of the following tables), are summarized for the three and six months ended June 30, 2014 and 2013. NOI is a non-GAAP financial measure. The Company uses NOI and its components as a measurement of the performance of its commercial real estate. Management believes that these financial measures provide them, as well as the investor, the most consistent measurement on a comparative basis of the performance of the commercial real estate and its contribution to the value of the Company. Depreciation and amortization have been excluded from NOI as they are generally not used in determining the value of commercial real estate by management or the investment community. Depreciation and amortization are generally not used in determining value as they consider the historical costs of an asset compared to its current value; therefore, to understand the effect of the assets' historical cost on the Company's results, investors should look at GAAP financial measures, such as total operating costs including depreciation and amortization. The Company's calculation of NOI may not be comparable to those of other companies and should not be used as an alternative to measures of performance calculated in accordance with GAAP. As part of the tables below, we have reconciled total NOI to income from continuing operations, which we consider the most directly comparable financial measure calculated in accordance with GAAP.



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In order to provide a meaningful period-to-period comparison, the tables below exclude amortization of the Long-Term Equity Incentive Plan ( LTEIP ) in cost of operations (for field leadership) and general and administrative expenses (for executive management).

**Concentration of Portfolio by Region:** The table below reflects the Company's square footage from continuing operations based on regional concentration as of June 30, 2014. As part of the table below, we have reconciled total NOI to income from continuing operations (*in thousands*):

| Region              | Square Footage | Percent of Square Footage | NOI For The Six Months Ended June 30, 2014 | Percent of NOI |
|---------------------|----------------|---------------------------|--|----------------|
| California          |                |                           |  |                |
| Northern California | 7,493          | 25.2%                     | \$ 26,390                                  | 21.0%          |
| Southern California | 3,988          | 13.4%                     | 18,479                                     | 14.7%          |
| Texas               |                |                           |  |                |
| Northern Texas      | 2,961          | 9.9%                      | 7,815                                      | 6.2%           |
| Southern Texas      | 1,717          | 5.8%                      | 6,247                                      | 5.0%           |
| Virginia            | 4,040          | 13.6%                     | 27,741                                     | 22.1%          |
| Florida             | 3,717          | 12.5%                     | 11,866                                     | 9.5%           |
| Maryland            | 2,352          | 7.9%                      | 15,285                                     | 12.2%          |
| Washington          | 1,479          | 5.0%                      | 4,508                                      | 3.6%           |
| Oregon              | 1,314          | 4.4%                      | 5,512                                      | 4.4%           |
| Arizona             | 679            | 2.3%                      | 1,670                                      | 1.3%           |
| <b>Total</b>        | <b>29,740</b>  | <b>100.0%</b>             | <b>\$ 125,513</b>                          | <b>100.0%</b>  |

## Reconciliation of NOI to income from continuing operations

|  |                  |
|--|------------------|
| Total NOI                                | \$ 125,513       |
| Other income and (expenses):             |                  |
| LTEIP amortization:                      |                  |
| Cost of operations                       | (1,185)          |
| General and administrative               | (2,047)          |
| Facility management fees                 | 331              |
| Interest and other income                | 157              |
| Interest and other expenses              | (6,779)          |
| Depreciation and amortization            | (56,736)         |
| General and administrative               | (3,803)          |
| <b>Income from continuing operations</b> | <b>\$ 55,451</b> |

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**Concentration of Credit Risk by Industry:** The information below depicts the industry concentration of our tenant base as of June 30, 2014. The Company analyzes this concentration to minimize significant industry exposure risk.

| <b>Industry</b>                                       | <b>Percent of Annualized Rental Income</b> |
|---|--|
| Business services                                     | 16.9%                                      |
| Government  | 10.3%                                      |
| Health services                                       | 10.2%                                      |
| Computer hardware, software and related services      | 10.0%                                      |
| Warehouse, distribution, transportation and logistics | 9.3%                                       |
| Retail, food, and automotive                          | 6.0%                                       |
| Engineering and construction                          | 6.0%                                       |
| Insurance and financial services                      | 5.3%                                       |
| Communications  | 4.0%                                       |
| Home furnishings                                      | 3.2%                                       |
| Electronics   | 3.0%                                       |
| Aerospace/defense products and services               | 2.7%                                       |
| Educational services                                  | 1.5%                                       |
| Other   | 11.6%                                      |
| <b>Total</b>  | <b>100.0%</b>                              |

The information below depicts the Company's top 10 customers by annualized rental income as of June 30, 2014 (*in thousands*):

| <b>Tenants</b>                  | <b>Square Footage</b> | <b>Annualized Rental Income <sup>(1)</sup></b> | <b>Percent of Annualized Rental Income</b> |
|---------------------------------|-----------------------|--|--|
| US Government                   | 856                   | \$ 21,882                                      | 5.8%                                       |
| Lockheed Martin Corporation     | 171                   | 4,371  | 1.2%                                       |
| Kaiser Permanente               | 199                   | 4,356  | 1.2%                                       |
| Keeco LLC                       | 460                   | 3,240  | 0.9%                                       |
| Nike, Inc.                      | 239                   | 2,946  | 0.8%                                       |
| Luminex Corporation             | 185                   | 2,526  | 0.7%                                       |
| Wells Fargo                     | 118                   | 1,930  | 0.5%                                       |
| Level 3 Communications, LLC     | 197                   | 1,929  | 0.5%                                       |
| Salient Federal Solutions, Inc. | 58                    | 1,899  | 0.5%                                       |
| Raytheon                        | 80                    | 1,786  | 0.5%                                       |
| <b>Total</b>                    | <b>2,563</b>          | <b>\$ 46,865</b>                               | <b>12.6%</b>                               |

- (1) For leases expiring prior to December 31, 2014, annualized rental income represents income to be received under existing leases from July 1, 2014 through the date of expiration.

**Comparative Analysis of the Three and Six Months Ended June 30, 2014 to the Three and Six Months Ended June 30, 2013**

**Results of Operations:** In order to evaluate the performance of the Company's portfolio over comparable periods, management analyzes the operating performance of properties owned and operated throughout both periods (herein referred to as "Same Park"). The Same Park portfolio includes all operating properties owned or acquired prior to January 1, 2012. Operating properties that the Company acquired subsequent to January 1, 2012 are referred to as "Non-Same Park." For the three and six months ended June 30, 2014 and 2013, the Same Park facilities constitute 27.0 million rentable square feet, representing 90.9% of the 29.7 million square feet in the Company's portfolio as of June 30, 2014.

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The following table presents the operating results of the Company's properties for the three and six months ended June 30, 2014 and 2013 in addition to other income and expenses items affecting income from continuing operations (in thousands, except per square foot data):

|   | For The Three<br>Months<br>Ended June 30, |           |         | For The Six Months<br>Ended June 30, |            |         |
|---|---|-----------|---------|--------------------------------------|------------|---------|
|   | 2014                                      | 2013      | Change  | 2014                                 | 2013       | Change  |
| <b>Rental income:</b>   |   |           |         |                                      |            |         |
| Same Park (27.0 million rentable square feet)                     | \$ 88,654                                 | \$ 86,645 | 2.3%    | \$ 178,277                           | \$ 173,569 | 2.7%    |
| Non-Same Park (2.7 million rentable square feet)                  | 5,332                                     | 1,285     | 314.9%  | 11,030                               | 2,481      | 344.6%  |
| Total rental income   | 93,986                                    | 87,930    | 6.9%    | 189,307                              | 176,050    | 7.5%    |
| <b>Cost of operations:</b>  |   |           |         |                                      |            |         |
| Same Park   | 28,246                                    | 27,931    | 1.1%    | 59,113                               | 56,391     | 4.8%    |
| Non-Same Park   | 2,433                                     | 554       | 339.2%  | 4,681                                | 1,113      | 320.6%  |
| Total cost of operations  | 30,679                                    | 28,485    | 7.7%    | 63,794                               | 57,504     | 10.9%   |
| <b>Net operating income</b>                                       |   |           |         |                                      |            |         |
| Same Park   | 60,408                                    | 58,714    | 2.9%    | 119,164                              | 117,178    | 1.7%    |
| Non-Same Park   | 2,899                                     | 731       | 296.6%  | 6,349                                | 1,368      | 364.1%  |
| Total net operating income  | 63,307                                    | 59,445    | 6.5%    | 125,513                              | 118,546    | 5.9%    |
| <b>Other income and (expenses):</b>                               |   |           |         |                                      |            |         |
| <b>LTEIP amortization:</b>  |   |           |         |                                      |            |         |
| Cost of operations  | (856)                                     | (235)     | 264.3%  | (1,185)                              | (600)      | 97.5%   |
| General and administrative  | (1,518)                                   | (682)     | 122.6%  | (2,047)                              | (1,363)    | 50.2%   |
| Facility management fees  | 165                                       | 157       | 5.1%    | 331                                  | 315        | 5.1%    |
| Other income and expenses   | (3,308)                                   | (3,892)   | (15.0%) | (6,622)                              | (8,437)    | (21.5%) |
| Depreciation and amortization                                     | (28,295)                                  | (26,629)  | 6.3%    | (56,736)                             | (53,590)   | 5.9%    |
| General and administrative  | (1,845)                                   | (1,688)   | 9.3%    | (3,803)                              | (3,406)    | 11.7%   |
| Income from continuing operations                                 | \$ 27,650                                 | \$ 26,476 | 4.4%    | \$ 55,451                            | \$ 51,465  | 7.7%    |
| Same Park gross margin <sup>(1)</sup>                             | 68.1%                                     | 67.8%     | 0.4%    | 66.8%                                | 67.5%      | (1.0%)  |
| Same Park weighted average occupancy                              | 92.5%                                     | 90.9%     | 1.8%    | 92.4%                                | 90.9%      | 1.7%    |
| Non-Same Park weighted average occupancy                          | 77.9%                                     | 61.9%     | 25.8%   | 76.7%                                | 58.8%      | 30.4%   |
| Same Park annualized realized rent per square foot <sup>(2)</sup> | \$ 14.19                                  | \$ 14.11  | 0.6%    | \$ 14.28                             | \$ 14.13   | 1.1%    |

- (1) Computed by dividing Same Park NOI by Same Park rental income.
- (2) Represents the annualized Same Park rental income earned per occupied square foot.

**Supplemental Property Data and Trends:** NOI from continuing operations is summarized for the three and six months ended June 30, 2014 and 2013 by region below. See above for more information on NOI, including why the Company presents NOI and how the Company uses NOI. The Company's calculation of NOI may not be comparable to those of other companies and should not be used as an alternative to measures of performance calculated in accordance with GAAP.

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The following tables summarize the Same Park and Non-Same Park operating results by region for the three and six months ended June 30, 2014 and 2013. In addition, the tables reflect the comparative impact on the overall rental income, cost of operations and NOI from properties that have been acquired since January 1, 2012, and the impact of such is included in Non-Same Park facilities in the tables below. As part of the tables below, we have reconciled total NOI to income from continuing operations (*in thousands*):

**Three Months Ended June 30, 2014 and 2013:**

| Region   | Rental    | Rental    | Increase<br>(Decrease) | Cost of   | Cost of    | Increase<br>(Decrease) | NOI       | NOI       | Increase<br>(Decrease) |
|--|-----------|-----------|------------------------|-----------|------------|------------------------|-----------|-----------|------------------------|
|  | Income    | Income    |                        | Operation | Operations |                        | June 30,  | June 30,  |                        |
|  | June      | June      |                        | June      | June       |                        | June 30,  | June 30,  |                        |
|  | 30,       | 30,       |                        | 30,       | 30,        |                        | 2014      | 2013      |                        |
|  | 2014      | 2013      |                        | 2014      | 2013       |                        |           |           |                        |
| <b>Same Park</b>   |           |           |                        |           |            |                        |           |           |                        |
| Northern   |           |           |                        |           |            |                        |           |           |                        |
| California   | \$ 17,102 | \$ 15,754 | 8.6%                   | \$ 5,047  | \$ 4,853   | 4.0%                   | \$ 12,055 | \$ 10,901 | 10.6%                  |
| Southern   |           |           |                        |           |            |                        |           |           |                        |
| California   | 13,566    | 13,387    | 1.3%                   | 4,487     | 4,388      | 2.3%                   | 9,079     | 8,999     | 0.9%                   |
| Northern Texas   | 4,533     | 4,450     | 1.9%                   | 1,647     | 1,510      | 9.1%                   | 2,886     | 2,940     | (1.8%)                 |
| Southern Texas   | 4,312     | 4,391     | (1.8%)                 | 1,567     | 1,471      | 6.5%                   | 2,745     | 2,920     | (6.0%)                 |
| Virginia   | 20,532    | 20,734    | (1.0%)                 | 6,045     | 6,073      | (0.5%)                 | 14,487    | 14,661    | (1.2%)                 |
| Florida  | 8,493     | 7,883     | 7.7%                   | 2,501     | 2,694      | (7.2%)                 | 5,992     | 5,189     | 15.5%                  |
| Maryland   | 12,049    | 12,037    | 0.1%                   | 4,077     | 3,818      | 6.8%                   | 7,972     | 8,219     | (3.0%)                 |
| Washington   | 2,100     | 1,966     | 6.8%                   | 591       | 647        | (8.7%)                 | 1,509     | 1,319     | 14.4%                  |
| Oregon   | 4,534     | 4,668     | (2.9%)                 | 1,653     | 1,844      | (10.4%)                | 2,881     | 2,824     | 2.0%                   |
| Arizona  | 1,433     | 1,375     | 4.2%                   | 631       | 633        | (0.3%)                 | 802       | 742       | 8.1%                   |
| <b>Total Same Park</b>                                     |           |           |                        |           |            |                        |           |           |                        |
|  | 88,654    | 86,645    | 2.3%                   | 28,246    | 27,931     | 1.1%                   | 60,408    | 58,714    | 2.9%                   |
| <b>Non-Same Park</b>                                       |           |           |                        |           |            |                        |           |           |                        |
| Northern   |           |           |                        |           |            |                        |           |           |                        |
| California   | 1,570     |           | 100.0%                 | 639       |            | 100.0%                 | 931       |           | 100.0%                 |
| Northern Texas   | 1,974     |           | 100.0%                 | 1,219     |            | 100.0%                 | 755       |           | 100.0%                 |
| Southern Texas   | 587       | 462       | 27.1%                  | 183       | 158        | 15.8%                  | 404       | 304       | 32.9%                  |
| Washington   | 1,201     | 823       | 45.9%                  | 392       | 396        | (1.0%)                 | 809       | 427       | 89.5%                  |
| <b>Total Non-Same Park</b>                                 |           |           |                        |           |            |                        |           |           |                        |
|  | 5,332     | 1,285     | 314.9%                 | 2,433     | 554        | 339.2%                 | 2,899     | 731       | 296.6%                 |
| <b>Total</b>   |           |           |                        |           |            |                        |           |           |                        |
|  | \$ 93,986 | \$ 87,930 | 6.9%                   | \$ 30,679 | \$ 28,485  | 7.7%                   | \$ 63,307 | \$ 59,445 | 6.5%                   |
| Reconciliation of NOI to income from continuing operations |           |           |                        |           |            |                        |           |           |                        |
| Total NOI  |           |           |                        |           |            |                        | \$ 63,307 | \$ 59,445 | 6.5%                   |

|                                   |           |           |         |
|-----------------------------------|-----------|-----------|---------|
| Other income and (expenses):      |           |           |         |
| LTEIP amortization:               |           |           |         |
| Cost of operations                | (856)     | (235)     | 264.3%  |
| General and administrative        | (1,518)   | (682)     | 122.6%  |
| Facility management fees          | 165       | 157       | 5.1%    |
| Other income and expenses         | (3,308)   | (3,892)   | (15.0%) |
| Depreciation and amortization     | (28,295)  | (26,629)  | 6.3%    |
| General and administrative        | (1,845)   | (1,688)   | 9.3%    |
| Income from continuing operations | \$ 27,650 | \$ 26,476 | 4.4%    |

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| Region  | Rental                     | Rental                     | Increase<br>(Decrease) | Cost of          | Cost of          | Increase<br>(Decrease) | NOI               | NOI               | Increase<br>(Decrease) |
|---|----------------------------|----------------------------|------------------------|------------------|------------------|------------------------|-------------------|-------------------|------------------------|
|   | Income<br>June 30,<br>2014 | Income<br>June 30,<br>2013 |                        | Operation        | Operations       |                        | June 30,<br>2014  | June 30,<br>2013  |                        |
| <b>Same Park</b>  |                            |                            |                        |                  |                  |                        |                   |                   |                        |
| Northern  |                            |                            |                        |                  |                  |                        |                   |                   |                        |
| California  | \$ 34,147                  | \$ 32,130                  | 6.3%                   | \$ 9,965         | \$ 9,694         | 2.8%                   | \$ 24,182         | \$ 22,436         | 7.8%                   |
| Southern  |                            |                            |                        |                  |                  |                        |                   |                   |                        |
| California  | 27,423                     | 26,748                     | 2.5%                   | 8,944            | 8,741            | 2.3%                   | 18,479            | 18,007            | 2.6%                   |
| Northern  |                            |                            |                        |                  |                  |                        |                   |                   |                        |
| Texas   | 9,108                      | 9,001                      | 1.2%                   | 3,094            | 3,005            | 3.0%                   | 6,014             | 5,996             | 0.3%                   |
| Southern  |                            |                            |                        |                  |                  |                        |                   |                   |                        |
| Texas   | 8,490                      | 8,733                      | (2.8%)                 | 3,077            | 2,938            | 4.7%                   | 5,413             | 5,795             | (6.6%)                 |
| Virginia  | 41,137                     | 40,975                     | 0.4%                   | 13,396           | 12,935           | 3.6%                   | 27,741            | 28,040            | (1.1%)                 |
| Florida   | 16,989                     | 16,006                     | 6.1%                   | 5,123            | 5,365            | (4.5%)                 | 11,866            | 10,641            | 11.5%                  |
| Maryland  | 24,831                     | 23,827                     | 4.2%                   | 9,546            | 7,758            | 23.0%                  | 15,285            | 16,069            | (4.9%)                 |
| Washington  | 4,275                      | 4,128                      | 3.6%                   | 1,273            | 1,285            | (0.9%)                 | 3,002             | 2,843             | 5.6%                   |
| Oregon  | 9,026                      | 9,278                      | (2.7%)                 | 3,514            | 3,451            | 1.8%                   | 5,512             | 5,827             | (5.4%)                 |
| Arizona   | 2,851                      | 2,743                      | 3.9%                   | 1,181            | 1,219            | (3.1%)                 | 1,670             | 1,524             | 9.6%                   |
| <b>Total Same Park</b>  | <b>178,277</b>             | <b>173,569</b>             | <b>2.7%</b>            | <b>59,113</b>    | <b>56,391</b>    | <b>4.8%</b>            | <b>119,164</b>    | <b>117,178</b>    | <b>1.7%</b>            |
| <b>Non-Same Park</b>  |                            |                            |                        |                  |                  |                        |                   |                   |                        |
| Northern  |                            |                            |                        |                  |                  |                        |                   |                   |                        |
| California  | 3,488                      |                            | 100.0%                 | 1,280            |                  | 100.0%                 | 2,208             |                   | 100.0%                 |
| Northern  |                            |                            |                        |                  |                  |                        |                   |                   |                        |
| Texas   | 4,006                      |                            | 100.0%                 | 2,205            |                  | 100.0%                 | 1,801             |                   | 100.0%                 |
| Southern  |                            |                            |                        |                  |                  |                        |                   |                   |                        |
| Texas   | 1,177                      | 929                        | 26.7%                  | 343              | 319              | 7.5%                   | 834               | 610               | 36.7%                  |
| Washington  | 2,359                      | 1,552                      | 52.0%                  | 853              | 794              | 7.4%                   | 1,506             | 758               | 98.7%                  |
| <b>Total Non-Same Park</b>  | <b>11,030</b>              | <b>2,481</b>               | <b>344.6%</b>          | <b>4,681</b>     | <b>1,113</b>     | <b>320.6%</b>          | <b>6,349</b>      | <b>1,368</b>      | <b>364.1%</b>          |
| <b>Total</b>  | <b>\$ 189,307</b>          | <b>\$ 176,050</b>          | <b>7.5%</b>            | <b>\$ 63,794</b> | <b>\$ 57,504</b> | <b>10.9%</b>           | <b>\$ 125,513</b> | <b>\$ 118,546</b> | <b>5.9%</b>            |
| <b>Reconciliation of NOI to income from continuing operations</b> |                            |                            |                        |                  |                  |                        |                   |                   |                        |
| <b>Total NOI</b>  |                            |                            |                        |                  |                  |                        | <b>\$ 125,513</b> | <b>\$ 118,546</b> | <b>5.9%</b>            |



|                                   |           |           |         |
|-----------------------------------|-----------|-----------|---------|
| Other income and (expenses):      |           |           |         |
| LTEIP amortization:               |           |           |         |
| Cost of operations                | (1,185)   | (600)     | 97.5%   |
| General and administrative        | (2,047)   | (1,363)   | 50.2%   |
| Facility management fees          | 331       | 315       | 5.1%    |
| Other income and expenses         | (6,622)   | (8,437)   | (21.5%) |
| Depreciation and amortization     | (56,736)  | (53,590)  | 5.9%    |
| General and administrative        | (3,803)   | (3,406)   | 11.7%   |
| Income from continuing operations | \$ 55,451 | \$ 51,465 | 7.7%    |

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The following tables summarize Same Park weighted average occupancy rates and annualized realized rent per square foot by region for the three and six months ended June 30, 2014 and 2013.

**Three Months Ended June 30, 2014 and 2013:**

| Region              | Weighted Average Occupancy Rates |       |        | Annualized Realized Rent Per Square Foot |          |        |
|---------------------|----------------------------------|-------|--------|--|----------|--------|
|                     | 2014                             | 2013  | Change | 2014                                     | 2013     | Change |
| Northern California | 93.6%                            | 88.6% | 5.6%   | \$ 10.22                                 | \$ 9.95  | 2.7%   |
| Southern California | 92.5%                            | 91.4% | 1.2%   | \$ 14.72                                 | \$ 14.70 | 0.1%   |
| Northern Texas      | 89.8%                            | 90.2% | (0.4%) | \$ 11.41                                 | \$ 11.15 | 2.3%   |
| Southern Texas      | 93.8%                            | 97.1% | (3.4%) | \$ 12.33                                 | \$ 12.13 | 1.6%   |
| Virginia            | 89.9%                            | 91.0% | (1.2%) | \$ 22.61                                 | \$ 22.55 | 0.3%   |
| Florida             | 97.5%                            | 94.8% | 2.8%   | \$ 9.37                                  | \$ 8.95  | 4.7%   |
| Maryland            | 88.1%                            | 87.0% | 1.3%   | \$ 23.26                                 | \$ 23.53 | (1.1%) |
| Washington          | 96.8%                            | 93.9% | 3.1%   | \$ 16.66                                 | \$ 16.07 | 3.7%   |
| Oregon              | 89.0%                            | 90.8% | (2.0%) | \$ 15.51                                 | \$ 15.65 | (0.9%) |
| Arizona             | 91.8%                            | 91.1% | 0.8%   | \$ 9.20                                  | \$ 8.89  | 3.5%   |
| Total Same Park     | 92.5%                            | 90.9% | 1.8%   | \$ 14.19                                 | \$ 14.11 | 0.6%   |

**Six Months Ended June 30, 2014 and 2013:**

| Region              | Weighted Average Occupancy Rates |       |        | Annualized Realized Rent Per Square Foot |          |        |
|---------------------|----------------------------------|-------|--------|--|----------|--------|
|                     | 2014                             | 2013  | Change | 2014                                     | 2013     | Change |
| Northern California | 93.5%                            | 87.9% | 6.4%   | \$ 10.21                                 | \$ 10.22 | (0.1%) |
| Southern California | 92.7%                            | 91.4% | 1.4%   | \$ 14.84                                 | \$ 14.68 | 1.1%   |
| Northern Texas      | 93.5%                            | 90.1% | 3.8%   | \$ 11.01                                 | \$ 11.29 | (2.5%) |
| Southern Texas      | 92.9%                            | 96.7% | (3.9%) | \$ 12.26                                 | \$ 12.11 | 1.2%   |
| Virginia            | 89.6%                            | 91.4% | (2.0%) | \$ 22.72                                 | \$ 22.19 | 2.4%   |
| Florida             | 97.6%                            | 95.2% | 2.5%   | \$ 9.36                                  | \$ 9.04  | 3.5%   |
| Maryland            | 87.6%                            | 87.5% | 0.1%   | \$ 24.10                                 | \$ 23.16 | 4.1%   |
| Washington          | 96.5%                            | 94.4% | 2.2%   | \$ 17.01                                 | \$ 16.79 | 1.3%   |
| Oregon              | 89.0%                            | 90.6% | (1.8%) | \$ 15.44                                 | \$ 15.59 | (1.0%) |
| Arizona             | 92.5%                            | 90.5% | 2.2%   | \$ 9.08                                  | \$ 8.93  | 1.7%   |
| Total Same Park     | 92.4%                            | 90.9% | 1.7%   | \$ 14.28                                 | \$ 14.13 | 1.1%   |

**Rental Income:** Rental income increased \$6.1 million from \$87.9 million for the three months ended June 30, 2013 to \$94.0 million for the three months ended June 30, 2014 as a result of a \$4.0 million increase in rental income from Non-Same Park facilities combined with an increase in rental income from the Same Park portfolio of \$2.0 million, or 2.3%. Rental income increased \$13.3 million from \$176.1 million for the six months ended June 30, 2013 to \$189.3 million for the six months ended June 30, 2014 as a result of an \$8.5 million increase in rental income from Non-Same Park facilities combined with an increase in rental income from the Same Park portfolio of \$4.7 million, or 2.7%. The Same Park increase was due to an increase in occupancy, while the increase in Non-Same Park was due to a combination of an increase in occupancy and the acquisition of additional parks during the latter half of 2013.

**Facility Management Fees:** Facility management fees, derived from Public Storage ( PS ), account for a small portion of the Company's revenues. During the three months ended June 30, 2014, \$165,000 of revenue was recognized from facility management fees compared to \$157,000 for the same period in 2013. During the six months ended June 30, 2014, \$331,000 in revenue was recognized from facility management fees compared to \$315,000 for the same period in 2013.

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**Cost of Operations:** Excluding the LTEIP amortization noted above, cost of operations for the three months ended June 30, 2014 was \$30.7 million compared to \$28.5 million for the three months ended June 30, 2013, an increase of \$2.2 million, or 7.7%, as a result of an increase in the Same Park portfolio of \$315,000, or 1.1%, combined with an increase from the Non-Same Park facilities of \$1.9 million. Cost of operations for the six months ended June 30, 2014 was \$63.8 million compared to \$57.5 million for the six months ended June 30, 2013, an increase of \$6.3 million, or 10.9%, as a result of an increase in the Same Park portfolio of \$2.7 million, or 4.8%, combined with an increase from the Non-Same Park facilities of \$3.6 million. While the three month increase in Same Park costs of operations was primarily a result of an increase in occupancy, the six month increase was driven by an increase in snow removal costs of \$1.6 million in Maryland and Virginia as a result of severe winter storms in 2014 compared to the same period in 2013. Including the LTEIP amortization, cost of operations increased \$2.8 million from \$28.7 million for the three months ended June 30, 2013 to \$31.5 million for the three months ended June 30, 2014 as a result of a \$871,000 increase in cost of operations from the Same Park portfolio combined with a \$1.9 million increase in cost of operations from the Non-Same Park facilities. Cost of operations increased \$6.9 million from \$58.1 million for the six months ended June 30, 2013 to \$65.0 million for the six months ended June 30, 2014 as a result of a \$3.2 million increase in cost of operations from the Same Park portfolio combined with a \$3.6 million increase in cost of operations from the Non-Same Park facilities.

**Depreciation and Amortization Expense:** Depreciation and amortization expense was \$28.3 million for the three months ended June 30, 2014 compared to \$26.6 million for the same period in 2013. Depreciation and amortization expense was \$56.7 million for the six months ended June 30, 2014 compared to \$53.6 million for the same period in 2013.

**General and Administrative Expenses:** Excluding the LTEIP amortization, for the three and six months ended June 30, 2014, general and administrative expenses increased \$157,000, or 9.3%, and \$397,000, or 11.7%, respectively, over the same periods in 2013 primarily due to the July, 2013 increases in executive compensation as well as an increase in legal costs. Including the LTEIP amortization, for the three and six months ended June 30, 2014, general and administrative expenses increased \$993,000, or 41.9%, and \$1.1 million, or 22.7%, respectively, over the same periods in 2013.

**Interest and Other Expenses:** Interest and other expenses was \$3.4 million for the three months ended June 30, 2014 compared to \$4.0 million for the three months ended June 30, 2013. Interest and other expenses was \$6.8 million and \$8.5 million for the six months ended June 30, 2014 and 2013, respectively. The three and six month decrease in interest and other expenses were primarily attributable to the repayment of the term loan and mortgage notes payable of \$18.1 million during 2013 combined with interest capitalized in 2014. The Company capitalized interest of \$233,000 and \$457,000 for the three and six months ended June 30, 2014, respectively.

**Net Income Allocable to Noncontrolling Interests:** Net income allocable to noncontrolling interests reflects the net income allocable to equity interests in the Operating Partnership that are not owned by the Company. Net income allocable to noncontrolling interests was \$2.7 million and \$2.6 million of allocated income to common unit holders for the three months ended June 30, 2014 and 2013, respectively. Net income allocable to noncontrolling interests was \$5.4 million and \$5.2 million of allocated income to common unit holders for the six months ended June 30, 2014 and 2013, respectively. These increases were due to an increase in net operating income combined with a decrease in interest expense, partially offset by an increase in depreciation expense.

**Liquidity and Capital Resources**

Cash and cash equivalents increased \$31.0 million from \$31.5 million at December 31, 2013 to \$62.5 million at June 30, 2014 for the reasons noted below.

Net cash provided by operating activities for the six months ended June 30, 2014 and 2013 was \$116.5 million and \$105.6 million, respectively. The increase of \$10.9 million in net cash provided by operating activities for the six months ended June 30, 2014 compared to the same period in 2013 was primarily due to an increase in net operating income of \$7.0 million. Management believes that the Company's internally generated net cash provided by operating activities will be sufficient to enable it to meet its operating expenses, capital improvements, debt service requirements and distributions to shareholders for the foreseeable future.

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Net cash used in investing activities was \$23.5 million and \$24.8 million for the six months ended June 30, 2014 and 2013, respectively. The change was primarily due a decrease in capital improvements of \$2.5 million, partially offset by an increase in development costs of \$1.2 million incurred related to the multifamily development project in Northern Virginia.

Net cash used in financing activities was \$62.0 million and \$75.0 million for the six months ended June 30, 2014 and 2013, respectively. The change was primarily due to debt repayment of \$128.1 million using net proceeds from preferred equity issuance of \$106.3 million in 2013, partially offset by an increase in preferred and common distributions as a result of the preferred equity issuance and common dividend increase effective March, 2014.

The Company had outstanding mortgage note payable of \$250.0 million at June 30, 2014 and December 31, 2013. See Notes 5 and 6 to the consolidated financial statements for a summary of the Company's outstanding borrowings as of June 30, 2014.

On April 28, 2014, the Company modified and extended the terms of its line of credit (the "Credit Facility") with Wells Fargo Bank, National Association ("Wells Fargo"). The expiration of the Credit Facility was extended from August 1, 2015 to May 1, 2019. The Credit Facility has a borrowing limit of \$250.0 million. The rate of interest charged on borrowings was modified to a rate ranging from the London Interbank Offered Rate ("LIBOR") plus 0.875% to LIBOR plus 1.70% depending on the Company's credit ratings. Currently, the Company's rate under the Credit Facility is LIBOR plus 0.925%. In addition, the Company is required to pay an annual facility fee ranging from 0.125% to 0.30% of the borrowing limit depending on the Company's credit ratings (currently 0.15%). The Company had no balance outstanding on the Credit Facility at June 30, 2014 and December 31, 2013. The Company had \$1.1 million and \$485,000 of unamortized commitment fees as of June 30, 2014 and December 31, 2013, respectively. The Credit Facility requires the Company to meet certain covenants, all of which the Company was in compliance June 30, 2014. Interest on outstanding borrowings is payable monthly.

The Company had a term loan with Wells Fargo (the "Term Loan"). Pursuant to the Term Loan, the Company borrowed \$250.0 million for a three year term maturing December 31, 2014. The Term Loan was repaid in full in November, 2013. Interest on the amounts borrowed under the Term Loan was accrued based on an applicable rate ranging from LIBOR plus 1.15% to LIBOR plus 2.25% depending on the Company's credit ratings. During 2013, the Company's rate under the Term Loan was LIBOR plus 1.20%.

The Company's preferred equity outstanding decreased to 24.3% of its market capitalization during the six months ended June 30, 2014, primarily due to an increase in the Company's stock price from \$76.42 at December 31, 2013 to \$83.49 at June 30, 2014. As of June 30, 2014, the Company had one fixed-rate mortgage note totaling \$250.0 million, which represented 6.1% of its total market capitalization. The Company calculates market capitalization by adding (1) the liquidation preference of the Company's outstanding preferred equity, (2) principal value of the Company's outstanding debt and (3) the total number of common shares and common units outstanding at June 30, 2014 multiplied by the closing price of the stock on that date. The interest rate for the mortgage note is 5.45% per annum. The Company had 20.6% of its properties, in terms of net book value, encumbered at June 30, 2014.

The Company focuses on retaining cash for reinvestment as we believe that this provides the greatest level of financial flexibility. While operating results have been negatively impacted by the slow economic conditions, we believe it is likely that as the economy recovers and operating fundamentals improve, additional increases in distributions to the Company's common shareholders will be required. Going forward, the Company will continue to monitor its taxable income and the corresponding dividend requirements. During the first quarter of 2014, the Company increased its quarterly dividend from \$0.44 per common share to \$0.50 per common share, increasing quarterly distributions by approximately \$2.0 million per quarter. As noted above in "Effect of Acquisitions and Dispositions of Properties on the

Company's Operations, the Company anticipates closing on the sale of its assets in Portland during the fourth quarter of 2014. The Company anticipates that the sale will generate taxable gains. If the Company is unable to acquire suitable properties to defer such gain, it would likely have to pay a special dividend to its shareholders.

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**Issuance of Preferred Stock:** On March 14, 2013, the Company issued \$110.0 million or 4.4 million depositary shares, each representing 1/1,000 of a share of the 5.70% Cumulative Preferred Stock, Series V, at \$25.00 per depositary share.

**Issuance of Common Stock:** On November 7, 2013, the Company sold 1,495,000 shares of common stock in a public offering and concurrently sold 950,000 shares of common stock at the public offering price to PS. The aggregate net proceeds were \$192.3 million.

**Repurchase of Common Stock:** No shares of common stock were repurchased under the board approved common stock repurchase program during the six months ended June 30, 2014 or for the year ended December 31, 2013.

**Mortgage Note Repayment:** In January, 2013, the Company repaid two mortgage notes payable totaling \$18.1 million with a combined weighted average stated interest rate of 5.60%.

**Capital Expenditures:** The Company defines recurring capital expenditures as those necessary to maintain and operate its commercial real estate at its current economic value. During the six months ended June 30, 2014 and 2013, the Company expended \$20.5 million and \$21.0 million, respectively, in recurring capital expenditures, or \$0.69 and \$0.75 per weighted average square foot owned, respectively. Tenant improvement amounts exclude those amounts reimbursed by the tenant. Nonrecurring capital improvements include property renovations and expenditures related to repositioning acquisitions. The following table depicts capital expenditures (*in thousands*):

|   | <b>For The Six<br/>Months<br/>Ended June 30,</b> |                  |
|---|--|------------------|
|   | <b>2014</b>                                      | <b>2013</b>      |
| Recurring capital expenditures              |  |                  |
| Capital improvements                        | \$ 3,781   | \$ 3,604         |
| Tenant improvements                         | 11,538   | 12,953           |
| Lease commissions                           | 5,144  | 4,460            |
| <b>Total recurring capital expenditures</b> | <b>20,463</b>                                    | <b>21,017</b>    |
| Nonrecurring capital improvements           | 1,787  | 3,705            |
| <b>Total capital expenditures</b>           | <b>\$ 22,250</b>                                 | <b>\$ 24,722</b> |

Capital expenditures on a per square foot owned basis are as follows:

|                                | <b>For The Six Months<br/>Ended June 30,</b> |             |
|--------------------------------|--|-------------|
|                                | <b>2014</b>                                  | <b>2013</b> |
| Recurring capital expenditures |  |             |
| Capital improvements           | \$ 0.13                                      | \$ 0.13     |
| Tenant improvements            | 0.39   | 0.46        |



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|                                      |         |         |
|--------------------------------------|---------|---------|
| Lease commissions                    | 0.17    | 0.16    |
| Total recurring capital expenditures | 0.69    | 0.75    |
| Nonrecurring capital improvements    | 0.06    | 0.13    |
| Total capital expenditures           | \$ 0.75 | \$ 0.88 |

The decrease in recurring capital expenditures of \$554,000, or 2.6%, was primarily due to cash paid for several significant tenant improvements projects within the Same Park portfolio in 2013. The decrease in nonrecurring capital expenditures of \$1.9 million, or 51.8%, was due to \$2.2 million of repositioning projects spent on 2012 acquisitions in 2013, partially offset by repositioning projects relating to 2013 acquisitions.

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***Distributions:*** The Company has elected and intends to qualify as a REIT for federal income tax purposes. In order to maintain its status as a REIT, the Company must meet, among other tests, sources of income, share ownership and certain asset tests. As a REIT, the Company is not taxed on that portion of its taxable income that is distributed to its shareholders provided that at least 90% of its taxable income is distributed to its shareholders prior to the filing of its tax return.

The Company's funding strategy has been to primarily use permanent capital, including common and preferred stock, along with internally generated retained cash flows to meet its liquidity needs. In addition, the Company may sell properties that no longer meet its investment criteria. From time to time, the Company may use its Credit Facility or other forms of debt to facilitate real estate acquisitions or other capital allocations. The Company targets a minimum ratio of FFO to combined fixed charges and preferred distributions of 3.0 to 1.0. Fixed charges include interest expense and capitalized interest while preferred distributions include amounts paid to preferred shareholders and preferred Operating Partnership unit holders. For the six months ended June 30, 2014, the FFO to fixed charges and preferred distributions coverage ratio was 3.2 to 1.0, excluding the charge for the issuance costs related to the redemption of preferred equity.

***Non-GAAP Supplemental Disclosure Measure: Funds from Operations:*** Management believes that Funds from Operations ( FFO ) is a useful supplemental measure of the Company's operating performance. The Company computes FFO in accordance with the White Paper on FFO approved by the Board of Governors of the National Association of Real Estate Investment Trusts ( NAREIT ). The White Paper defines FFO as net income, computed in accordance with GAAP, before depreciation, amortization, gains or losses on asset dispositions, net income allocable to noncontrolling interests common units, net income allocable to restricted stock unit holders, impairment charges and nonrecurring items. Management believes that FFO provides a useful measure of the Company's operating performance and when compared year over year, reflects the impact to operations from trends in occupancy rates, rental rates, operating costs, development activities, general and administrative expenses and interest costs, providing a perspective not immediately apparent from net income.

FFO should be analyzed in conjunction with net income. However, FFO should not be viewed as a substitute for net income as a measure of operating performance or liquidity as it does not reflect depreciation and amortization costs or the level of capital expenditure and leasing costs necessary to maintain the operating performance of the Company's properties, which are significant economic costs and could materially affect the Company's results of operations.

Management believes FFO provides useful information to the investment community about the Company's operating performance when compared to the performance of other real estate companies as FFO is generally recognized as the industry standard for reporting operations of REITs. Other REITs may use different methods for calculating FFO and, accordingly, our FFO may not be comparable to other real estate companies.

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FFO for the Company is computed as follows (*in thousands, except per share data*):

|  | For The Three Months<br>Ended June 30, |               | For The Six Months<br>Ended June 30, |               |
|--|--|---------------|--------------------------------------|---------------|
|  | 2014                                   | 2013          | 2014                                 | 2013          |
| Net income allocable to common shareholders                        | \$ 9,826                               | \$ 8,711      | \$ 19,766                            | \$ 17,251     |
| Depreciation and amortization                                      | 28,295                                 | 26,629        | 56,736                               | 53,590        |
| Net income allocable to noncontrolling interests<br>common units   | 2,669                                  | 2,613         | 5,372                                | 5,179         |
| Net income allocable to restricted stock unit holders              | 33                                     | 30            | 69                                   | 63            |
| <b>FFO allocable to common and dilutive shares</b>                 | <b>40,823</b>                          | <b>37,983</b> | <b>81,943</b>                        | <b>76,083</b> |
| FFO allocated to noncontrolling interests common<br>units          | (8,704)                                | (8,738)       | (17,481)                             | (17,514)      |
| FFO allocated to restricted stock unit holders                     | (67)                                   | (110)         | (134)                                | (228)         |
| FFO allocated to common shares                                     | \$ 32,052                              | \$ 29,135     | \$ 64,328                            | \$ 58,341     |
| Weighted average common shares outstanding                         | 26,899                                 | 24,358        | 26,881                               | 24,333        |
| Weighted average common Operating Partnership<br>units outstanding | 7,305                                  | 7,305         | 7,305                                | 7,305         |
| Weighted average restricted stock units outstanding                | 56                                     | 92            | 56                                   | 95            |
| Weighted average common share equivalents<br>outstanding           | 100                                    | 112           | 100                                  | 108           |
| <b>Total common and dilutive shares</b>                            | <b>34,360</b>                          | <b>31,867</b> | <b>34,342</b>                        | <b>31,841</b> |
| Net income per common share diluted                                | \$ 0.36                                | \$ 0.36       | \$ 0.73                              | \$ 0.71       |
| Depreciation and amortization <sup>(1)</sup>                       | 0.83                                   | 0.83          | 1.66                                 | 1.68          |
| FFO per common and dilutive shares, as reported <sup>(1)</sup>     | \$ 1.19                                | \$ 1.19       | \$ 2.39                              | \$ 2.39       |

<sup>(1)</sup> Per share amounts are computed using additional dilutive shares related to noncontrolling interests and restricted stock units.

In order to provide a meaningful period-to-period comparison of FFO derived from the Company's ongoing business operations, the table below reconciles reported FFO to adjusted FFO, which excludes the LTEIP amortization for the three and six months ended June 30, 2014 and 2013 (*in thousands, except per share data*):

|  | For The Three Months<br>Ended June 30, |      | For The Six Months<br>Ended June 30, |      |
|--|--|------|--------------------------------------|------|
|  | 2014                                   | 2013 | 2014                                 | 2013 |

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|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| FFO allocable to common and dilutive shares, as reported | \$ 40,823 | \$ 37,983 | \$ 81,943 | \$ 76,083 |
| LTEIP amortization                                       | 2,374     | 917       | 3,232     | 1,963     |
| FFO allocable to common and dilutive shares, as adjusted | \$ 43,197 | \$ 38,900 | \$ 85,175 | \$ 78,046 |
| FFO per common and dilutive shares, as reported          | \$ 1.19   | \$ 1.19   | \$ 2.39   | \$ 2.39   |
| LTEIP amortization                                       | 0.07      | 0.03      | 0.09      | 0.06      |
| FFO per common and dilutive share, as adjusted           | \$ 1.26   | \$ 1.22   | \$ 2.48   | \$ 2.45   |

Adjusted FFO allocable to common and dilutive shares increased \$4.3 million and \$7.1 million, respectively, for the three and six months ended June 30, 2014 compared to the same periods in 2013. The three and six month increase in FFO was primarily the result of increases in both Same Park and Non-Same Park NOI. Reported FFO per share for the three and six months ended June 30, 2014 compared to the same periods in 2013 was flat due to LTEIP amortization. Both adjusted and reported FFO per share were impacted by an increase in shares outstanding as a result of the November, 2013 common equity offering.

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***Related Party Transactions:*** Assuming issuance of the Company's common stock upon redemption of its partnership units, PS would own 42.3% of the outstanding shares of the Company's common stock. At June 30, 2014, PS owned 26.6% of the outstanding shares of the Company's common stock and 22.2% of the outstanding common units of the Operating Partnership (100.0% of the common units not owned by the Company). Ronald L. Havner, Jr., the Company's chairman, is also the Chairman of the Board, Chief Executive Officer and President of PS. Gary E. Pruitt, an independent director of the Company is also a trustee of PS.

Pursuant to a cost sharing and administrative services agreement, the Company shares costs with PS for certain administrative services and rental of corporate office space. The administrative services include investor relations, legal, corporate tax and information systems, which were allocated to PS in accordance with a methodology intended to fairly allocate those costs. These costs totaled \$118,000 and \$108,000 for the three months ended June 30, 2014 and 2013, respectively and \$226,000 and \$216,000 for the six months ended June 30, 2014 and 2013, respectively. In addition, the Company provides property management services for properties owned by PS for a management fee of 5% of the gross revenues of such properties in addition to reimbursement of direct costs. These management fee revenues recognized under management contract with PS totaled \$165,000 and \$157,000 for the three months ended June 30, 2014 and 2013, respectively and \$331,000 and \$315,000 for the six months ended June 30, 2014 and 2013, respectively. PS also provides property management services for the self-storage component of two assets owned by the Company for a fee of 6% of the gross revenues of such properties in addition to reimbursement of certain costs. Management fee expense recognized under the management contract with PS totaled \$17,000 and \$14,000 for the three months ended June 30, 2014 and 2013, respectively and \$33,000 and \$28,000 for the six months ended June 30, 2014 and 2013, respectively.

The PS Business Parks name and logo is owned by PS and licensed to the Company under a non-exclusive, royalty-free license agreement. The license can be terminated by either party for any reason with six months written notice.

***Off-Balance Sheet Arrangements:*** The Company does not have any off-balance sheet arrangements that have or are reasonably likely to have a material effect on the Company's financial condition, results of operations, liquidity, capital expenditures or capital resources.

***Contractual Obligations:*** The Company is scheduled to pay cash dividends of \$60.5 million per year on its preferred equity outstanding as of June 30, 2014. Dividends are paid when and if declared by the Company's Board of Directors and accumulate if not paid. Shares and units of preferred equity are redeemable by the Company in order to preserve its status as a REIT and are also redeemable five years after issuance.

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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

To limit the Company's exposure to market risk, the Company principally finances its operations and growth with permanent equity capital consisting of either common or preferred stock. The Company, from time to time, will use debt financing to facilitate acquisitions. In connection with a portfolio acquisition in 2011, the Company assumed a \$250.0 million mortgage note and obtained a \$250.0 million Term Loan. The outstanding balance on the Term Loan was fully repaid in November, 2013. As a result, the Company's debt as a percentage of total equity (based on book values) was 13.1% as of June 30, 2014.

Our exposure to market risk for changes in interest rates relates primarily to the Credit Facility, which is subject to variable interest rates. See Notes 2, 5 and 6 to the consolidated financial statements included in this Form 10-Q for additional information regarding the terms, valuations and approximate principal maturities of the Company's indebtedness, including the mortgage note payable, Credit Facility and Term Loan. Based on borrowing rates currently available to the Company, the difference between the carrying amount of debt and its fair value is insignificant.

**ITEM 4. CONTROLS AND PROCEDURES**

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of June 30, 2014. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of the Company's disclosure controls and procedures as of June 30, 2014, the Company's Chief Executive Officer and Chief Financial Officer concluded that, as of such date, the Company's disclosure controls and procedures were effective at the reasonable assurance level.

No change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended June 30, 2014 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

The Company currently is neither subject to any material litigation nor, to management's knowledge, is any material litigation currently threatened against the Company other than routine litigation and administrative proceedings arising in the ordinary course of business.

**ITEM 1A. RISK FACTORS**

There have been no material changes to the risk factors included in our Annual Report on Form 10-K for the year ended December 31, 2013.

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

The Company's Board of Directors has authorized the repurchase, from time to time, of up to 6.5 million shares of the Company's common stock on the open market or in privately negotiated transactions. The authorization has no expiration date. Purchases will be made subject to market conditions and other investment opportunities available to the Company.

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During the three months ended June 30, 2014, there were no shares of the Company's common stock repurchased. As of June 30, 2014, 1,614,721 shares remain available for purchase under the program.

See Note 9 to the consolidated financial statements for additional information on repurchases of equity securities.



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**ITEM 6. EXHIBITS**

Exhibits

|                 |  |
|-----------------|--|
| Exhibit 10.1    | Second Amended and Restated Revolving Credit Agreement dated as of April 28, 2014 by and among PS Business Parks, L.P., a California limited partnership, as borrower, and Wells Fargo Bank, National Association, as Administrative Agent for the Lenders. Filed with the Registrant's Current Report on Form 8-K dated April 28, 2014 (SEC File No. 001-10709) and incorporated herein by reference. |
| Exhibit 12      | Statement re: Computation of Ratio of Earnings to Fixed Charges. Filed herewith.   |
| Exhibit 31.1    | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. Filed herewith.  |
| Exhibit 31.2    | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. Filed herewith.  |
| Exhibit 32.1    | Certifications of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. Filed herewith.   |
| Exhibit 101.INS | XBRL Instance Document. Filed herewith.  |
| Exhibit 101.SCH | XBRL Taxonomy Extension Schema. Filed herewith.  |
| Exhibit 101.CAL | XBRL Taxonomy Extension Calculation Linkbase. Filed herewith.  |
| Exhibit 101.DEF | XBRL Taxonomy Extension Definition Linkbase. Filed herewith.   |
| Exhibit 101.LAB | XBRL Taxonomy Extension Label Linkbase. Filed herewith.  |
| Exhibit 101.PRE | XBRL Taxonomy Extension Presentation Linkbase. Filed herewith.   |

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**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.

Dated: August 1, 2014

PS BUSINESS PARKS, INC.

BY: /s/ Edward A. Stokx  
Edward A. Stokx  
Executive Vice President and Chief  
Financial Officer  
(Principal Financial Officer)

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