CommonWealth REIT
Form 10-Q
May 08, 2014
Table of Contents

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 March 31, 2014

OR

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

Commission File Number 1-9317

COMMONWEALTH REIT

(Exact Name of Registrant as Specified in Its Charter)

Maryland	**04-6558834**

(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)

Two Newton Place, 255 Washington Street, Suite 300, Newton, Massachusetts	**02458-1634**
(Address of Principal Executive Offices)	(Zip Code)

617-332-3990

(Registrant s Telephone Number, Including Area Code)

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 x No o

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 x No o

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

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

Number of registrant s common shares of beneficial interest, $0.01 par value per share, outstanding as of May 7, 2014: 118,436,415.

Table of Contents

COMMONWEALTH REIT

FORM 10-Q

March 31, 2014

INDEX

		Page
PART I	Financial Information	
Item 1.	Financial Statements (unaudited)	
	Condensed Consolidated Balance Sheets March 31, 2014 and December 31, 2013	1
	Condensed Consolidated Statements of Operations Three Months Ended March 31, 2014 and 2013	2
	Condensed Consolidated Statements of Comprehensive Income Three Months Ended March 31, 2014 and 2013	3
	Condensed Consolidated Statements of Cash Flows Three Months Ended March 31, 2014 and 2013	4
	Notes to Condensed Consolidated Financial Statements	6
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	23
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	39
Item 4.	Controls and Procedures	42
	Warning Concerning Forward Looking Statements	43
	Statement Concerning Limited Liability	45
PART II	Other Information	
Item 1.	Legal Proceedings	46
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	50
Item 6.	Exhibits	50
	Signatures	53

Table of Contents

References in this Quarterly Report on Form 10-Q to the Company , CWH , we , us or our refer to CommonWealth REIT and its consolidated subsidiaries, as of March 31, 2014, unless the context indicates otherwise.

EXPLANATORY NOTE

On March 18, 2014, Related Fund Management, LLC and Corvex Management LP, or together, Related/Corvex, delivered to CWH written consents they represented were from a sufficient number of holders of our outstanding common shares, to remove, without cause, all of CWH s then Trustees and any other person or persons elected or appointed to the Board of Trustees of CWH prior to the effective time of the Related/Corvex removal proposal. After inspection, the then Board of Trustees of CWH certified the results of the Related/Corvex consent solicitation on March 25, 2014, whereupon all of the then Trustees of CWH were removed. The officers of CWH have called a special meeting of shareholders to be held on May 23, 2014 for the purpose of electing new Trustees of CWH.

Because our entire Board of Trustees was removed during the quarter ended March 31, 2014, we ceased to actively market two central business district properties (two buildings) and 29 suburban properties (65 buildings) which we had classified as held for sale as of December 31, 2013. Therefore, for this and other reasons, these properties no longer meet the requirements under U.S. generally accepted accounting principles for classification as held for sale, and the financial information presented in this Quarterly Report on Form 10-Q reflects the reclassification of these properties from discontinued operations to continuing operations for all periods presented. Properties classified as held for sale as of December 31, 2013 which are subject to an agreement for sale have not been reclassified from discontinued operations to continuing operations.

The financial information presented in this Quarterly Report on Form 10-Q includes the results of operations of Select Income REIT, or SIR, for periods prior to July 2, 2013 when SIR was CWH s consolidated subsidiary, unless the context indicates otherwise. SIR is itself a public company that has common shares registered under the Securities Exchange Act of 1934, as amended. On July 2, 2013, SIR completed an underwritten public offering of its common shares, at which time we ceased to own a majority of SIR s common shares. Accordingly, following July 2, 2013, we no longer consolidate our investment in SIR, but instead account for such investment under the equity method. For further information about SIR, please see SIR s periodic reports and other filings with the Securities and Exchange Commission, or the SEC, which are available at the SEC s website at www.sec.gov. References in this Quarterly Report on Form 10-Q to SIR s filings with the SEC are included as textual references only, and the information in SIR s filings with the SEC is not incorporated by reference into this Quarterly Report on Form 10-Q.

INFORMATION IN THIS QUARTERLY REPORT ON FORM 10-Q REFLECTS THE VIEWS, BELIEFS, EXPECTATIONS AND JUDGMENTS OF OUR CURRENT MANAGEMENT AND HAS NOT BEEN REVIEWED BY A BOARD OF TRUSTEES OR AUDIT COMMITTEE OF CWH. A NEW BOARD OF TRUSTEES OR NEW MANAGEMENT OF CWH MAY HAVE DIFFERENT VIEWS, BELIEFS, EXPECTATIONS AND JUDGMENTS.

Table of Contents

PART I. **Financial Information**

Item 1. **Financial Statements.**

COMMONWEALTH REIT

CONDENSED CONSOLIDATED BALANCE SHEETS

(amounts in thousands, except share data)

(unaudited)

		March 31, 2014		December 31, 2013
ASSETS				
Real estate properties:				
Land	$	747,181	$	699,135
Buildings and improvements		5,168,335		4,838,030
		5,915,516		5,537,165
Accumulated depreciation		(934,776)		(895,059)
		4,980,740		4,642,106
Properties held for sale		214,677		573,531
Acquired real estate leases, net		244,634		255,812
Equity investments		518,934		517,991
Cash and cash equivalents		177,555		222,449
Restricted cash		17,441		22,101
Rents receivable, net of allowance for doubtful accounts of $7,462 and $7,885, respectively		239,766		223,769
Other assets, net		206,967		188,675
Total assets	$	6,600,714	$	6,646,434
LIABILITIES AND SHAREHOLDERS EQUITY				
Revolving credit facility	$	235,000	$	235,000
Senior unsecured debt, net		1,856,135		1,855,900
Mortgage notes payable, net		898,804		914,510
Liabilities related to properties held for sale		23,066		28,734
Accounts payable and accrued expenses		136,482		165,855
Assumed real estate lease obligations, net		33,064		33,935
Rent collected in advance		29,618		27,553
Security deposits		13,682		11,976
Due to related persons		15,793		9,385
Total liabilities		3,241,644		3,282,848
Shareholders equity:				
Preferred shares of beneficial interest, $0.01 par value: 50,000,000 shares authorized;				
Series D preferred shares; 6 1/2% cumulative convertible; 15,180,000 shares issued and outstanding, aggregate liquidation preference $379,500		368,270		368,270

Series E preferred shares; 7 1/4% cumulative redeemable on or after May 15, 2016; 11,000,000 shares issued and outstanding, aggregate liquidation preference $275,000	265,391	265,391
Common shares of beneficial interest, $0.01 par value: 350,000,000 shares authorized; 118,413,730 and 118,386,918 shares issued and outstanding, respectively	1,184	1,184
Additional paid in capital	4,217,651	4,213,474
Cumulative net income	2,230,288	2,209,840
Cumulative other comprehensive loss	(26,724)	(38,331)
Cumulative common distributions	(3,111,868)	(3,082,271)
Cumulative preferred distributions	(585,122)	(573,971)
Total shareholders equity	3,359,070	3,363,586
Total liabilities and shareholders equity	$ 6,600,714	$ 6,646,434

See accompanying notes.

Table of Contents

COMMONWEALTH REIT

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(amounts in thousands, except per share data)

(unaudited)

	Three Months Ended March 31, 2014	2013
Revenues:		
Rental income	$ 172,040	$ 211,300
Tenant reimbursements and other income	45,220	51,312
Total revenues	217,260	262,612
Expenses:		
Operating expenses	101,731	104,130
Depreciation and amortization	51,649	62,570
General and administrative	24,848	16,663
Reversal of loss on asset impairment	(4,761)	
Acquisition related costs	5	628
Total expenses	173,472	183,991
Operating income	43,788	78,621
Interest and other income	384	455
Interest expense (including net amortization of debt discounts, premiums and deferred financing fees of ($309) and $608, respectively)	(37,935)	(51,896)
Loss on early extinguishment of debt		(60,027)
Gain on sale of equity investment		66,293
Gain on issuance of shares by an equity investee	109	
Income from continuing operations before income tax expense and equity in earnings of investees	6,346	33,446
Income tax expense	(555)	(988)
Equity in earnings of investees	10,934	4,262
Income from continuing operations	16,725	36,720
Discontinued operations:		
Income (loss) from discontinued operations	4,011	(6)
Loss on asset impairment from discontinued operations	(288)	(3,946)
Gain on sale of properties from discontinued operations		1,260
Income before gain on sale of properties	20,448	34,028
Gain on sale of properties		1,596
Net income	20,448	35,624
Net income attributable to noncontrolling interest in consolidated subsidiary		(9,957)
Net income attributable to CommonWealth REIT	20,448	25,667
Preferred distributions	(11,151)	(11,151)
Net income available for CommonWealth REIT common shareholders	$ 9,297	$ 14,516
Amounts attributable to CommonWealth REIT common shareholders:		
Income from continuing operations	$ 5,574	$ 17,208
Income (loss) from discontinued operations	4,011	(6)

Loss on asset impairment from discontinued operations		(288)		(3,946)
Gain on sale of properties from discontinued operations				1,260
Net income	$	9,297	$	14,516
Weighted average common shares outstanding basic and diluted		118,400		94,154
Basic and diluted earnings per common share attributable to CommonWealth REIT common shareholders:				
Income from continuing operations	$	0.05	$	0.18
Income (loss) from discontinued operations	$	0.03	$	(0.03)
Net income available for common shareholders	$	0.08	$	0.15

See accompanying notes.

Table of Contents

COMMONWEALTH REIT

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(amounts in thousands)

(unaudited)

	Three Months Ended March 31, 2014	Three Months Ended March 31, 2013
Net income	$ 20,448	$ 35,624
Other comprehensive income (loss), net of tax:		
Unrealized gain on derivative instruments	1,000	1,051
Foreign currency translation adjustments	10,587	973
Equity in unrealized income (loss) of an investee	20	(16)
Total comprehensive income	32,055	37,632
Less: comprehensive income attributable to noncontrolling interest in consolidated subsidiary		(9,953)
Comprehensive income attributable to CommonWealth REIT	$ 32,055	$ 27,679

See accompanying notes.

Table of Contents

COMMONWEALTH REIT

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(amounts in thousands)

(unaudited)

	Three Months Ended March 31, 2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 20,448	$ 35,624
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation	37,682	47,349
Net amortization of debt discounts, premiums and deferred financing fees	(309)	629
Straight line rental income	(5,977)	(10,962)
Amortization of acquired real estate leases	11,979	16,903
Other amortization	4,231	4,800
(Reversal of) loss on asset impairment	(4,473)	3,946
Loss on early extinguishment of debt		60,027
Equity in earnings of investees	(10,934)	(4,262)
Gain on sale of equity investment		(66,293)
Gain on issuance of shares by an equity investee	(109)	
Distributions of earnings from investees	10,120	4,111
Gain on sale of properties		(2,856)
Other non-cash expenses	10,496	
Change in assets and liabilities:		
Restricted cash	5,362	3,100
Rents receivable and other assets	(18,250)	(21,203)
Accounts payable and accrued expenses	(12,545)	(27,769)
Rent collected in advance	(1,125)	(1,948)
Security deposits	204	(42)
Due to related persons	(173)	1,678
Cash provided by operating activities	46,627	42,832
CASH FLOWS FROM INVESTING ACTIVITIES:		
Real estate acquisitions		(149,318)
Real estate improvements	(38,457)	(26,964)
Principal payments received from direct financing lease	1,795	1,711
Proceeds from sale of properties, net		2,163
Proceeds from sale of equity investment, net		239,576
Distributions in excess of earnings from investees		168
Increase in restricted cash	(702)	(1,197)
Cash (used in) provided by investing activities	(37,364)	66,139
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common shares, net		626,991
Repurchase and retirement of outstanding debt securities		(728,021)
Proceeds from borrowings		921,000
Payments on borrowings	(14,066)	(942,135)
Deferred financing fees		(1,193)

Distributions to common shareholders		(29,597)		(20,951)
Distributions to preferred shareholders		(11,151)		(11,151)
Distributions to noncontrolling interest in consolidated subsidiary				(7,259)
Cash used in financing activities		(54,814)		(162,719)
Effect of exchange rate changes on cash		657		221
Decrease in cash and cash equivalents		(44,894)		(53,527)
Cash and cash equivalents at beginning of period		222,449		102,219
Cash and cash equivalents at end of period	$	177,555	$	48,692

See accompanying notes.

Table of Contents

COMMONWEALTH REIT

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

(amounts in thousands)

(unaudited)

	Three Months Ended March 31, 2014	2013
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid	$ 43,228	$ 71,368
Taxes paid	2,321	507
NON-CASH INVESTING ACTIVITIES:		
Investment in real estate mortgage receivable	$	$ (7,688)

See accompanying notes.

Table of Contents

COMMONWEALTH REIT

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except per share data)

Note 1. Basis of Presentation

The accompanying condensed consolidated financial statements of CommonWealth REIT and its subsidiaries, or the Company, CWH, we, us or our, have been prepared without audit. Certain information and footnote disclosures required by U.S. generally accepted accounting principles, or GAAP, for complete financial statements have been condensed or omitted. We believe the disclosures made are adequate to make the information presented not misleading. However, the accompanying condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes contained in our Annual Report on Form 10-K for the year ended December 31, 2013, or our Annual Report. In the opinion of our management, all adjustments, which include only normal recurring adjustments considered necessary for a fair presentation, have been included. All intercompany transactions and balances with or among our subsidiaries have been eliminated. Operating results for interim periods are not necessarily indicative of the results that may be expected for the full year. Reclassifications have been made to the prior years financial statements to conform to the current year s presentation.

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect reported amounts. Actual results could differ from those estimates. Significant estimates in the condensed consolidated financial statements include the allowance for doubtful accounts, purchase price allocations, useful lives of fixed assets and impairment of real estate and intangible assets.

Note 2. Recent Accounting Pronouncements

In April 2014, the Financial Accounting Standards Board issued Accounting Standards Update No. 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity, or ASU 2014-08. ASU 2014-08 changes the criteria for reporting a discontinued operation. Under the new pronouncement, a disposal of a part of an organization that has a major effect on its operations and financial results is a discontinued operation. We are required to adopt ASU 2014-08 prospectively for all disposals or components of our business classified as held for sale during fiscal periods beginning after December 15, 2014 and are currently evaluating what impact, if any, its adoption will have to the presentation of our condensed consolidated financial statements.

Note 3. Board of Trustees

On March 18, 2014, Related Fund Management, LLC and Corvex Management LP, or together, Related/Corvex, delivered to us written consents which they represented were from a sufficient number of holders of our outstanding common shares to remove, without cause, all of our then Trustees and any other person or persons elected or appointed to our Board of Trustees prior to the effective time of the Related/Corvex removal proposal. After inspection, our then Board of Trustees determined that holders of more than 2/3 of our outstanding common shares as of the February 18, 2014 record date consented to the Related/Corvex proposal, reaching the threshold required to remove, without cause, all of our then Trustees and any other person or persons appointed as a Trustee prior to the effective time of the Related/Corvex removal proposal. Accordingly, on March 25, 2014, all of our Trustees certified their removal as Trustees of CWH. As a result, we currently have no Trustees and therefore no Trustees serving on our Board of Trustees or on an Audit Committee, Compensation Committee or Nominating and Governance Committee of our Board of Trustees.

Our officers have called a special meeting of shareholders to be held on May 23, 2014 for the purpose of electing new Trustees of CWH. For further information regarding this special meeting, please see the Definitive Information Statement we filed with the Securities and Exchange Commission, or the SEC, on April 11, 2014. Copies of all our documents filed with the SEC are available at the SEC s website, www.sec.gov.

Note 4. Real Estate Properties

During the three months ended March 31, 2014, we made improvements to our properties totaling $27,830.

Table of Contents

COMMONWEALTH REIT

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(dollars in thousands, except per share data)

Property Sales:

We classify all properties that meet the criteria outlined in the Property, Plant and Equipment Topic of the *FASB Accounting Standards Codification*, or the Codification, as held for sale, as such on our condensed consolidated balance sheets. As of March 31, 2014, we had one central business district, or CBD, property (two buildings) and 13 suburban properties (41 buildings) with a combined 2,784,098 square feet held for sale. As of March 31, 2014, these properties are subject to an agreement for sale which we currently expect to close.

During the three months ended March 31, 2014, we ceased to actively market two CBD properties (two buildings) and 29 suburban properties (65 buildings) with a combined 5,641,450 square feet which we had previously classified as held for sale as of December 31, 2013, which were not under agreement for sale when our entire Board of Trustees was removed. These properties were reclassified to properties held and used in operations because they no longer meet the requirements under GAAP for classification as held for sale. Operating results for these properties were reclassified from discontinued operations to continuing operations for all periods presented herein. In connection with this reclassification, we reversed previously recorded impairment losses totaling $4,761 which includes the elimination of estimated costs to sell.

Results of operations for properties sold or held for sale are included in discontinued operations in our condensed consolidated statements of operations once the criteria for discontinued operations in the Presentation of Financial Statements Topic of the Codification are met. Summarized balance sheet information for all properties classified as held for sale and income statement information for properties held for sale or sold is as follows:

Balance Sheets:

	March 31, 2014	December 31, 2013
Real estate properties	$ 201,557	$ 536,552
Acquired real estate leases	4,943	6,937
Rents receivable	4,207	14,180
Other assets, net	3,970	15,862
Properties held for sale	$ 214,677	$ 573,531
Mortgage notes payable	$ 19,688	$ 20,018
Assumed real estate lease obligations	1,419	2,070
Rent collected in advance	859	4,043
Security deposits	1,100	2,603
Liabilities related to properties held for sale	$ 23,066	$ 28,734

Income Statements:

	Three Months Ended March 31, 2014	2013
Rental income	$ 7,274	$ 15,512
Tenant reimbursements and other income	522	1,731
Total revenues	7,796	17,243
Operating expenses	3,479	11,564
Depreciation and amortization		3,953
General and administrative	3	1,287
Total expenses	3,482	16,804
Operating income	4,314	439
Interest and other income		3
Interest expense	(303)	(448)
Income (loss) from discontinued operations	$ 4,011	$ (6)

Table of Contents

COMMONWEALTH REIT

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(dollars in thousands, except per share data)

Note 5. Investment in Direct Financing Lease

We have an investment in a direct financing lease that relates to a lease with a term that exceeds 75% of the useful life of an office tower located within a mixed use property in Phoenix, AZ. We recognize income using the effective interest method to produce a level yield on funds not yet recovered. Estimated unguaranteed residual values at the date of lease inception represent our initial estimates of the fair value of the leased assets at the expiration of the lease, which do not exceed their original cost. Significant assumptions used in estimating residual values include estimated net cash flows over the remaining lease term and expected future real estate values. The carrying amount of our net investment is included in other assets in our condensed consolidated balance sheets. The following table summarizes the carrying amount of our net investment in this direct financing lease:

	March 31, 2014	December 31, 2013
Total minimum lease payments receivable	$ 20,962	$ 22,986
Estimated unguaranteed residual value of leased asset	4,951	4,951
Unearned income	(7,945)	(8,174)
Net investment in direct financing lease	$ 17,968	$ 19,763

We monitor the payment history and credit profile of the tenant and have determined that no allowance for losses related to our direct financing lease was necessary at March 31, 2014 and December 31, 2013. Our direct financing lease has an expiration date in 2045.

Note 6. Equity Investments

At March 31, 2014 and December 31, 2013, we had the following equity investments in Select Income REIT, or SIR, Government Properties Income Trust, or GOV, and Affiliates Insurance Company, or AIC:

	Ownership Percentage		Equity Investments		Equity in Earnings (Loss) Three Months Ended March 31,	
	March 31, 2014	December 31, 2013	March 31, 2014	December 31, 2013	2014	2013
SIR	44.1%	44.2%	$ 513,099	$ 512,078	$ 11,032	$
GOV	0.0%	0.0%				4,111
AIC	12.5%	12.5%	5,835	5,913	(98)	151

	$ 518,934	$ 517,991	$ 10,934	$ 4,262

At March 31, 2014, we owned 22,000,000, or approximately 44.1%, of the common shares of beneficial interest of SIR, with a carrying value of $513,099 and a market value, based on quoted market prices, of $665,940 ($30.27 per share). SIR is a real estate investment trust, or REIT, that is primarily focused on owning and investing in net leased, single tenant properties and was one of our consolidated subsidiaries until July 2, 2013. On July 2, 2013, our ownership percentage of SIR was reduced to below 50% and we began accounting for our investment in SIR under the equity method. Under the equity method, we record our percentage share of net earnings of SIR in our consolidated statements of operations. Prior to July 2, 2013, the operating results and investments of SIR were included in our consolidated results of operations and financial position. On July 2, 2013, our share of the underlying equity of SIR exceeded our carrying value by $17,609. As required under GAAP, we are amortizing this difference to equity in earnings of investees over a 34 year period, which approximates the average remaining useful lives of the buildings owned by SIR as of July 2, 2013. If we determine there is an other than temporary decline in the fair value of this investment, we would record a charge to earnings as determined under applicable accounting standards. See Note 15 for additional information regarding SIR.

Table of Contents

COMMONWEALTH REIT

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(dollars in thousands, except per share data)

During the three months ended March 31, 2014, we received cash distributions from SIR totaling $10,120.

The following summarized financial data of SIR as reported in SIR s Quarterly Report on Form 10-Q for the period ended March 31, 2014, or the SIR Quarterly Report, includes the results of operations for periods prior to July 2, 2013 (the date on which SIR ceased to be our consolidated subsidiary), which are included on a consolidated basis in our condensed consolidated results of operations when SIR was our consolidated subsidiary. References in our financial statements to the SIR Quarterly Report are included as references to the source of the data only, and the information in the SIR Quarterly Report is not incorporated by reference into our financial statements.

Table of Contents

COMMONWEALTH REIT

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(dollars in thousands, except per share data)

Condensed Consolidated Balance Sheets:

	March 31, 2014	December 31, 2013
Real estate properties, net	$ 1,573,489	$ 1,579,234
Acquired real estate leases, net	125,530	129,426
Cash and cash equivalents	204,319	20,025
Rents receivable, net	58,462	55,335
Other assets, net	22,515	17,839
Total assets	$ 1,984,315	$ 1,801,859
Revolving credit facility	$ 345,000	$ 159,000
Term loan	350,000	350,000
Mortgage notes payable	19,232	27,147
Assumed real estate lease obligations, net	26,239	26,966
Other liabilities	41,856	40,055
Shareholders equity	1,201,988	1,198,691
Total liabilities and shareholders equity	$ 1,984,315	$ 1,801,859

Condensed Consolidated Statements of Income:

	Three Months Ended March 31, 2014	2013
Rental income	$ 45,063	$ 37,458
Tenant reimbursements and other income	7,965	6,402
Total revenues	53,028	43,860
Operating expenses	9,979	7,874
Depreciation and amortization	9,294	6,665
Acquisition related costs	238	533
General and administrative	5,176	2,719
Total expenses	24,687	17,791
Operating income	28,341	26,069
Interest expense	(3,358)	(3,473)
Gain on early extinguishment of debt	243	
Income before income tax expense and equity in earnings (loss) of an investee	25,226	22,596
Income tax expense	(71)	(40)

Equity in earnings (loss) of an investee		(97)		76
Net income	$	25,058	$	22,632
Weighted average common shares outstanding		49,841		39,283
Net income per common share	$	0.50	$	0.58

As of March 31, 2014, we had invested $5,209 in AIC, an insurance company owned in equal proportion by us, our manager, Reit Management & Research LLC, or RMR, GOV, SIR and four other companies to which RMR provides management services. At March 31, 2014, we owned 12.5% of AIC with a carrying value of $5,835. For the three months ended March 31, 2013, during which time SIR was both a shareholder of AIC and our consolidated subsidiary, our condensed consolidated financial statements include SIR s equity investment interest in AIC. We use the equity method to account for our investment in AIC because we believe that

COMMONWEALTH REIT

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(dollars in thousands, except per share data)

during the relevant period we had significant influence over AIC as a majority of our former Trustees, our President and principals of our manager are also directors of AIC. Under the equity method, we record our and our percentage share of SIR s percentage share of net earnings from AIC while SIR was our consolidated subsidiary in our condensed consolidated statements of operations. If we determine there is an other than temporary decline in the fair value of this investment, we would record a charge to earnings as determined under applicable accounting standards. In evaluating the fair value of this investment, we have considered, among other things, the assets and liabilities held by AIC, AIC s overall financial condition and the financial condition and prospects for AIC s insurance business. See Note 15 for additional information about our investment in AIC.

On March 25, 2014, as a result of the removal, without cause, of all of our Trustees, we underwent a change in control, as defined in the shareholders agreement among us, the other shareholders of AIC and AIC. In April 2014, as a result of this change in control and in accordance with the terms of the shareholders agreement, the other shareholders of AIC provided notice of exercise of their right to purchase the 20,000 shares of AIC we own. The aggregate proceeds we would receive if those other shareholders fully exercise their right to purchase all of the AIC shares we own would be $5,776. We expect that those other AIC shareholders will purchase from us pro rata all of the AIC shares we own, following which we will no longer own any equity interest in AIC. The purchase of any of our AIC shares will not affect our current participation in the AIC property insurance program, which is scheduled to expire in June 2014, unless renewed.

Note 7. Real Estate Mortgages Receivable

As of March 31, 2014 and December 31, 2013, we had total real estate mortgages receivable with an aggregate carrying value of $8,107 included in other assets in our condensed consolidated balance sheets. We provided mortgage financing totaling $7,688 at 6.0% per annum in connection with our sale of three suburban office and industrial properties (18 buildings) in January 2013 in Dearborn, MI; this real estate mortgage requires monthly interest payments and matures on January 24, 2023. We also provided mortgage financing totaling $419 at 6.0% per annum in connection with our sale of a suburban office property in Salina, NY in April 2012; this real estate mortgage requires monthly interest payments and matures on April 30, 2019.

Note 8. Shareholders Equity

Common Share Issuances:

On January 28, 2014, we granted 2,000 common shares of beneficial interest, par value $0.01 per share, valued at $23.46 per share, the closing price of our common shares on the New York Stock Exchange, or NYSE, on that day, to two of our former Trustees as part of their then annual compensation.

On February 7, 2014, March 7, 2014, April 7, 2014 and May 7, 2014, we issued 12,187, 10,625, 11,410 and 11,275 common shares, respectively, to RMR pursuant to the amended and restated business management agreement discussed in Note 15.

Share Awards:

As a result of the removal, without cause, of our Trustees on March 25, 2014, the vesting of 130,914 common shares previously issued to our officers and certain employees of RMR pursuant to our equity compensation plans accelerated in accordance with the terms of their governing share grants. During the three months ended March 31, 2014, we recorded $3,412 of compensation expense related to the vesting of these shares.

Common and Preferred Share Distributions:

On February 15, 2014, we paid a quarterly distribution on our series D cumulative convertible preferred shares, or series D preferred shares, of $0.4063 per share, or $6,167, and a quarterly distribution on our series E preferred shares of $0.4531 per share, or $4,984, both of which were paid to shareholders of record as of February 1, 2014.

On February 21, 2014, we paid a quarterly distribution on our common shares of $0.25 per share, or $29,597, to shareholders of record on January 13, 2014.

Table of Contents

COMMONWEALTH REIT

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(dollars in thousands, except per share data)

Under our governing documents and Maryland law, distributions to our shareholders are to be authorized and declared by CWH s Board of Trustees. Accordingly, no additional distributions may be declared on our preferred shares or common shares until new Trustees are elected and qualified and take action to declare such distributions, if any.

Series D Preferred Shares:

As of March 31, 2014, we had 15,180,000 outstanding series D preferred shares. The removal, without cause, of our entire prior Board of Trustees on March 25, 2014, triggered a Fundamental Change Conversion Right of the series D preferred shares, as defined in our articles supplementary setting forth the terms of the series D preferred shares. Pursuant to such right, the holders of series D preferred shares have the option to elect to convert all or any portion of their series D preferred shares at any time from April 9, 2014 until prior to the close of business on May 14, 2014 into a number of common shares per $25.00 liquidation preference of the series D preferred shares equal to the sum of such $25.00 liquidation preference plus accrued and unpaid dividends to, but not including, May 14, 2014, divided by 98% of the average of the closing sale prices of the common shares for the five consecutive trading days ending on May 9, 2014.

Note 9. Cumulative Other Comprehensive Income (Loss)

The following table presents the amounts recognized in cumulative other comprehensive income (loss) by component for the three months ended March 31, 2014:

	Unrealized Gain (Loss) on Derivative Instruments	Foreign Currency Translation Adjustments	Equity in Unrealized Gain (Loss) of an Investee	Total
Balances as of December 31, 2013	$ (11,706)	$ (26,647)	$ 22	$ (38,331)
Other comprehensive income (loss) before reclassifications	(229)	10,587	27	10,385
Amounts reclassified from cumulative other comprehensive income (loss) to net income	1,229		(7)	1,222
Net current period other comprehensive income	1,000	10,587	20	11,607
Balances as of March 31, 2014	$ (10,706)	$ (16,060)	$ 42	$ (26,724)

The following table presents reclassifications out of cumulative other comprehensive income (loss) for the three months ended March 31, 2014:

Details about Cumulative Other Comprehensive Income (Loss) Components	**Amounts Reclassifed from Cumulative Other Comprehensive Income (Loss) to Net Income**	**Affected Line Items in the Statement of Operations**
Interest rate swap contracts	$ 1,229	Interest expense
Unrealized gains and losses on available for sale securities	(7)	Equity in earnings of investees
	$ 1,222	

Table of Contents

COMMONWEALTH REIT

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(dollars in thousands, except per share data)

Note 10. Indebtedness

Prepayments:

In March 2014, we prepaid $11,988 of mortgage debt using cash on hand.

Unsecured Revolving Credit Facility and Unsecured Term Loan:

We have a $750,000 unsecured revolving credit facility, maturing on October 19, 2015, that we have used in the past for general business purposes, including acquisitions. We also have a $500,000 unsecured term loan that matures in December 2016. The removal of our entire Board of Trustees, without cause, constitutes events of default under our revolving credit facility and term loan agreements and, as a result, we are not able to borrow under our revolving credit facility. Effective as of April 11, 2014, we entered into separate forbearance agreements regarding our revolving credit facility and term loan agreements in respect of which we were required to pay certain fees to, and expenses of, the lenders. Pursuant to each forbearance agreement, the applicable lenders have agreed, on and subject to the terms and conditions set forth therein, to forbear during the period described below from exercising certain of their rights and remedies under the revolving credit facility or term loan, as applicable, including, without limitation, their right to accelerate repayment of the loans thereunder and to require that the loans bear interest at the post-default rate. The forbearance period under each forbearance agreement runs from April 11, 2014 through the first to occur of the following:

- 5:00 p.m. Eastern time on July 10, 2014;

- 5:00 p.m. Eastern time on the date 21 calendar days following the date on which our shareholders elect a replacement Board of Trustees;

- the occurrence of any event of default (other than with respect to an event of default as a result of the removal of our entire Board of Trustees, without cause, or our failure to provide quarterly financial statements and related certificates to the lenders) under the revolving credit facility agreement or the term loan agreement, as applicable;

- our failure to continue to satisfy certain minimum available cash requirements, including maintaining 80% (eighty percent) of the net cash proceeds received from certain asset dispositions;

- our exercise of our right to repurchase any series D preferred shares otherwise convertible upon a Fundamental Change, as defined in our articles supplementary setting forth the terms of the series D preferred shares; or

- our breach of the forbearance agreement.

Upon termination of the forbearance period, the lenders under our revolving credit facility and term loan agreements will be entitled to exercise certain remedies, including the right to accelerate repayment of their loans and to require that their loans bear interest at the post-default rate. A new Board of Trustees and management will be required to negotiate with our bank lenders for amendments to, or waivers under, our revolving credit facility and term loan agreements, or explore alternatives for funding the repayment of amounts outstanding under these agreements. Access to various types of future financing sources, including debt or equity offerings and new bank loan facilities, will depend upon a number of factors, including our business practices and plans under a new Board of Trustees, our credit ratings and market conditions. We can provide no assurance regarding the future availability of borrowings under our revolving credit facility, our access to future financing or whether some or all of our indebtedness may be accelerated.

Borrowings under our revolving credit facility bear interest at LIBOR plus a premium, which was 150 basis points as of March 31, 2014. We also pay a facility fee of 35 basis points per annum on the total amount of lending commitments under our revolving credit facility. Both the interest rate premium and the facility fee are subject to adjustment based upon changes to our credit ratings. As of March 31, 2014, the interest rate payable on borrowings under our revolving credit facility was 1.7%. The weighted average interest rate for borrowings under our revolving credit facility was 1.7% for both the three months ended March 31, 2014 and 2013. As a result of the event of default described above, subject to the terms of the applicable forbearance agreement, lenders under our revolving credit facility may elect to apply the post-default interest rate, which is generally an additional 4% to the then prevailing

COMMONWEALTH REIT

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(dollars in thousands, except per share data)

interest rate under this agreement, to borrowings outstanding thereunder. As of March 31, 2014, we had $235,000 outstanding under our revolving credit facility.

Our term loan bears interest at a rate of LIBOR plus a premium, which was 185 basis points as of March 31, 2014. The interest rate premium is subject to adjustment based upon changes to our credit ratings. As of March 31, 2014, the interest rate for the amount outstanding under our term loan was 2.0%. The weighted average interest rate for the amount outstanding under our term loan was 2.0% and 2.1% for the three months ended March 31, 2014 and 2013, respectively. As a result of the event of default described above, subject to the terms of the applicable forbearance agreement, lenders under our term loan may elect to apply the post-default interest rate, which is generally an additional 4% to the then prevailing interest rate under this agreement, to borrowings outstanding thereunder.

Credit Facility and Term Loan Debt Covenants:

Our public debt indenture and related supplements, our revolving credit facility agreement and our term loan agreement contain a number of financial and other covenants, including covenants that restrict our ability to incur indebtedness or to make distributions under certain circumstances and require us to maintain financial ratios and a minimum net worth. At March 31, 2014, we believe we were in compliance with all of our respective covenants under our public debt indenture and related supplements, our revolving credit facility and our term loan agreements, except for the defaults noted above.

Mortgage Debt:

At March 31, 2014, 12 of our continuing properties (17 buildings) costing $1,250,900 with an aggregate net book value of $1,087,104 secured mortgage notes totaling $898,804 (including net premiums and discounts) maturing from 2015 through 2026. In addition, we had mortgage debt secured by two properties (three buildings) classified as held for sale totaling $19,688 (including net premiums and discounts).

Note 11. Income Taxes

We have elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended, and are generally not subject to federal and state income taxes provided we distribute a sufficient amount of our taxable income to our shareholders and meet other requirements for qualifying as a REIT. However, we are subject to certain state, local and Australian taxes without regard to our REIT status. Our provision for income taxes consists of the following:

	Three Months Ended March 31, 2014		Three Months Ended March 31, 2013	
State	$	34	$	163
Foreign		521		825
Income tax provision	$	555	$	988

Table of Contents

COMMONWEALTH REIT

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(dollars in thousands, except per share data)

Note 12. Fair Value of Assets and Liabilities

The table below presents certain of our assets and liabilities measured at fair value during 2014, categorized by the level of inputs used in the valuation of each asset and liability:

[redacted]

Recurring Fair Value Measurements:				
Effective portion of interest rate swap contracts(1)	$ (10,706)	$	$ (10,706)	$
Non-Recurring Fair Value Measurements:				
Properties held for sale(2)	$ 213,244	$	$	$ 213,244

(1) The fair value of our interest rate swap contracts is determined using the net discounted cash flows of the expected cash flows of each derivative based on the market based interest rate curve (level 2 inputs) and adjusted for our credit spread and the actual and estimated credit spreads of the counterparties (level 3 inputs). Although we have determined that the majority of the inputs used to value our derivatives fall within level 2 of the fair value hierarchy, the credit valuation adjustments associated with our derivatives utilize level 3 inputs, such as estimates of current credit spreads, to evaluate the likelihood of default by us and the counterparties. As of March 31, 2014, we have assessed the significance of the impact of the credit valuation adjustments on the overall valuation of our derivative positions and have determined that the credit valuation adjustments are not significant to the overall valuation of our derivatives. As a result, we have determined that our derivative valuations in their entirety are classified as level 2 inputs in the fair value hierarchy.

(2) As of March 31, 2014, we recorded a loss on asset impairment totaling $288 for one of our CBD properties (two buildings) and 13 of our suburban properties (41 buildings) to reduce the aggregate carrying value of these properties from $213,532 to their estimated fair value of $218,000, reflected in the table below, or $213,244 net of costs to sell. All of these properties were classified as held for sale as of December 31, 2013. We used current contracted sale prices (level 3 inputs) in determining the fair value of these properties. The valuation techniques and significant unobservable inputs used for our level 3 fair value measurements at March 31, 2014 were as follows:

Description	**Fair Value at March 31, 2014**	**Primary Valuation Techniques**	**Unobservable Inputs**	**Range (Weighted Average)**

Properties held for sale on which we recognized impairment losses	$	218,000	Current Contracted Sale Prices	N/A	N/A

We are exposed to certain risks relating to our ongoing business operations, including the effect of changes in foreign currency exchange rates and interest rates. The only risk we currently manage by using derivative instruments is a part of our interest rate risk. Although we have not done so as of March 31, 2014, and have no present intention to do so, we may manage our Australian currency exchange exposure by borrowing in Australian dollars or using derivative instruments in the future, depending on the relative significance of our business activities in Australia at that time. We have interest rate swap agreements to manage our interest rate risk exposure on $172,822 of mortgage debt due 2019, which require interest at a premium over LIBOR. The interest rate swap agreements utilized by us qualify as cash flow hedges and effectively modify our exposure to interest rate risk by converting our floating interest rate debt to a fixed interest rate basis for this loan through December 1, 2016, thus reducing the impact of interest rate changes on future interest expense. These agreements involve the receipt of floating interest rate amounts in exchange for fixed rate

Table of Contents

COMMONWEALTH REIT

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(dollars in thousands, except per share data)

interest payments over the life of the agreements without an exchange of the underlying principal amount. The fair value of our derivative instruments increased by $1,000 and $1,051 during the three months ended March 31, 2014 and 2013, respectively, based primarily on changes in market interest rates. As of March 31, 2014 and December 31, 2013, the fair value of these derivative instruments included in accounts payable and accrued expenses and cumulative other comprehensive loss in our condensed consolidated balance sheets totaled ($10,706) and ($11,706), respectively. We may enter additional interest rate swaps or hedge agreements to manage some of our additional interest rate risk associated with our floating rate borrowings. The table below presents the effects of our interest rate derivatives on our condensed consolidated statements of operations and condensed consolidated statements of comprehensive income for the three months ended March 31, 2014 and 2013:

	Three Months Ended March 31,	
	2014	2013
Balance at beginning of period	$ (11,706)	$ (16,624)
Amount of loss recognized in cumulative other comprehensive income	(229)	(185)
Amount of loss reclassified from cumulative other comprehensive income into interest expense	1,229	1,236
Unrealized gain on derivative instruments	1,000	1,051
Balance at end of period	$ (10,706)	$ (15,573)

Over the next 12 months, we estimate that approximately $4,916 will be reclassified from cumulative other comprehensive income as an increase to interest expense.

In addition to the assets and liabilities described in the above table, our financial instruments include our cash and cash equivalents, rents receivable, investment in direct financing lease receivable, real estate mortgages receivable, restricted cash, revolving credit facility, senior notes and mortgage notes payable, accounts payable and accrued expenses, rent collected in advance, security deposits and amounts due to related persons. At March 31, 2014 and December 31, 2013, the fair values of these additional financial instruments, excluding mortgage debt related to properties held for sale, were not materially different from their carrying values, except as follows:

	March 31, 2014		December 31, 2013
	Carrying	Fair	