

HIGHWOODS PROPERTIES INC  
Form 10-Q  
November 07, 2006

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# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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## FORM 10-Q

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QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2006

Commission file number: 001-13100

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# HIGHWOODS PROPERTIES, INC.

(Exact name of registrant as specified in its charter)

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Maryland  
(State or other jurisdiction of

incorporation or organization)

56-1871668  
(I.R.S. Employer

Identification Number)

3100 Smoketree Court, Suite 600, Raleigh, N.C.

(Address of principal executive office)

27604

(Zip Code)

(919) 872-4924

(Registrant's telephone number, including area code)

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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 is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Securities Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer   
Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act). Yes  No

The Company had 56,063,828 shares of common stock outstanding as of October 19, 2006.

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HIGHWOODS PROPERTIES, INC.

QUARTERLY REPORT FOR THE PERIOD ENDED SEPTEMBER 30, 2006

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**PART I - FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

We refer to (1) Highwoods Properties, Inc. as the Company, (2) Highwoods Realty Limited Partnership as the Operating Partnership, (3) the Company's common stock as Common Stock, (4) the Company's preferred stock as Preferred Stock, (5) the Operating Partnership's common partnership interests as Common Units, (6) the Operating Partnership's preferred partnership interests as Preferred Units and (7) in-service properties (excluding apartment units) to which the Company has title and all of the ownership rights as the Wholly Owned Properties.

The information furnished in the accompanying Condensed Consolidated Financial Statements reflect all adjustments (consisting of normal recurring accruals) that are, in our opinion, necessary for a fair presentation of the aforementioned financial statements for the interim period.

The aforementioned financial statements should be read in conjunction with the notes to Consolidated Financial Statements, Management's Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors included herein and in our 2005 Annual Report on Form 10-K.

**HIGHWOODS PROPERTIES, INC.****Condensed Consolidated Balance Sheets**

(Unaudited and in thousands, except share and per share amounts)

	September 30, 2006	December 31, 2005
<b>Assets:</b>		
Real estate assets, at cost:		
Land	\$ 347,426	\$ 341,509
Buildings and tenant improvements	2,567,469	2,510,968
Development in process	80,943	19,434
Land held for development	118,036	134,844
Furniture, fixtures and equipment	23,706	22,467
	3,137,580	3,029,222
Less accumulated depreciation	(606,633)	(561,558)
Net real estate assets	2,530,947	2,467,664
Real estate and other assets, net, held for sale	46,952	187,770
Cash and cash equivalents	7,524	1,212
Restricted cash	2,138	16,223
Accounts receivable, net	21,759	24,201
Notes receivable, net	8,125	9,232
Accrued straight-line rents receivable, net	67,081	60,729
Investments in unconsolidated affiliates	61,795	69,247
Deferred financing and leasing costs, net	65,085	59,374
Prepaid expenses and other	16,300	13,326
Total Assets	\$ 2,827,706	\$ 2,908,978
<b>Liabilities, Minority Interest and Stockholders Equity:</b>		
Mortgages and notes payable	\$ 1,461,105	\$ 1,471,616
Accounts payable, accrued expenses and other liabilities	141,718	127,455
Financing obligations	36,098	34,154
Total Liabilities	1,638,921	1,633,225
Minority interest	84,252	94,134
Stockholders Equity:		
Preferred Stock, \$.01 par value, 50,000,000 authorized shares; 8 5/8% Series A Cumulative Redeemable Preferred Shares (liquidation preference \$1,000 per share), 104,945 shares issued and outstanding at September 30, 2006 and December 31, 2005	104,945	104,945
8% Series B Cumulative Redeemable Preferred Shares (liquidation preference \$25 per share), 3,700,000 and 5,700,000 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively	92,500	142,500
Common Stock, \$.01 par value, 200,000,000 authorized shares; 55,635,448 and 54,028,507 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively	556	540
Additional paid-in capital	1,442,759	1,419,683
Distributions in excess of net earnings	(534,546)	(479,901)
Deferred compensation restricted stock and stock options		(3,936)
Accumulated other comprehensive loss	(1,681)	(2,212)
Total Stockholders Equity	1,104,533	1,181,619
Total Liabilities, Minority Interest and Stockholders Equity	\$ 2,827,706	\$ 2,908,978

See accompanying notes to condensed consolidated financial statements.

## HIGHWOODS PROPERTIES, INC.

## Consolidated Statements of Income

(Unaudited and in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
<b>Rental and other revenues</b>	\$ 106,291	\$ 100,051	\$ 313,933	\$ 300,970
<b>Operating expenses:</b>				
Rental property and other expenses	40,086	37,005	114,592	105,456
Depreciation and amortization	29,056	27,666	86,565	84,350
Impairment of assets held for use	2,600	4,415	2,600	7,587
General and administrative	8,546	7,513	26,298	23,859
<b>Total operating expenses</b>	<b>80,288</b>	<b>76,599</b>	<b>230,055</b>	<b>221,252</b>
<b>Interest expense:</b>				
Contractual	23,809	24,239	71,855	74,032
Amortization of deferred financing costs	557	823	1,883	2,508
Financing obligations	850	1,073	3,190	4,118
	25,216	26,135	76,928	80,658
<b>Other income/(expense):</b>				
Interest and other income	1,189	2,119	4,336	5,453
Loss on debt extinguishment		(323)	(467)	(453)
	1,189	1,796	3,869	5,000
<b>Income/(loss) before disposition of property, minority interest and equity in earnings of unconsolidated affiliates</b>	<b>1,976</b>	<b>(887)</b>	<b>10,819</b>	<b>4,060</b>
Gains on disposition of property	2,977	9,693	8,295	11,479
Minority interest	(292)	63	(1,272)	398
Equity in earnings of unconsolidated affiliates	1,342	2,060	5,349	6,964
<b>Income from continuing operations</b>	<b>6,003</b>	<b>10,929</b>	<b>23,191</b>	<b>22,901</b>
Discontinued operations:				
Income from discontinued operations, net of minority interest	311	1,800	1,499	7,693
Net gains and (impairments) on sales of discontinued operations, net of minority interest, including gain from related party transactions of \$4,816 in the nine months ended September 30, 2005	2,595	10,142	4,638	24,865
	2,906	11,942	6,137	32,558
<b>Net income</b>	<b>8,909</b>	<b>22,871</b>	<b>29,328</b>	<b>55,459</b>
Dividends on Preferred Stock	(4,113)	(6,699)	(12,950)	(22,125)
Excess of Preferred Stock redemption cost over carrying value		(4,272)	(1,803)	(4,272)
<b>Net income available for common stockholders</b>	<b>\$ 4,796</b>	<b>\$ 11,900</b>	<b>\$ 14,575</b>	<b>\$ 29,062</b>
Net income per common share basic:				
Income/(loss) from continuing operations	\$ 0.04	\$	\$ 0.16	\$ (0.07)
Income from discontinued operations	0.05	0.22	0.11	0.61

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Net income	\$ 0.09	\$ 0.22	\$ 0.27	\$ 0.54
Weighted average common shares outstanding basic	54,470	53,768	54,069	53,725
<b>Net income per common share diluted:</b>				
Income/(loss) from continuing operations	\$ 0.04	\$	\$ 0.15	\$ (0.07)
Income from discontinued operations	0.05	0.22	0.11	0.61
Net income	\$ 0.09	\$ 0.22	\$ 0.26	\$ 0.54
Weighted average common shares outstanding - diluted	61,457	53,768	60,786	53,725
Dividends declared per common share	\$ 0.425	\$ 0.425	\$ 1.275	\$ 1.275

See accompanying notes to condensed consolidated financial statements.



**HIGHWOODS PROPERTIES, INC.****Consolidated Statement of Stockholders Equity****For the Nine Months Ended September 30, 2006**

(Unaudited and in thousands, except share amounts)

	Number of Common Shares	Common Stock	Series A Preferred	Series B Preferred	Additional Paid-In Capital	Deferred Compen- sation	Accumulated Other Compre- hensive Loss	Distributions In Excess of Net Earnings	Total
Balance at December 31, 2005	54,028,507	\$ 540	\$ 104,945	\$ 142,500	\$ 1,419,683	\$ (3,936)	\$ (2,212)	\$ (479,901)	\$ 1,181,619
Reversal of unvested deferred compensation as a result of the adoption of SFAS No. 123(R)					(3,936)	3,936			
Issuance of Common Stock, net	1,464,784	15			30,802				30,817
Conversion of warrants to shares	16,407								
Common Stock dividends								(69,220)	(69,220)
Preferred Stock dividends								(12,950)	(12,950)
Adjustment to minority interest of unitholders in the Operating Partnership					(8,525)				(8,525)
Issuance of restricted stock, net	125,750								
Redemption of Preferred Stock				(50,000)	1,803			(1,803)	(50,000)
Amortization of restricted stock and stock options		1			2,932				2,933
Other comprehensive income							531		531
Net income								29,328	29,328
Balance at September 30, 2006	55,635,448	\$ 556	\$ 104,945	\$ 92,500	\$ 1,442,759	\$	\$ (1,681)	\$ (534,546)	\$ 1,104,533

See accompanying notes to condensed consolidated financial statements.

## HIGHWOODS PROPERTIES, INC.

## Condensed Consolidated Statements of Cash Flows

(Unaudited and in thousands)

	Nine Months Ended September 30,	
	2006	2005
<b>Operating activities:</b>		
Net income	\$ 29,328	\$ 55,459
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	87,655	97,336
Amortization of lease incentives	623	706
Impairment of assets held for use	2,600	7,587
Amortization of stock-based compensation	2,933	1,860
Amortization of deferred financing costs	1,883	2,508
Amortization of accumulated other comprehensive loss	531	527
Loss on debt extinguishments	467	453
Net (gains) and impairments on disposition of property	(13,340)	(39,039)
Minority interest	1,828	3,129
Equity in earnings of unconsolidated affiliates	(5,349)	(6,964)
Change in financing obligations	896	235
Distributions of earnings from unconsolidated affiliates	5,458	6,431
Changes in operating assets and liabilities	(6,338)	(7,965)
Net cash provided by operating activities	109,175	122,263
<b>Investing activities:</b>		
Additions to real estate assets and deferred leasing costs	(133,539)	(122,427)
Proceeds from disposition of real estate assets	186,894	342,946
Distributions of capital from unconsolidated affiliates	11,204	1,975
Net repayments in notes receivable	1,107	4,228
Contributions to unconsolidated affiliates	(100)	
Cash assumed upon consolidation of unconsolidated affiliate	645	
Other investing activities	12,478	108
Net cash provided by investing activities	78,689	226,830
<b>Financing activities:</b>		
Dividends and distributions paid on Common Stock and Common Units	(75,916)	(76,216)
Redemption of Preferred Stock	(50,000)	(130,000)
Dividends paid on Preferred Stock	(12,950)	(22,125)
Distributions of earnings to minority partner in consolidated affiliate	(420)	
Net proceeds from the sale of Common Stock	28,203	1,645
Repurchase of Common Units	(15,369)	(10,082)
Borrowings on revolving credit facilities	498,500	109,000
Repayments of revolving credit facilities	(392,500)	(121,000)
Borrowings on mortgages and notes payable		28,281
Repayments of mortgages and notes payable	(157,247)	(151,793)
Additions to deferred financing costs and other financing activities	(3,853)	(384)
Payments on debt extinguishments		(255)
Net cash used in financing activities	(181,552)	(372,929)
Net increase/(decrease) in cash and cash equivalents	6,312	(23,836)

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Cash and cash equivalents at beginning of the period	1,212	24,482
Cash and cash equivalents at end of the period	\$ 7,524	\$ 646

**Supplemental disclosure of cash flow information:**

Cash paid for interest, net of amounts capitalized (excludes cash distributions to owners of sold properties accounted for as financings of \$1,283 and \$2,862 for 2006 and 2005, respectively)	\$ 69,810	\$ 73,174
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See accompanying notes to condensed consolidated financial statements.

**HIGHWOODS PROPERTIES, INC.****Condensed Consolidated Statements of Cash Flows - Continued**

(Unaudited and in thousands)

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

The following table summarizes the net asset acquisitions and dispositions subject to mortgage notes payable and other non-cash transactions:

	<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Assets:</b>		
Net real estate assets	\$ 44,512	\$ (23,985)
Restricted cash	(1,865)	
Accounts receivable	102	10
Accrued straight-line rents receivable	962	(434)
Investments in unconsolidated affiliates	(1,938)	1,553
Deferred financing and leasing costs, net	287	(61)
Prepaid and other		(268)
	<b>\$ 42,060</b>	<b>\$ (23,185)</b>
<b>Liabilities:</b>		
Mortgages and notes payable	40,736	4,019
Accounts payable accrued expenses and other liabilities	(1,652)	9,777
Financing obligation	1,048	(30,218)
	<b>\$40,132</b>	<b>\$ (16,422)</b>
<b>Minority Interest and Stockholders Equity</b>	<b>\$ 1,928</b>	<b>\$ (6,763)</b>

See accompanying notes to condensed consolidated financial statements.

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**HIGHWOODS PROPERTIES, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2006**

**(tabular dollar amounts in thousands, except per share data)**

(Unaudited)

**1. DESCRIPTION OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES**

**Description of Business**

Highwoods Properties, Inc., together with its consolidated subsidiaries (the Company), is a fully-integrated, self-administered and self-managed equity real estate investment trust (REIT) that operates in the southeastern and midwestern United States. As of September 30, 2006, the Company's wholly owned assets included: 344 in-service office, industrial and retail properties; 96 apartment units; 798 acres of undeveloped land suitable for future development, of which 394 acres are considered core holdings; and an additional 15 properties under development.

The Company conducts substantially all of its activities through, and substantially all of its interests in the properties are held directly or indirectly by, Highwoods Realty Limited Partnership (the Operating Partnership). The Company is the sole general partner of the Operating Partnership. At September 30, 2006, the Company owned all of the preferred partnership interests (Preferred Units) and 91.7% of the common partnership interests (Common Units) in the Operating Partnership. Limited partners (including certain officers and directors of the Company) own the remaining Common Units. Each Common Unit is redeemable for the cash value of one share of the Company's common stock, \$.01 par value (the Common Stock), or, at the Company's option, one share of Common Stock. During the nine months ended September 30, 2006, the Company redeemed 436,038 Common Units from limited partners for approximately \$15.4 million in cash. During the nine months ended September 30, 2006, as required by the terms of the partnership agreement of the Operating Partnership, the Operating Partnership issued approximately 1.5 million additional Common Units to the Company simultaneously upon the Company's issuance of a like number of shares of Common Stock in connection with restricted stock awards, purchases under the Company's employee stock purchase plan and the exercise of stock options and warrants. As a result of the foregoing, the percentage of Common Units owned by the Company increased to 91.7% at September 30, 2006 from 90.8% at December 31, 2005. Preferred Units in the Operating Partnership were issued to the Company in connection with the Company's preferred stock offerings in 1997 and 1998 (the Preferred Stock). The net proceeds raised from each of the Preferred Stock issuances were contributed by the Company to the Operating Partnership in exchange for the Preferred Units. The terms of each series of Preferred Units generally parallel the terms of the respective Preferred Stock as to dividends, liquidation and redemption rights.

**Basis of Presentation**

The Condensed Consolidated Financial Statements of the Company are prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP). As more fully described in Note 10, as required by Statement of Financial Accounting Standard No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, (SFAS No. 144), the Condensed Consolidated Balance Sheet at December 31, 2005 and the Consolidated Statements of Income for the three and nine months ended September 30, 2005 were revised from previously reported amounts to reflect in real estate and other assets held for sale and in discontinued operations the assets and operations for those properties sold or held for sale in the first nine months of 2006 which qualified for discontinued operations.

The Condensed Consolidated Financial Statements include the Operating Partnership, wholly owned subsidiaries and those subsidiaries in which the Company owns a majority voting interest with the ability to control operations of the subsidiaries and where no substantive participating rights or substantive kick out rights have been granted to the minority interest holders. In accordance with EITF Issue No. 04-5, Determining Whether a General Partner or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights, the Company consolidates partnerships, joint ventures and limited liability companies when the Company controls the major operating and financial policies of the entity through majority ownership or in its capacity as general partner or managing member. In addition, the Company consolidates those entities, if any, where the Company is deemed to be the primary beneficiary in a variable interest entity (as defined by FASB Interpretation No. 46 (revised December 2003) Consolidation of Variable Interest Entities (FIN 46(R))). All significant intercompany transactions and accounts have been eliminated.

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**HIGHWOODS PROPERTIES, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(tabular dollar amounts in thousands, except per share data)**

**1. DESCRIPTION OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES - Continued**

The Company has elected and expects to continue to qualify as a REIT under Sections 856 through 860 of the Internal Revenue Code of 1986, as amended (the Code). As a REIT, the Company generally will not be subject to federal or state income taxes on its net income that it distributes to stockholders. Continued qualification as a REIT depends on the Company's ability to satisfy the dividend distribution tests, stock ownership requirements and various other qualification tests prescribed in the Code. The Company conducts certain business activities through a taxable REIT subsidiary, as permitted under the Code. The taxable REIT subsidiary is subject to federal and state income taxes on its net taxable income and the Company records provisions for such taxes, to the extent required, based on its income recognized for financial statement purposes, including the effects of temporary differences between such income and the amount recognized for tax purposes. Through September 30, 2006, the taxable REIT subsidiary has not paid income taxes and has cumulative net taxable losses of approximately \$3.1 million. Because the future tax benefit of the cumulative losses is not assured, the approximate \$1.2 million related deferred tax asset has been fully reserved as management does not believe that it is more likely than not that the deferred tax asset will be recognized and no tax benefit has been recognized in the accompanying financial statements. The tax benefit of the cumulative losses could be recognized for financial reporting purposes in future periods if the taxable REIT subsidiary generates sufficient taxable income.

The accompanying unaudited financial information, in the opinion of management, contains all adjustments (including normal recurring accruals) necessary for a fair presentation of the Company's financial position, results of operations and cash flows. The Company has condensed or omitted certain notes and other information from the interim financial statements presented in this Quarterly Report on Form 10-Q. These financial statements should be read in conjunction with the Company's 2005 Annual Report on Form 10-K.

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

**Minority Interest**

Minority interest in the accompanying Condensed Consolidated Financial Statements relates primarily to the Common Units in the Operating Partnership and, beginning January 1, 2006 as described below, to the 50.0% interest in a consolidated affiliate, Highwoods-Markel Associates, LLC (Markel), that are owned by various individuals and entities other than the Company. As of September 30, 2006, the minority interest in the Operating Partnership consisted of 5.0 million Common Units. Minority interest in the net income/(loss) of the Operating Partnership is computed by applying the weighted average percentage of Common Units not owned by the Company during the period (as a percent of the total number of outstanding Common Units) to the Operating Partnership's net income/(loss) after deducting distributions on Preferred Units. The result is the amount of minority interest expense or income recorded for the period. In addition, when a Common Unitholder redeems a Common Unit for a share of Common Stock or cash, the minority interest is reduced and the Company's share in the Operating Partnership is increased. At the end of each reporting period, the Company determines the amount that represents the minority unitholders' share of the net assets (at book value) of the Operating Partnership and compares this amount to the minority interest balance that resulted from transactions during the period involving minority interest. The Company adjusts the minority interest liability to the computed share of net assets with an offsetting adjustment to the Company's paid-in capital.

In addition, minority interest at September 30, 2006 in the accompanying Condensed Consolidated Balance Sheet includes \$2.3 million related to the consolidation of Markel as a result of the Company's adoption of EITF Issue No. 04-5, as described below in Impact of Newly Adopted and Issued Financial Standards.

## HIGHWOODS PROPERTIES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(tabular dollar amounts in thousands, except per share data)

## 1. DESCRIPTION OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES - Continued

Minority interest in net income is reflected in the Consolidated Statements of Income as follows:

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Amount shown as minority interest in continuing operations	\$ (292)	\$ 63	\$ (1,272)	\$ 398
Amount related to loss/(income) from discontinued operations	(30)	(186)	(149)	(832)
Amount related to gain on sale of discontinued operations	(243)	(1,051)	(407)	(2,695)
Total minority interest in net income	\$ (565)	\$ (1,174)	\$ (1,828)	\$ (3,129)

## Impact of Newly Adopted and Issued Accounting Standards

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS No. 154). The Statement replaces Accounting Principles Board Opinion No. 20, Accounting Changes (APB Opinion No. 20) and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements and changes the requirements for the accounting for and reporting of a change in accounting principle. APB Opinion No. 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. This Statement requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. The Statement is effective for any accounting changes and corrections of errors made on or after January 1, 2006.

In July 2005, the FASB issued Staff Position (FSP) SOP 78-9-1, Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5. The EITF states that a general partner is presumed to control a limited partnership and should consolidate the limited partnership unless the limited partners possess substantive kick-out rights or the limited partners possess substantive participating rights. This FSP eliminates the concept of important rights of SOP 78-9 and replaces it with the concepts of kick-out rights and substantive participating rights as defined in Issue 04-5. This FSP is effective after June 29, 2005 for general partners of all new partnerships formed and for existing partnerships for which the partnership agreements are modified. For general partners in all other partnerships, the guidance in this FSP is effective no later than January 1, 2006. The Company consolidated one of its existing joint ventures, Markel, upon the adoption of this FSP in January 2006; the Company treated this as a prospective change of accounting principle as permitted by EITF No. 04-5. This change resulted in the inclusion on the Consolidated Balance Sheet at January 1, 2006 of approximately \$44 million of real estate assets, net of accumulated depreciation, and other assets, and approximately \$39.3 million in mortgages and notes payable and other liabilities, with the remaining effects to investments in unconsolidated affiliates and to minority interest.

The organizational documents of Markel require the entity to be liquidated through the sale of its assets upon reaching December 31, 2100. As controlling partner, the Company has an obligation to cause this property-owning entity to distribute proceeds of liquidation to the minority interest partner in these partially owned properties only if the net proceeds received by the entity from the sale of its assets warrant a distribution as determined by the agreement. In accordance with the disclosure provisions of SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (SFAS No. 150), the Company estimates the value of minority interest distributions would have been approximately \$12 million had the entity been liquidated as of September 30, 2006. This estimated settlement value is based on assumed third party consideration realizable by the entity upon a hypothetical disposition of the properties and is net of all other assets and liabilities. The amount of any actual distributions to the minority interest holder in this entity is difficult to predict due to many factors, including the inherent uncertainty of real estate sales. If the entity's underlying assets are worth less than the underlying liabilities on the date of such liquidation, the Company would have no obligation to remit any consideration to the minority interest holder.





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**HIGHWOODS PROPERTIES, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(tabular dollar amounts in thousands, except per share data)**

**1. DESCRIPTION OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES - Continued**

In June 2006, the FASB issued FASB Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes, an interpretation of SFAS No. 109, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken in an income tax return. The interpretation is effective for fiscal years beginning after December 15, 2006. The Company is currently assessing the effect of FIN 48 on the Company's financial condition and results of operations upon adoption on January 1, 2007.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 becomes effective for the Company on January 1, 2008. The Company is currently evaluating the impact SFAS No. 157 may have on its financial condition and results of operations.

In September 2006, the Securities and Exchange Commission ( SEC ) released Staff Accounting Bulletin No. 108 ( SAB No. 108 ), which addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements. SAB No. 108 requires companies to quantify misstatements using both the balance sheet and income statement approaches and to evaluate whether either approach is material. If, in evaluating misstatements following an approach not previously used by the Company, the effect of initial adoption is determined to be material, SAB No. 108 allows companies to record that effect as a cumulative effect adjustment to beginning retained earnings. The requirements of this guidance are effective for the Company for the annual financial statements as of December 31, 2006. The Company is currently evaluating what impact, if any, SAB No. 108 may have on its financial statements.

**Employee Benefit Plans and Stock-Based Compensation**

The Company's officers generally receive annual grants of stock options and restricted stock on March 1 of each year under the Amended and Restated 1994 Stock Option Plan (the Stock Option Plan ). Stock options have also been granted to the Company's directors; currently, directors do not receive annual stock option grants. Restricted stock grants are also made annually to directors and certain non-officer employees. As of September 30, 2006, 9.0 million shares of Common Stock were authorized for issuance under the Stock Option Plan. Stock options issued prior to 2005 vest ratably over four years and remain outstanding for 10 years. Stock options issued in 2005 and 2006 continue to vest ratably over a four-year period, but remain outstanding for seven years. The value of all options as of the date of grant is calculated using the Black-Scholes option-pricing model.

The Company elected to follow Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for its stock options issued through December 31, 2002. During 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, which provided methods of transition to the fair value based method of accounting for stock-based employee compensation. This standard was effective for financial statements issued for fiscal years beginning after December 15, 2002. The Company elected the prospective method as defined by SFAS No. 148 for options issued on or after January 1, 2003. In December 2004, the FASB issued SFAS No. 123(R), Share-Based Payment, which revised SFAS No. 123, Accounting for Stock-Based Compensation. SFAS No. 123(R) requires compensation costs related to share-based payment transactions to be recognized in the financial statements and forfeitures to be estimated at the grant date rather than as they occur. The Company based its estimated forfeiture rate on historical forfeitures of all stock option grants. The Company adopted SFAS No. 123(R) effective January 1, 2006 using the modified-prospective method.

## HIGHWOODS PROPERTIES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(tabular dollar amounts in thousands, except per share data)

## 1. DESCRIPTION OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES - Continued

Using the Black-Scholes options valuation model, the weighted average fair values of options granted during the nine months ended September 30, 2006 and 2005 were \$4.00 and \$1.89, respectively, per option. The fair values of the options granted in 2006 and 2005 were estimated at the grant dates using the following weighted average assumptions:

	Nine Months Ended September 30,	
	2006	2005
Risk free interest rate (1)	4.63%	4.19%
Common stock dividend yield (2)	5.20%	6.45%
Expected volatility (3)	18.90%	16.30%
Average expected option life (years)	4.75(4)	7.0
Options granted	243,610	652,325

- (1) Represents interest rate on US treasury bonds having the same life as the estimated life of the Company's options.
- (2) The dividend yield is calculated utilizing the dividends paid for the previous one-year period and the Company's stock price on the date of grant.
- (3) Based on historical volatility of the Company's stock over a period relevant to the related stock option grant.
- (4) The average expected option life for the 2006 grant is based on an analysis of historical company data and is based on the contractual term for the 2005 grant.

The following table illustrates the effect on net income available to common stockholders and earnings per share for the three and nine months ended September 30, 2005 if a fair value based method had been applied to all outstanding and unvested stock options granted prior to January 1, 2003:

	Three Months Ended	Nine Months Ended
	September 30, 2005	September 30, 2005
Net income available for common stockholders - as reported	\$ 11,900	\$ 29,062
Add: Stock option expense included in reported net income	134(1)	350(1)
Deduct: Total stock option expense determined under fair value recognition method for all awards	(186)(1)	(541)(1)
Pro forma net income attributable to common stockholders	\$ 11,848	\$ 28,871
Basic net income per common share - as reported	\$ 0.22	\$ 0.54
Basic net income per common share - pro forma	\$ 0.22	\$ 0.54
Diluted net income per common share - as reported	\$ 0.22	\$ 0.54
Diluted net income per common share - pro forma	\$ 0.22	\$ 0.54

- (1) Amounts include the effect of dividend equivalent rights. Dividends on unvested shares of restricted stock are accounted for as compensation expense.



## HIGHWOODS PROPERTIES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(tabular dollar amounts in thousands, except per share data)

## 2. INVESTMENTS IN UNCONSOLIDATED AND OTHER AFFILIATES

The Company has various joint ventures with unrelated investors and has retained minority equity interests ranging from 12.5% to 50.0% in these joint ventures. The Company generally accounts for its unconsolidated joint ventures using the equity method of accounting. As a result, the assets and liabilities of these joint ventures for which the Company uses the equity method of accounting are not included on the Company's consolidated balance sheet.

During the third quarter of 2006, three of the Company's joint ventures made distributions aggregating \$17.0 million as a result of a refinancing of debt related to various properties held by the joint ventures. The Company received 50.0% of such distribution. As a result of these distributions, the Company's investment account in these joint ventures became negative. The new debt is non-recourse; however, the Company and its partner have guaranteed other debt and have contractual obligations to support the joint ventures, which are included in the Guarantees and Other Obligations table in Note 12. Therefore, in accordance with SOP 78-9 Accounting for Investments in Real Estate Ventures, the Company recorded the distributions as a reduction of the investment account and included the resulting negative investment balances of \$6.3 million in Accounts Payable, Accrued Expenses and Other Liabilities in the Consolidated Balance Sheet at September 30, 2006.

The Company currently has three consolidated joint ventures. SF-HIW Harborview, LP is accounted for as a financing arrangement pursuant to SFAS No. 66, as described in Note 3 to the Consolidated Financial Statements in the Company's 2005 Annual Report on Form 10-K; The Vinings at University Center, LLC is consolidated pursuant to FIN 46(R) as described further below; and Markel is consolidated beginning January 1, 2006 pursuant to EITF 04-5, as discussed above.

Investments in unconsolidated affiliates as of September 30, 2006 and combined summarized income statements for the Company's unconsolidated joint ventures for the three and nine months ended September 30, 2006 and 2005 are as follows:

Joint Venture	Location of Properties	Total Rentable Square Feet (000)	Ownership Interest
Board of Trade Investment Company	Kansas City, MO	166	49.0%
Dallas County Partners I, LP	Des Moines, IA	641	50.0%
Dallas County Partners II, LP	Des Moines, IA	272	50.0%
Dallas County Partners III, LP	Des Moines, IA	7	50.0%
Fountain Three	Des Moines, IA	785	50.0%
RRHWoods, LLC	Des Moines, IA	800(1)	50.0%
Kessinger/Hunter, LLC	Kansas City, MO	(2)	26.5%
4600 Madison Associates, LLC	Kansas City, MO	262	12.5%
Plaza Colonnade, LLC	Kansas City, MO	293	50.0%
Highwoods DLF 98/29, LP	Atlanta, GA; Charlotte, NC; Greensboro, NC; Raleigh, NC;		
	Orlando, FL; Baltimore, MD	1,199	22.8%
Highwoods DLF 97/26 DLF 99/32, LP	Atlanta, GA; Greensboro, NC; Orlando, FL	822	42.9%
Highwoods KC Glenridge Office, LP	Atlanta, GA	185	40.0%
Highwoods KC Glenridge Land, LP	Atlanta, GA		40.0%
HIW-KC Orlando LLC	Orlando, FL	1,273	40.0%
Concourse Center Associates, LLC	Greensboro, NC	118	50.0%
Weston Lakeside, LLC	Raleigh, NC	(3)	50.0%
Total		6,823(4)	

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- (1) Includes a 75,000 square foot office building and a 31,000 square foot office building currently under development.
- (2) This joint venture provides property management, leasing and brokerage services and provides certain construction related services to certain Wholly Owned Properties of the Company; therefore, no rentable square feet is provided.
- (3) This joint venture is constructing approximately 332 rental residential units on 22.4 acres of land.
- (4) Total does not include properties held by consolidated joint ventures totaling 618,000 square feet.

## HIGHWOODS PROPERTIES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(tabular dollar amounts in thousands, except per share data)

## 2. INVESTMENTS IN UNCONSOLIDATED AND OTHER AFFILIATES - Continued

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005(1)	2006	2005(1)
<b>Income Statements:</b>				
<b>Revenues</b>	\$ 35,960	\$ 35,101	\$ 103,762	\$ 104,147
<b>Expenses:</b>				
Operating expenses	15,920	14,712	44,591	42,788
Depreciation and amortization	7,338	7,450	21,328	22,039
Interest expense and loan cost amortization	8,369	8,752	25,094	25,830
Loss on debt extinguishment	1,448		1,448	
Total expenses	33,075	30,914	92,461	90,657
<b>Net income</b>	\$ 2,885	\$ 4,187	\$ 11,301	\$ 13,490
<b>The Company's share of:</b>				
Net income (2)	\$ 1,342	\$ 2,060	\$ 5,349	\$ 6,964
Depreciation and amortization (real estate related)	\$ 2,790	\$ 2,771	\$ 8,143	\$ 8,039
Interest expense and loan cost amortization	\$ 3,507	\$ 3,685	\$ 10,509	\$ 10,834
Loss on debt extinguishment	\$ 724	\$	\$ 724	\$

(1) Amounts for 2005 include Markel, which has been consolidated beginning January 1, 2006, as described in Note 1.

(2) The Company's share of net income differs from its weighted average ownership percentage in the joint ventures' net income due to the Company's purchase accounting and other related adjustments.

On December 22, 2004, the Company and Easlan Investment Group, Inc. (Easlan) formed The Vinings at University Center, LLC. The Company contributed 7.8 acres of land at an agreed upon value of \$1.6 million to the joint venture in December 2004 in return for a 50% equity interest and Easlan contributed \$1.1 million, in the form of non-interest bearing promissory notes, for a 50% equity interest in the entity. At September 30, 2006, the Company has consolidated this joint venture under the provisions of FIN 46(R) because Easlan has no at-risk equity and the Company absorbs the majority of the joint venture's expected losses. Accordingly, the Company's balance sheet at September 30, 2006 includes \$11.0 million of building and land and a \$9.7 million construction note payable. On November 1, 2006, the joint venture sold the buildings and land to a third party for gross proceeds of \$14.3 million, paid off the construction note payable and made cash distributions to the partners. The Company received a distribution of \$2.9 million.

For additional information regarding the Company's investments in unconsolidated and other affiliates, see Note 2 to the Consolidated Financial Statements in the Company's 2005 Annual Report on Form 10-K.

## 3. FINANCING ARRANGEMENTS

For information regarding sale transactions that were accounted for as financing arrangements under paragraphs 25 through 29 of SFAS No. 66, see Note 5 herein and Note 3 to the Consolidated Financial Statements in the Company's 2005 Annual Report on Form 10-K.

**4. ASSET DISPOSITIONS**

During the nine months ended September 30, 2006, the Company's dispositions consisted of the following:

	<b>For the Quarters Ended</b>		
	<b>March 31, 2006</b>	<b>June 30, 2006</b>	<b>September 30, 2006</b>
Operating properties (square feet in thousands)	1,999		292
Land held for development (acres)	60.6	6.6	11.5
Gross sale proceeds on operating properties	\$ 153,900	\$	\$ 22,787
Gross sale proceeds on development land	\$ 5,490	\$ 1,600	\$ 4,200

## HIGHWOODS PROPERTIES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(tabular dollar amounts in thousands, except per share data)

**4. ASSET DISPOSITIONS - Continued**

In January 2006, the Company sold office and industrial properties in Atlanta, Georgia, Columbia, South Carolina and Tampa, Florida in a single transaction for gross proceeds of approximately \$141 million. This transaction was classified as held for sale and an impairment loss of \$7.7 million was recorded in the fourth quarter of 2005. The properties subject to this sale were classified as discontinued operations in the fourth quarter of 2005.

In March 2006, the Company sold an office property in Raleigh, North Carolina for gross proceeds of approximately \$12.9 million. A gain of approximately \$1.4 million was recorded in the first quarter of 2006. This property was classified as discontinued operations in the first quarter of 2006.

In August 2006, the Company sold five office properties in Raleigh, North Carolina for gross proceeds of approximately \$22.8 million. A gain of approximately \$2.8 million was recorded in the third quarter of 2006. This property was classified as discontinued operations in the third quarter of 2006.

In October 2006, the Company sold 94.6 acres of land in Atlanta, Georgia for gross proceeds of approximately \$22.5 million. A gain of approximately \$7.4 million will be recorded in the fourth quarter of 2006. The Company also sold a retail property aggregating 105,325 rentable square feet in Kansas City, Missouri for gross proceeds of approximately \$10.5 million. A gain of approximately \$1.5 million will be recorded in the fourth quarter of 2006.

Gains, losses and impairments on disposition of properties, net, from dispositions not classified as discontinued operations, consisted of the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Gains on disposition of land	\$ 2,103	\$ 4,799	\$ 5,143	\$ 5,990
Impairments on land		(59)	(74)	(269)
Gains on disposition of depreciable properties	874	4,953	3,226	5,758
Total	\$ 2,977	\$ 9,693	\$ 8,295	\$ 11,479

The above gains on land and depreciable properties include deferred gain recognition from prior sales and adjustments to prior sale transactions.

Net gains on sale and impairments of discontinued operations, net of minority interest, consisted of the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Gains on disposition of depreciable properties	\$ 2,838	\$ 11,193	\$ 5,045	\$ 28,257
Impairments on disposition of depreciable properties				(697)
Allocable minority interest	(243)	(1,051)	(407)	(2,695)
Total	\$ 2,595	\$ 10,142	\$ 4,638	\$ 24,865



See Note 10 for information on discontinued operations and impairment of long-lived assets.

**HIGHWOODS PROPERTIES, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(tabular dollar amounts in thousands, except per share data)

**5. MORTGAGES, NOTES PAYABLE AND FINANCING OBLIGATIONS**

The Company's consolidated mortgages and notes payable consisted of the following at September 30, 2006 and December 31, 2005:

	September 30, 2006	December 31, 2005
Secured mortgage loans	\$ 704,605(1)	\$ 721,116
Unsecured loans	756,500	750,500
<b>Total</b>	<b>\$ 1,461,105</b>	<b>\$ 1,471,616</b>

(1) Amount includes \$38.5 million from the consolidation of Markel, as described in Note 1.

As of September 30, 2006, the Company's outstanding mortgages and notes payable were secured by real estate assets with an aggregate undepreciated book value of approximately \$1.2 billion.

**Refinancings and Preferred Stock Redemptions in 2005 and 2006**

During 2005 and through the third quarter of 2006, the Company paid off \$196.2 million of outstanding loans, excluding any normal debt amortization and the refinancings of the credit facility and bank term loans, which included \$176.2 million of secured debt with a weighted average interest rate of 6.9% and \$20 million of unsecured floating rate debt with an interest rate of 4.9%. Included in the \$176.2 million was \$89.8 million of floating rate secured debt. The Company incurred a \$0.5 million loss on debt extinguishments in 2005 in connection with these loan pay-downs. Approximately \$350 million of real estate assets (based on undepreciated cost basis) became unencumbered after paying off the secured debt. The Company also used some of the proceeds from its disposition activity to redeem, in August 2005 and February 2006, all of the Company's outstanding Series D Preferred Shares and 3,200,000 of its outstanding Series B Preferred Shares, aggregating \$180.0 million plus accrued dividends. These reductions in outstanding debt and Preferred Stock balances were funded primarily from proceeds from property dispositions that closed in 2005 and 2006. In connection with the redemption of Preferred Stock, the excess of the redemption cost over the net carrying amount of the redeemed shares was recorded as a reduction to net income available for common stockholders. These reductions amounted to \$4.3 million and \$1.8 million for the third quarter of 2005 and first quarter of 2006, respectively.

On May 1, 2006, the Company obtained a new \$350 million, three-year unsecured revolving credit facility from Bank of America, N.A. The Company used \$273 million of proceeds from the new revolving credit facility, together with available cash, to pay off the remaining outstanding balance of \$178 million under its previous revolving credit facility and a \$100 million bank term loan, both of which were terminated. Loss on debt extinguishments of approximately \$0.5 million was recorded in the second quarter of 2006.

On August 8, 2006, the Company's revolving credit facility was amended and restated as part of a syndication with a group of 15 banks. The revolving credit facility was also upsized from \$350 million to \$450 million. The Company's revolving credit facility is initially scheduled to mature on May 1, 2009. Assuming no default exists, the Company has an option to extend the maturity date by one additional year and, at any time prior to May 1, 2008, may request increases in the borrowing availability under the credit facility by up to an additional \$50 million. The interest rate is LIBOR plus 80 basis points and the annual base facility fee is 20 basis points. The revolving credit facility has up to \$167.7 million of additional availability as of October 19, 2006.

## HIGHWOODS PROPERTIES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(tabular dollar amounts in thousands, except per share data)

**5. MORTGAGES, NOTES PAYABLE AND FINANCING OBLIGATIONS - Continued**

As of the date of this filing, the Operating Partnership has not yet satisfied the requirement under the indenture governing its outstanding notes to file timely SEC reports, but expects to do so as soon as practicable. Under the indenture, the notes may be accelerated if the trustee or 25% of the holders provide written notice of a default and such default remains uncured after 60 days. If the Operating Partnership failed to file its delinquent SEC reports prior to expiration of the 60-day cure period after receipt of any such default notice, the lender under the Company's revolving credit facility would also have the ability to accelerate amounts outstanding under the revolving credit facility. To date, neither the trustee nor any holder has sent the Company any such default notice. The Operating Partnership is in compliance with all other covenants under the indenture and is current on all payments required thereunder.

**Financing Obligations**

The Company's financing obligations consisted of the following at September 30, 2006 and December 31, 2005:

	September 30, 2006	December 31, 2005
SF-HIW Harborview, LP financing obligation	\$ 15,870	\$ 14,983
Tax increment financing obligation (1)	19,171	19,171
Capitalized ground lease obligation (2)	1,057	
Total	\$ 36,098	\$ 34,154

- (1) In connection with tax increment financing for construction of a public garage related to an office building constructed by the Company in 2000, the Company is obligated to pay fixed special assessments over a 20-year period. The net present value of these assessments, discounted at 6.9% at the inception of the obligation, is shown as a financing obligation in the balance sheet. The Company also receives special tax revenues and property tax rebates, which are intended, but not guaranteed, to provide funds to pay the special assessments.
- (2) Represents a capitalized lease obligation to the lessor of land on which the Company is constructing a new building. The Company is obligated to make fixed payments to the lessor through October 2022 and the lease provides for fixed price purchase options in the ninth and tenth years of the lease. The Company intends to exercise the purchase option in order to prevent an economic penalty related to conveying the building to the lessor at the expiration of the lease. The net present value of the fixed rental payments and purchase option through the ninth year was calculated using a discount rate of 7.1%. The assets and liabilities under the capital lease are recorded at the lower of the present value of minimum lease payments or the fair value. The fair value of the land is included in financing obligations on the Condensed Consolidated Balance Sheet. The liability accretes each month for the difference between the interest rate on the financing obligation and the fixed payments. The accretion will continue until the liability equals the purchase option of the land in the ninth year of the lease.

## HIGHWOODS PROPERTIES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(tabular dollar amounts in thousands, except per share data)

## 6. STOCK-BASED COMPENSATION

## Stock Options

The following table summarizes information about stock option activity during the nine months ended September 30, 2006:

	Options Outstanding	
	Number of Shares	Weighted Average Exercise Price
Balances at December 31, 2005	5,153,648	\$ 24.23
Options granted	243,610	32.40
Options forfeited	(18,262)	27.16
Options cancelled	(32,057)	25.73
Options exercised	(1,736,780)	23.83
Balances at September 30, 2006	3,610,159	\$ 24.95

Cash received or receivable at September 30, 2006 from options exercised was \$29.1 million and \$2.7 million for the nine months ended September 30, 2006 and 2005, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2006 and 2005 was \$22.9 million and \$1.0 million, respectively. The total intrinsic value of options outstanding at September 30, 2006 and 2005 was \$44.3 million and \$27.7 million, respectively.

The Company generally does not permit the net cash settlement of exercised stock options, but does permit net share settlement for certain qualified exercises.

The portion of stock option expense recorded at September 30, 2006 related to unvested awards granted prior to January 1, 2003 was immaterial.

The following tables set forth additional information about stock options outstanding and exercisable at September 30, 2006.

Exercise Price of Stock Options	Stock Options Outstanding			Stock Options Exercisable		
	Number Outstanding (in 000s)	Weighted Average Remaining Life (years)	Weighted Average Exercise Price	Number Exercisable (in 000s)	Weighted Average Remaining Life (years)	Weighted Average Exercise Price
\$10.00 to \$15.00	57	3.4	\$ 11.63	57	3.4	\$ 11.63
\$15.01 to \$20.00	35	3.4	\$ 18.69	35	3.4	\$ 18.69
\$20.01 to \$25.00	1,507	4.2	\$ 22.41	1,390	4.2	\$ 22.52
\$25.01 to \$30.00	1,725	5.9	\$ 26.47	1,001	6.0	\$ 26.62
\$30.01 to \$35.00	285	5.5	\$ 32.60	52	5.6	\$ 33.60
\$35.01 to \$40.00	1	6.9	\$ 37.60			\$

## Stock Options Exercisable

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	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Aggregate Intrinsic Value (in 000s)</b>
September 30, 2005	3,738,710	\$ 26.06	\$ 22,081
September 30, 2006	2,534,621	\$ 24.05	\$ 33,345

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HIGHWOODS PROPERTIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(tabular dollar amounts in thousands, except per share data)

**6. STOCK-BASED COMPENSATION - Continued**

**Restricted Stock Grants**

The Company generally makes annual grants of time-based restricted stock under its Stock Option Plan to its directors, officers and other employees. Restricted stock issued prior to 2005 generally vests 50.0% three years from the date of grant and the remaining 50.0% five years from date of grant. Shares of time-based restricted stock that were issued in 2005 will vest one-third on the third anniversary, one-third on the fourth anniversary and one-third on the fifth anniversary of the date of grant. Shares of time-based restricted stock that were issued in 2006 will vest 25% on the first, second, third and fourth anniversary dates, respectively. Shares of time-based restricted stock issued to directors generally vest 25% at the end of the first, second, third and fourth anniversary dates, respectively. The value of grants of time-based restricted stock is based on the market value of Common Stock as of the date of grant.

During 2005 and 2006, the Company also issued shares of restricted stock to officers under its Stock Option Plan that will vest if the Company's total shareholder return exceeds the average total returns of a selected group of peer companies over a three-year period. If the Company's total shareholder return does not exceed such average total returns, none of the total return-based restricted stock will vest. The 2006 grants also contain a provision allowing for partial vesting if the annual return in any given year exceeds 9%. The fair values of each such share of total return-based restricted stock were determined by an outside consultant to be approximately 76% and 87% of the market value of a share of Common Stock as of the grant dates for the 2005 and 2006 grants, respectively. The total grant date fair value of these shares of total-return based restricted stock is being amortized to expense on a straight-line method over the three-year period.

During 2005 and 2006, the Company also issued shares of performance-based restricted stock to officers under its Stock Option Plan that will vest pursuant to company-wide performance-based criteria. The performance-based criteria are based on whether or not the Company meets or exceeds four operating and financial goals established under its Strategic Management Plan by the end of 2007 and 2008, respectively. To the extent actual performance equals or exceeds threshold performance goals, the portion of shares of performance-based restricted stock that vest can range from 50% to 100%. If actual performance does not meet such threshold goals, none of the performance-based restricted stock will vest. The fair value of performance-based restricted share grants is based on the market value of Common Stock as of the date of grant and the estimated performance to be achieved at the end of the three-year period. Such fair value is being amortized to expense during the period from grant date to December 31, 2007 and 2008, respectively, adjusting for the expected level of vesting that will occur at those dates.

Up to 100% of additional total return-based restricted stock and up to 50% of additional performance-based restricted stock may be issued at the end of the three-year periods if actual performance exceeds certain levels of performance. Such additional shares, if any, would be fully vested when issued. The Company will also accrue and record expense for additional performance-based shares during the three-year period to the extent issuance of the additional shares is expected based on current and projected actual performance. In accordance with GAAP, no expense is recorded for additional shares of total return-based restricted stock that may be issued at the end of the three-year period since that possibility is already reflected in the grant date fair value.

## HIGHWOODS PROPERTIES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(tabular dollar amounts in thousands, except per share data)

## 6. STOCK-BASED COMPENSATION - Continued

The following table summarizes activity in the nine months ended September 30, 2006 for all time-based restricted stock grants:

	Nine Months Ended September 30, 2006	
	Number	Average Issuance Price
	of Shares	Price
Restricted shares outstanding at December 31, 2005	268,409(1)	\$ 24.79
Number of restricted shares awarded and issued	72,906	32.50
Restricted shares vested (2)	(42,927)	24.15
Restricted shares forfeited	(15,945)	25.50
Restricted shares surrendered for payment of withholding taxes upon vesting	(23,275)	23.77
Restricted shares outstanding at September 30, 2006	259,168	\$ 27.11

(1) Amount includes 20,396 shares granted during the blackout period in 2005. These shares were issued in 2006 and are included in the Consolidated Statement of Stockholders' Equity at September 30, 2006.

(2) The total fair value of restricted shares that vested during each of the nine months ended September 30, 2006 and 2005 was \$1.9 million. The following table summarizes activity in the nine months ended September 30, 2006 for all performance-based and total return-based restricted stock grants:

	Nine Months Ended September 30, 2006	
	Number	Weighted Average Issuance Price
	of Shares	Price
Restricted shares outstanding at December 31, 2005	62,576	\$ 26.82
Number of restricted shares awarded and issued	52,938	30.62
Restricted shares vested	(4,546)	28.19
Restricted shares forfeited	(4,546)	28.19
Restricted shares surrendered for payment of withholding taxes upon vesting	(4,546)	28.19
Restricted shares outstanding at September 30, 2006	110,968	\$ 28.58

During the nine months ended September 30, 2006 and 2005, the Company recognized approximately \$2.9 million and \$2.0 million, respectively, of stock-based compensation expense. As of September 30, 2006 and 2005, there was \$7.0 million and \$5.0 million, respectively, of total unrecognized stock-based compensation costs, which will be recognized over a weighted average remaining contractual term of 2.5

years and 2.9 years, respectively.

**Retirement Plan**

Effective for 2006, the Company adopted a retirement plan applicable to all employees, including executive officers, who, at the time of retirement, have at least 30 years of continuous qualified service or are at least 55 years old and have at least 10 years of continuous qualified service. Subject to advance retirement notice and execution of a non-compete agreement with the Company, eligible retirees would be entitled to receive a pro rata amount of the annual bonus earned during the year of retirement. Stock options and time-based restricted stock granted to such eligible retiree during his or her employment would be non-forfeitable and become exercisable according to the terms of their original grants. Eligible retirees would also be entitled to receive a pro rata amount of any performance-based and total return-based restricted stock originally granted to such eligible retiree during his or her employment that subsequently vests after the retirement date according to the terms of their original grants. The benefits of this retirement plan apply only to restricted stock and stock option grants beginning in 2006 and will be phased in 25% on March 1, 2006 and 25% on each anniversary thereof. For employees eligible for these benefits as of the date of grant after March 1, 2006, 25% of their grants were fully expensed at the grant date, which increased compensation expense by approximately \$0.2 million in the nine months ended September 30, 2006. Grants made prior to 2006 are unaffected.



**HIGHWOODS PROPERTIES, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(tabular dollar amounts in thousands, except per share data)

**6. STOCK-BASED COMPENSATION - Continued****Deferred Compensation**

The Company has a deferred compensation plan pursuant to which each executive officer and director can elect to defer a portion of base salary and/or annual bonus (or director fees) for investment in various unrelated mutual funds. Prior to January 1, 2006, executive officers and directors also could elect to defer cash compensation for investment in units of phantom stock. At the end of each calendar quarter, any executive officer and director who deferred compensation into phantom stock was credited with units of phantom stock at a 15.0% discount. Dividends on the phantom units are assumed to be issued in additional units of phantom stock at a 15.0% discount. If an officer that deferred compensation under this plan leaves the Company's employ voluntarily or for cause within two years after the end of the year in which such officer deferred compensation for units of phantom stock, at a minimum, the 15.0% discount and any deemed dividends are forfeited. Over the two-year vesting period, the Company records additional compensation expense equal to the 15.0% discount, the accrued dividends and any changes in the market value of Common Stock from the date of the deferral, which aggregated \$(0.05) million and \$0.07 million for the three months ended September 30, 2006 and 2005, respectively, and \$1.2 million and \$0.5 million for the nine months ended September 30, 2006 and 2005, respectively. Cash payments from the plan for the nine months ended September 30, 2006 and 2005 were \$0.5 million and \$0.02 million, respectively.

**7. RELATED PARTY TRANSACTIONS**

As more fully described in Note 8 to the Consolidated Financial Statements in the Company's 2005 Annual Report on Form 10-K, the Company purchased land in 2005 from GAPI, Inc., an entity owned by a current director, and also sold certain buildings in 2005 to a director who subsequently retired from the Board of Directors on December 31, 2005.

**8. DERIVATIVE FINANCIAL INSTRUMENTS**

Accumulated Other Comprehensive Loss (AOCL) at September 30, 2006 and December 31, 2005 was \$1.7 million and \$2.2 million, respectively, and consisted of deferred gains and losses from past cash flow hedging instruments which are being recognized as interest expense over the terms of the related debt (see Note 9). The Company expects that the portion of the cumulative loss recorded in AOCL at September 30, 2006 associated with these derivative instruments, which will be recognized as interest expense within the next 12 months, will be approximately \$0.7 million.

The land purchase agreement with GAPI, Inc. described in Note 8 to the Consolidated Financial Statements in the Company's 2005 Annual Report on Form 10-K included an embedded derivative feature due to the price for the land parcels being determined by the fair value of Common Units, which was accounted for in accordance with SFAS No. 133.

**9. OTHER COMPREHENSIVE INCOME**

Other comprehensive income represents net income plus the changes in certain amounts deferred in accumulated other comprehensive income/(loss) related to hedging activities not reflected in the Consolidated Statements of Income. The components of other comprehensive income are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net income	\$ 8,909	\$ 22,871	\$ 29,328	\$ 55,459
Other comprehensive income:				
Unrealized derivative gains/(losses) on cash flow hedges				(101)

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Amortization of hedging gains and losses included in other comprehensive income	177	176	531	527
Total other comprehensive income	177	176	531	426
Total comprehensive income	\$ 9,086	\$ 23,047	\$ 29,859	\$ 55,885

## HIGHWOODS PROPERTIES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(tabular dollar amounts in thousands, except per share data)

## 10. DISCONTINUED OPERATIONS AND THE IMPAIRMENT OF LONG-LIVED ASSETS

As part of its business strategy, the Company will from time to time selectively dispose of non-core properties and use the net proceeds for investments or other purposes. The table below sets forth the net operating results and net carrying value of those assets classified as discontinued operations. The assets classified as discontinued operations comprise 6.9 million square feet of office and industrial properties and 46 apartment units sold during 2005 and the nine months ended September 30, 2006 and 0.2 million square feet of property and 156 apartment units held for sale at September 30, 2006. These long-lived assets relate to disposal activities that were initiated subsequent to the effective date of SFAS No. 144, or that met certain stipulations prescribed by SFAS No. 144. The operations of these assets have been reclassified from the ongoing operations of the Company to discontinued operations, and the Company does not or will not have any significant continuing involvement in the operations after the disposal transactions:

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
<b>Rental and other revenues</b>	\$ 1,558	\$ 8,717	\$ 5,227	\$ 40,375
<b>Operating expenses:</b>				
Rental property and other expenses	647	3,962	1,950	17,078
Depreciation and amortization	221	2,276	1,090	12,986
General and administrative	75	298	75	849
Total operating expenses	943	6,536	3,115	30,913
<b>Interest expense</b>	277	251	482	1,072
<b>Other income</b>	3	56	18	135
<b>Income before minority interest in the Operating Partnership and net gains on sale and impairment of discontinued operations</b>	341	1,986	1,648	8,525
Minority interest in discontinued operations	(30)	(186)	(149)	(832)
<b>Income from discontinued operations, net of minority interest in the Operating Partnership</b>	311	1,800	1,499	7,693
Net gains on sale and impairment of discontinued operations	2,838	11,193	5,045	27,560
Minority interest in discontinued operations	(243)	(1,051)	(407)	(2,695)
<b>Net gains on sale and impairment of discontinued operations, net of minority interest in the Operating Partnership</b>	2,595	10,142	4,638	24,865
<b>Total discontinued operations</b>	\$ 2,906	\$ 11,942	\$ 6,137	\$ 32,558

The net book value of property classified as discontinued operations that was sold during 2005 and the nine months ended September 30, 2006 and was held for sale at September 30, 2006 aggregated \$488.4 million.

Certain other assets were sold during 2005 that did not meet the criteria of SFAS No. 144 to be classified as discontinued operations due to the magnitude of the Company's ongoing management and/or leasing services on behalf of the new owners.

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SFAS No. 144 also requires that a long-lived asset classified as held for sale be measured at the lower of the carrying value or fair value less cost to sell. During the nine months ended September 30, 2006, there were no properties held for sale which had a carrying value that was greater than fair value less cost to sell; therefore, no impairment loss was recognized in the Consolidated Statements of Income for the nine months ended September 30, 2006. During the nine months ended September 30, 2005, the Company recorded impairment losses of \$0.7 million related to three properties sold and \$3.2 million related to two land parcels sold.

## HIGHWOODS PROPERTIES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(tabular dollar amounts in thousands, except per share data)

**10. DISCONTINUED OPERATIONS AND THE IMPAIRMENT OF LONG-LIVED ASSETS - Continued**

SFAS No. 144 also requires that if indicators of impairment exist, the carrying value of a long-lived asset classified as held for use be compared to the sum of its estimated undiscounted future cash flows. If the carrying value is greater than the sum of its undiscounted future cash flows, an impairment loss should be recognized for the excess of the carrying amount of the asset over its estimated fair value. In each of the nine months ended September 30, 2006 and 2005, a property had indicators of impairment where the carrying value exceeded the sum of estimated undiscounted future cash flows. Therefore, impairment losses of \$2.6 million and \$4.4 million were recorded in the nine months ended September 30, 2006 and 2005, respectively.

The following table includes the major classes of assets and liabilities of the properties classified as held for sale as of September 30, 2006 and December 31, 2005:

	September 30, 2006	December 31, 2005
Land	\$ 4,520	\$ 28,301
Land held for development	22,706	27,526
Buildings and tenant improvements	22,875	154,411
Development in process		9,266
Accumulated depreciation	(3,572)	(36,244)
Net real estate assets	46,529	183,260
Deferred leasing costs, net	99	2,188
Accrued straight line rents receivable	249	2,294
Prepaid expenses and other	75	28
Total assets	\$ 46,952	\$ 187,770
Tenant security deposits, deferred rents and accrued costs (1)	\$ 1,084	\$ 1,082
Mortgages payable (2)	\$ 14,656	\$ 14,794

(1) Included in accounts payable, accrued expenses and other liabilities.

(2) Included in mortgages and notes payable.

**11. EARNINGS PER SHARE**

The following table sets forth the computation of basic and diluted earnings per share:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
<b>Basic income/(loss) per share:</b>				
<b>Numerator:</b>				
Income from continuing operations	\$ 6,003	\$ 10,929	\$ 23,191	\$ 22,901
Preferred Stock dividends	(4,113)	(6,699)	(12,950)	(22,125)

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Excess of Preferred Stock redemption costs over carrying value		(4,272)	(1,803)	(4,272)
Income/(loss) from continuing operations attributable to common stockholders	1,890	(42)	8,438	(3,496)
Income from discontinued operations	2,906	11,942	6,137	32,558
Net income attributable to common stockholders	\$ 4,796	\$ 11,900	\$ 14,575	\$ 29,062
<b>Denominator:</b>				
Denominator for basic earnings per share weighted average shares	54,470	53,768	54,069	53,725
Basic earnings per share:				
Income/(loss) from continuing operations	\$ 0.04	\$	\$ 0.16	\$ (0.07)
Income from discontinued operations	0.05	0.22	0.11	0.61
Net income	\$ 0.09	\$ 0.22	\$ 0.27	\$ 0.54

## HIGHWOODS PROPERTIES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(tabular dollar amounts in thousands, except per share data)

## 11. EARNINGS PER SHARE - Continued

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
<b>Diluted income/(loss) per share:</b>				
<b>Numerator:</b>				
Income from continuing operations	\$ 6,003	\$ 10,929	\$ 23,191	\$ 22,901
Preferred Stock dividends	(4,113)	(6,699)	(12,950)	(22,125)
Excess of Preferred Stock redemption costs over carrying value		(4,272)	(1,803)	(4,272)
Minority interest in the Operating Partnership	175		826	
Income/(loss) from continuing operations attributable to common stockholders	2,065	(42)	9,264	(3,496)
Income from discontinued operations	2,906	11,942	6,137	32,558
Minority interest in discontinued operations	273		556	
Income from discontinued operations	3,179	11,942	6,693	32,558
Net income attributable to common stockholders	\$ 5,244	\$ 11,900	\$ 15,957	\$ 29,062
<b>Denominator:</b>				
Denominator for basic earnings per share weighted average shares	54,470	53,768	54,069	53,725
Add:				
Employee stock options and warrants	1,592	(1)	1,335	(1)
Common Units	5,171	(1)	5,280	(1)
Unvested restricted stock	224	(1)	102	(1)
Denominator for diluted earnings per share adjusted weighted average shares and assumed conversions	61,457	53,768	60,786	53,725
<b>Diluted earnings per share (1):</b>				
Income/(loss) from continuing operations	\$ 0.04	\$	\$ 0.15	\$ (0.07)
Income from discontinued operations	0.05	0.22	0.11	0.61
Net income	\$ 0.09	\$ 0.22	\$ 0.26	\$ 0.54

- (1) Pursuant to SFAS No. 128, income/(loss) from continuing operations, after preferred dividends and Preferred Stock redemption charge, is the controlling number in determining whether potential common shares are dilutive or antidilutive. Because such potential common shares would be antidilutive to loss from continuing operations allocable to common stockholders, diluted earnings per share is the same as basic earnings per share for the three and nine months ended September 30, 2005. Potential common shares include stock options, warrants, shares issuable upon conversions of Common Units and unvested restricted shares, and would have amounted to approximately 6.7 million shares and 6.6 million shares in the three and nine months ended September 30, 2005, respectively. In addition, potential common shares that would have been antidilutive due to the option or warrant exercise price being less than the average stock price for the periods reported were approximately 0.9 million shares for the three months ended September 30, 2005 and 0.08 million shares and 1.7 million shares for the nine months ended September 30, 2006 and 2005, respectively. The amount of shares reported for the three

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months ended September 30, 2006 that would have been anti-dilutive due to the option or warrant exercise price being less than the average stock price for the period was immaterial.



**HIGHWOODS PROPERTIES, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(tabular dollar amounts in thousands, except per share data)

**12. COMMITMENTS AND CONTINGENCIES****Concentration of Credit Risk**

The Company maintains its cash and cash equivalent investments and its restricted cash at financial institutions. The combined account balances at each institution typically exceed FDIC insurance coverage and, as a result, there is a concentration of credit risk related to amounts on deposit in excess of FDIC insurance coverage.

**Land Leases**

Certain properties in the Company's wholly owned portfolio are subject to land leases expiring through 2082. Rental payments on these leases are adjusted annually based on either the consumer price index (CPI) or on a pre-determined schedule. Land leases subject to increases under a pre-determined schedule are accounted for under the straight-line method.

For four properties, the Company has the option to purchase the leased land during the lease term, three options at the greater of 85.0% of appraised value or approximately \$30,000 per acre, and one option at an initial stated purchase price of \$1.0 million, which increases 2% per year beginning in year five through the ninety-ninth year of the lease.

As of September 30, 2006, the Company's payment obligations for future minimum payments on operating leases (which include scheduled fixed increases, but exclude increases based on CPI) were as follows:

Remainder of 2006	\$ 271
2007	1,048
2008	1,064
2009	1,105
2010	1,123
Thereafter	46,256
	\$ 50,867

**Capital Expenditures**

The Company incurs capital expenditures to lease space to its customers, maintain the quality of its existing properties and build new properties. Capital expenditures include tenant improvements, building improvements, new building completion costs and land infrastructure costs. Tenant improvements are the costs required to customize space for the specific needs of first-generation and second-generation customers. Building improvements are recurring capital costs not related to a specific customer to maintain existing buildings. New building completion costs are expenses for the construction of new buildings. Land infrastructure costs are expenses to prepare development land for future development activity that is not specifically related to a single building. Excluding recurring capital expenditures for leasing costs and tenant improvements and for normal building improvements, the Company's expected future capital expenditures for started and/or committed new development projects as of October 19, 2006 are approximately \$280 million, which includes several projects started or committed after December 31, 2005. A significant portion of these future expenditures are currently subject to binding contractual arrangements.

**Environmental Matters**

Substantially all of the Company's in-service properties have been subjected to Phase I environmental assessments (and, in certain instances, Phase II environmental assessments). Such assessments and/or updates have not revealed, nor is management aware of, any environmental liability that management believes would have a material adverse effect on the accompanying Condensed Consolidated Financial Statements.



## HIGHWOODS PROPERTIES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(tabular dollar amounts in thousands, except per share data)

## 12. COMMITMENTS AND CONTINGENCIES - Continued

## Joint Ventures

Most of the Company's joint venture agreements with unaffiliated parties have buy/sell options that may be exercised to acquire the other partner's interest by either the Company or its joint venture partner if certain conditions are met as set forth in the respective joint venture agreement.

## Guarantees and Other Obligations

The following is a tabular presentation and related discussion of various guarantees and other obligations as of September 30, 2006:

Entity or Transaction	Type of Guarantee or Other Obligation	Amount Recorded/Deferred	Date Guarantee Expires
Des Moines Joint Ventures (1),(6)	Debt	\$	Various through 11/2015
RRHWoods, LLC (2),(7)	Indirect Debt (4)	\$ 704	8/2006
Plaza Colonnade (2),(8)	Indirect Debt (4)	\$ 51	12/2009
SF-HIW Harborview, LP (3),(5)	Rent and tenant improvement (4)	\$	9/2007
Eastshore (Capital One) (3),(9)	Rent (4)	\$ 5,169	11/2007
Industrial (3),(10)	Rent (4)	\$ 105	12/2006
Industrial Environmental (3),(10)	Rent and environmental costs (4)	\$ 125	Until Remediated
Highwoods DLF 97/26 DLF 99/32, LP (2),(11)	Rent (4)	\$ 504	6/2008
RRHWoods, LLC and Dallas County Partners (2),(12)	Indirect Debt (4)	\$ 104	6/2014
RRHWoods, LLC (2),(14)	Indirect Debt (4)	\$ 63	11/2009
HIW-KC Orlando, LLC (3),(13)	Rent (4)	\$ 443	4/2011
HIW-KC Orlando, LLC (3),(13)	Leasing Costs	\$ 356	12/2024

- (1) Represents guarantees entered into prior to the January 1, 2003 effective date of FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45) for initial recognition and measurement.
- (2) Represents guarantees that fall under the initial recognition and measurement requirements of FIN 45.
- (3) Represents guarantees that are excluded from the fair value accounting and disclosure provisions of FIN 45 because the existence of such guarantees prevents sale treatment and/or the recognition of profit from the sale transaction.
- (4) The maximum potential amount of future payments disclosed for these guarantees assumes the Company pays the maximum possible liability under the guaranty with no offsets or reductions. If the space is leased, it assumes the existing tenant defaults at September 30, 2006 and the space remains unleased through the remainder of the guaranty term. If the space is vacant, it assumes the space remains vacant through the expiration of the guaranty. Since it is assumed that no new tenant will occupy the space, lease commissions, if applicable, are excluded.
- (5) As more fully described in Note 3 to the Consolidated Financial Statements in our 2005 Annual Report on Form 10-K, in 2002 the Company granted its partner in SF-HIW Harborview, LP a put option and entered into a master lease arrangement for five years covering vacant space in the building owned by the partnership. The Company also agreed to pay certain tenant improvement costs. The maximum potential amount of future payments the Company could be required to make related to the rent guarantees and tenant improvements was \$0.4 million as of September 30, 2006.



## HIGHWOODS PROPERTIES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(tabular dollar amounts in thousands, except per share data)

## 12. COMMITMENTS AND CONTINGENCIES - Continued

- (6) The Company has guaranteed certain loans in connection with the Des Moines joint ventures. The maximum potential amount of future payments the Company could have been required to make under the guarantees was \$14.0 million at September 30, 2006. Of this amount, \$8.6 million arose from housing revenue bonds that require credit enhancements in addition to the real estate mortgages. The bonds bear a floating interest rate, which at September 30, 2006 averaged approximately 3.63%, and mature in 2015. A guarantee of \$5.4 million will expire upon an industrial building becoming 95.0% leased or when the related loan matures. As of September 30, 2006, this building was 94.9% leased. If the joint ventures are unable to repay the outstanding balances under the loans that remain outstanding, the Company will be required, under the terms of the agreements, to repay the outstanding balances. Recourse provisions exist to enable the Company to recover some or all of such payments from the joint ventures' assets and/or the other partners. The joint ventures currently generate sufficient cash flow to cover the debt service required by the loans. On July 31, 2006, \$6.0 million in loans related to four office buildings that had been previously guaranteed by the Company were refinanced with no guarantee.
- (7) In connection with the RRHWoods, LLC joint venture, the Company guaranteed \$3.1 million of debt. The term of the letter of credit and corresponding master lease is four years. The agreement requires the Company to pay under a contingent master lease if the cash flows from the building securing the letter of credit do not cover at least 50% of the minimum debt service. The letter of credit along with the building secure the industrial revenue bonds used to finance the property. These bonds mature in 2015. Recourse provisions exist such that the Company could recover some or all of the payments made under the letter of credit guarantee from the joint venture's assets. The Company recorded a \$0.7 million deferred charge included in other assets and liabilities on its Consolidated Balance Sheet with respect to this guarantee. The Company's maximum potential exposure under this guarantee is \$3.1 million.
- (8) The Plaza Colonnade, LLC joint venture has a \$50 million non-recourse mortgage that bears a fixed interest rate of 5.7%, requires monthly principal and interest payments and matures on January 31, 2017. The Company and its joint venture partner have signed a contingent master lease limited to 30,772 square feet for five years. The Company's maximum exposure under this master lease was \$1.4 million at September 30, 2006. However, the current occupancy level of the building is sufficient to cover all debt service requirements. On March 30, 2004, the Industrial Development Authority of the City of Kansas City, Missouri issued \$18.5 million in non-recourse bonds to finance public improvements made by the joint venture for the benefit of the Kansas City Missouri Public Library. Since the joint venture leases the land for the office building from the library, the joint venture was obligated to build certain public improvements. The net bond proceeds were \$18.1 million and will be used for project and debt service costs. The joint venture has recorded this obligation on its balance sheet. Cash proceeds from tax increment financing revenue generated by the building and its tenants are expected to be sufficient in the future to pay the required debt service on the bonds.
- (9) As more fully described in Note 3 to the Consolidated Financial Statements in our 2005 Annual Report on Form 10-K, in connection with the sale of three office buildings to a third party in 2002 (the Eastshore transaction), the Company agreed to guarantee rent shortfalls and re-tenanting costs for a five-year period of time from the date of sale (through November 2007). The Company's maximum exposure to loss under these agreements as of September 30, 2006 was \$5.2 million. These three buildings are currently leased to a single tenant, Capital One Services, Inc., a subsidiary of Capital One Financial Services, Inc., under leases that expire from May 2006 to March 2010. This transaction had been accounted for as a financing transaction and was recorded as a completed sale transaction in the third quarter of 2005 when the maximum exposure to loss under these guarantees became less than the related deferred gain; gain is being recognized beginning in the third quarter of 2005 as the maximum exposure under the guarantees is reduced.

## HIGHWOODS PROPERTIES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(tabular dollar amounts in thousands, except per share data)

## 12. COMMITMENTS AND CONTINGENCIES - Continued

- (10) In December 2003, the Company sold 1.9 million square feet of industrial property for \$58.4 million in cash, a \$5.0 million note receivable that bears interest at 12.0% and a \$1.7 million note receivable that bears interest at 8.0%. In addition, the Company agreed to guarantee, over various contingency periods through December 2006, any rent shortfalls on 16.3% of the rentable square feet of the industrial property, which is occupied by two tenants. The total gain as a result of the transaction was \$6.0 million. Because the terms of the notes required only interest payments to be made by the buyer until 2005, in accordance with SFAS No. 66, the entire \$6.0 million gain was deferred and offset against the note receivable on the balance sheet and the cost recovery method was being used for this transaction. On June 30, 2005, the Company agreed to modify the note receivable to reduce the amount due by \$0.3 million. The modified note balance and all accrued interest aggregating \$6.2 million, was paid in full on July 1, 2005. Because the maximum exposure to loss from the rent guarantee at July 1, 2005 was \$0.8 million, that amount of gain was deferred and \$4.3 million of the deferred gain was recognized at that date. As of September 30, 2006, \$0.1 million remains deferred, which represents the Company's contingent liability with respect to the guarantee. Additionally, as part of the sale, the Company agreed to indemnify and hold the buyer harmless with respect to environmental concerns on the property of up to \$0.1 million. As a result, \$0.1 million of the gain was deferred at the time of sale and will remain deferred until the environmental concerns are remediated.
- (11) In the Highwoods DLF 97/26 DLF 99/32, LP joint venture, a single tenant currently leases an entire building under a lease scheduled to expire on June 30, 2008. The tenant also leases space in other buildings owned by the Company. In conjunction with an overall restructuring of the tenant's leases with the Company and with this joint venture, the Company agreed to certain changes to the lease with the joint venture in September 2003. The modifications included allowing the tenant to vacate the premises on January 1, 2006, reducing the rent obligation by 50% and converting the net lease to a full service lease with the tenant liable for 50% of these costs at that time. In turn, the Company agreed to compensate the joint venture for any economic losses incurred as a result of these lease modifications. As of September 30, 2006, the Company has recorded approximately \$0.5 million in other liabilities and \$0.5 million as a deferred charge in other assets on its Consolidated Balance Sheet to account for the lease guarantee. However, should new tenants occupy the vacated space during the two and a half year guarantee period, the Company's liability under the guarantee would diminish. The Company's maximum potential amount of future payments with regard to this guarantee as of September 30, 2006 is \$0.9 million. No recourse provisions exist to enable the Company to recover any amounts paid to the joint venture under this lease guarantee arrangement.
- (12) RRHWoods, LLC and Dallas County Partners each developed a new office building in Des Moines, Iowa. On June 25, 2004, the joint ventures financed both buildings with a \$7.4 million ten-year loan from a lender. As an inducement to make the loan at a 6.3% long-term rate, the Company and its partner agreed to master lease the vacant space and each guaranteed \$0.8 million of the debt with limited recourse. As leasing improves, the guarantee obligations under the loan agreement diminish. As of September 30, 2006, no master lease payments were necessary. The Company currently has recorded \$0.1 million in other liabilities and \$0.1 million as a deferred charge included in other assets on its Condensed Consolidated Balance Sheet with respect to this guarantee. The maximum potential amount of future payments that the Company could be required to make based on the current leases in place is approximately \$3.1 million as of September 30, 2006. The likelihood of the Company paying on its \$0.8 million guarantee is remote since the joint venture currently satisfies the minimum debt coverage ratio and should the Company have to pay its portion of the guarantee, it would be entitled to recover the \$0.8 million from other joint venture assets.
- (13) In connection with the formation of HIW-KC Orlando, LLC, the Company agreed to guarantee rent to the joint venture for 3,248 rentable square feet commencing in August 2004 and expiring in April 2011. The Company's maximum potential amount of future payments with regard to the guarantee is \$0.4 million as of September 30, 2006. Additionally, the Company agreed to guarantee the initial leasing costs, originally estimated at \$4.1 million, for approximately 11% of the total square feet of the property owned by the joint venture. The Company has paid approximately \$0.3 million in the first nine months of 2006 and \$0.5 million in the first nine months of 2005 under this guarantee, and approximately \$0.4 million is estimated to remain under the guarantee at September 30, 2006.

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**HIGHWOODS PROPERTIES, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(tabular dollar amounts in thousands, except per share data)**

**12. COMMITMENTS AND CONTINGENCIES - Continued**

(14) In connection with the RRHWoods, LLC joint venture, the Company and its partner each guaranteed \$2.9 million to a bank. This guarantee expires in November 2009 and can be renewed, at the joint venture's option, through November 2011. The bank provides a letter of credit securing industrial revenue bonds, which mature in November 2015. The joint venture's industrial building secures the bonds. The Company would be required to perform under the guarantee should the joint venture be unable to repay the bonds. The Company has recourse provisions to recover from the joint venture's assets. The property collateralizing the bonds generates sufficient cash flow to cover the debt service required by the bond financing. In addition to the direct guarantee, the Company is committed to a master lease for 50% of the debt service should the cash flow from the property not be able to pay the debt service of the bonds. As a result of this master lease, the Company has recorded approximately \$60,000 in other liabilities and as a deferred charge in other assets on its Consolidated Balance Sheet at September 30, 2006.

Currently, RRHWoods, LLC is developing a new office building. In October 2006, the joint venture entered into a commitment to finance the development with a \$4.1 million ten-year loan from a lender. As part of the agreement, the Company and its partner agreed to each guarantee \$0.7 million until the building becomes 93.0% leased or when the related loan matures. Under the terms of the agreement, the Company will be required to pay on its guarantee should the joint venture be unable to repay the outstanding loan balance. However, the joint venture currently generates sufficient cash flows to cover the debt service required by the loan. Although the Company is still evaluating the impact of the guarantee, the Company does not expect a significant effect on its financial condition and results of operations.

**Litigation, Claims and Assessments**

The Company is from time to time a party to a variety of legal proceedings, claims and assessments arising in the ordinary course of its business. The Company regularly assesses the liabilities and contingencies in connection with these matters based on the latest information available. For those matters where it is probable that the Company has incurred or will incur a loss and the loss or range of loss can be reasonably estimated, reserves are recorded in the Consolidated Financial Statements. In other instances, because of the uncertainties related to both the probable outcome and amount or range of loss, a reasonable estimate of liability, if any, cannot be made. Based on the current expected outcome of such matters, none of these proceedings, claims or assessments is expected to have a material adverse effect on the Company's business, financial condition or results of operations.

In June, August, September and October 2006, the Company received assessments for state excise taxes and related interest amounting to approximately \$4.5 million, related to periods 2002 through 2004, and may receive additional assessments for later periods, which the Company estimates could aggregate an additional approximate \$1.1 million. The Company believes that it is not subject to such taxes and intends to vigorously dispute the assessment. Based on advice of counsel, the Company currently believes that any exposure for such taxes is not probable, and accordingly no provision for such taxes is reflected in the Company's financial statements.

As previously disclosed, the SEC's Division of Enforcement has issued a confidential formal order of investigation in connection with the Company's previous restatement of its financial results. Even though the Company is cooperating fully, it cannot provide any assurances that the SEC's Division of Enforcement will not take any action that would adversely affect the Company.

## HIGHWOODS PROPERTIES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(tabular dollar amounts in thousands, except per share data)

## 13. SEGMENT INFORMATION

The sole business of the Company is the acquisition, development and operation of rental real estate properties. The Company operates office, industrial and retail properties and apartment units. There are no material inter-segment transactions.

The Company's chief operating decision maker ( CDM ) assesses and measures operating results based upon property level net operating income. The operating results for the individual assets within each property type have been aggregated since the CDM evaluates operating results and allocates resources within the various property types.

All operations are within the United States and, at September 30, 2006, no tenant of the Wholly Owned Properties comprised more than 6.8% of the Company's consolidated revenues.

The following table summarizes the rental income, net operating income and assets for each reportable segment for the three and nine months ended September 30, 2006 and 2005:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
<b>Rental and Other Revenues (1):</b>				
Office segment	\$ 88,263	\$ 83,365	\$ 260,025	\$ 249,944
Industrial segment	7,401	6,967	21,896	20,956
Retail segment	10,322	9,440	31,096	29,246
Apartment segment	305	279	916	824
Total Rental and Other Revenues	\$ 106,291	\$ 100,051	\$ 313,933	\$ 300,970
<b>Net Operating Income (1):</b>				
Office segment	\$ 53,593	\$ 51,089	\$ 161,580	\$ 158,954
Industrial segment	5,517	5,317	16,670	15,839
Retail segment	6,957	6,509	20,684	20,350
Apartment segment	138	131	407	371
Total Net Operating Income	66,205	63,046	199,341	195,514
<b>Reconciliation to (loss)/income before disposition of property, minority interest and equity in earnings of unconsolidated affiliates:</b>				
Depreciation and amortization	(29,056)	(27,666)	(86,565)	(84,350)
Interest expense	(25,216)	(26,135)	(76,928)	(80,658)
Impairment of assets held for use	(2,600)	(4,415)	(2,600)	(7,587)
General and administrative expense	(8,546)	(7,513)	(26,298)	(23,859)
Interest and other income	1,189	2,119	4,336	5,453
Loss on debt extinguishment		(323)	(467)	(453)
Income/(loss) before disposition of property, minority interest and equity in earnings of unconsolidated affiliates	\$ 1,976	\$ (887)	\$ 10,819	\$ 4,060



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	September 30, 2006	December 31, 2005
<b>Total Assets (2):</b>		
Office segment	\$ 2,207,681	\$ 2,245,595
Industrial segment	198,159	226,199
Retail segment	257,474	259,544
Apartment segment	23,674	21,121
Corporate and other	140,718	156,519
<b>Total Assets</b>	<b>\$ 2,827,706</b>	<b>\$ 2,908,978</b>

- 
- (1) Net of discontinued operations.  
(2) Real estate and other assets held for sale are included in this table according to the segment type.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND**

**RESULTS OF OPERATIONS**

You should read the following discussion and analysis in conjunction with the accompanying Condensed Consolidated Financial Statements and related notes contained elsewhere in this Quarterly Report.

**DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS**

Some of the information in this Quarterly Report may contain forward-looking statements. Such statements include, in particular, statements about our plans, strategies and prospects under this section. You can identify forward-looking statements by our use of forward-looking terminology such as may, will, expect, anticipate, estimate, continue or other similar words. Although we believe that our plans, intentions or expectations reflected in or suggested by such forward-looking statements are reasonable, we cannot assure you that our plans, intentions or expectations will be achieved. When considering such forward-looking statements, you should keep in mind the following important factors that could cause our actual results to differ materially from those contained in any forward-looking statement:

speculative development activity by our competitors in our existing markets could result in an excessive supply of office, industrial and retail properties relative to tenant demand;

the financial condition of our tenants could deteriorate;

we may not be able to complete development, acquisition, reinvestment, disposition or joint venture projects as quickly or on as favorable terms as anticipated;

we may not be able to lease or release space quickly or on as favorable terms as old leases;

increases in interest rates would increase our debt service costs;

we may not be able to meet our liquidity requirements or obtain capital on favorable terms to fund our working capital needs and growth initiatives or to repay or refinance outstanding debt upon maturity;

we could lose key executive officers; and

our southeastern and midwestern markets may suffer unexpected declines in economic growth.

This list of risks and uncertainties, however, is not intended to be exhaustive. You should also review the other cautionary statements we make in **Business Risk Factors** set forth in our 2005 Annual Report.

Given these uncertainties, you should not place undue reliance on forward-looking statements. We undertake no obligation to publicly release the results of any revisions to these forward-looking statements to reflect any future events or circumstances or to reflect the occurrence of unanticipated events.

**OVERVIEW**

We are a fully integrated, self-administered and self-managed equity REIT that provides leasing, management, development, construction and other customer-related services for our properties and for third parties. As of September 30, 2006, we owned or had an interest in 414 in-service office, industrial and retail properties, encompassing 34.9 million square feet and 96 apartment units. As of that date, we also wholly owned 798

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acres of development land, of which 394 acres are considered core holdings. We are based in Raleigh, North Carolina, and our properties and development land are located in Florida, Georgia, Iowa, Kansas, Maryland, Missouri, North Carolina, South Carolina, Tennessee and Virginia. Additional information about us can be found on our website at [www.highwoods.com](http://www.highwoods.com). Information on our website is not part of this Quarterly Report.

## Results of Operations

Although we operate in the industrial, retail and apartment segments, our operating results depend heavily on our office segment. Furthermore, since more than a majority of our office properties are located in Florida, Georgia and North Carolina, economic growth in those states is and will continue to be an important determinative factor in predicting our future operating results. Accordingly, most of the analysis and comments below focus on our office segment properties.

The key components affecting our rental revenue stream are dispositions, acquisitions, new developments placed in service, average occupancy and rental rates. Average occupancy generally increases during times of improving economic growth, as our ability to lease space outpaces vacancies that occur upon the expirations of existing leases. Average occupancy generally declines during times of slower economic growth, when new vacancies tend to outpace our ability to lease space. Asset acquisitions, dispositions and new developments placed in service directly impact our rental revenues and could impact our average occupancy, depending upon the occupancy rate of the properties that are acquired, sold or placed in service. A further indicator of the predictability of future revenues is the expected lease expirations of our portfolio. As a result, in addition to seeking to increase our average occupancy by leasing current vacant space, we also must concentrate our leasing efforts on renewing leases on expiring space. Whether or not our rental revenue tracks average occupancy proportionally depends upon whether rents under new leases signed are higher or lower than the rents under the previous leases.

Our expenses primarily consist of rental property expenses, depreciation and amortization, general and administrative expenses and interest expense. Rental property expenses are expenses associated with our ownership and operation of rental properties and include variable expenses, such as common area maintenance and utilities, and relatively fixed expenses, such as property taxes and insurance. Some of these variable expenses may be lower when our average occupancy declines. Fixed expenses remain relatively constant regardless of average occupancy. Depreciation and amortization is a non-cash expense associated with the ownership of real property and generally remains relatively consistent each year, unless we buy or sell assets, since we depreciate our properties on a straight-line basis over fixed lives. General and administrative expenses, net of amounts capitalized, consist primarily of management and employee salaries and other personnel costs, corporate and division overhead and long-term incentive compensation. Interest expense depends primarily upon the amount of our borrowings, the weighted average interest rates on our debt and the amount of interest capitalized on development projects.

We record in equity in earnings of unconsolidated affiliates our proportionate share of net income or loss, adjusted for purchase accounting effects, of our unconsolidated joint ventures.

Additionally, SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, requires us to record net income received from properties sold or held for sale that qualify as discontinued operations under SFAS No. 144 separately as income from discontinued operations. As a result, we separately record revenues and expenses from these qualifying properties. As also required by SFAS No. 144, prior period results are reclassified to reflect the operations for such properties in discontinued operations.

## Liquidity and Capital Resources

We incur capital expenditures to lease space to our customers and to maintain the quality of our properties to successfully compete against other properties. Tenant improvements are the costs required to customize the space for the specific needs of the customer. Lease commissions are costs incurred to find the customer for the space. Lease incentives are costs paid to or on behalf of tenants to induce them to enter into leases and that do not relate to customizing the space for the tenant's specific needs. Building improvements are recurring capital costs not related to a customer to maintain the buildings. As leases expire, we either attempt to relet the space to an existing customer or attract a new customer to occupy the space. Generally, customer renewals require lower leasing capital expenditures than reletting to new customers. However, market conditions such as supply of available space in the market, as well as demand for space, drive not only customer rental rates but also tenant improvement costs. Leasing capital expenditures are amortized over the initial term of the lease and building improvements are depreciated over the appropriate useful life of the assets acquired. Both are included in depreciation and amortization in results of operations.

Because we are a REIT, we are required under the federal tax laws to distribute at least 90% of our REIT taxable income, excluding capital gains, to our stockholders. We generally use rents received from customers and proceeds from sales of non-core development land to fund our operating expenses, recurring capital expenditures and stockholder dividends. To fund property acquisitions, development activity or building renovations, we may sell other assets and may incur debt from time to time. Our debt generally consists of mortgage debt, unsecured debt securities and borrowings under our revolving credit facility.

Our revolving credit facility and the indenture governing our outstanding long-term unsecured debt securities require us to satisfy various operating and financial covenants and performance ratios. As a result, to ensure that we do not violate the provisions of these debt instruments, we may from time to time be limited in undertaking certain activities that may otherwise be in the best interest of our stockholders, such as repurchasing capital stock, acquiring additional assets, increasing the total amount of our debt or increasing stockholder dividends. We review our current and expected operating results, financial condition and planned strategic actions on an ongoing basis for the purpose of monitoring our continued compliance with these covenants and ratios. Any unwaived event of default could result in an acceleration of some or all of our debt, severely restrict our ability to incur additional debt to fund short- and long-term cash needs or result in higher interest expense.

To generate additional capital to fund our growth and other strategic initiatives and to lessen the risks typically associated with owning all of the interests in a property, we may sell or contribute some of our properties to joint ventures. When we create a joint venture with a strategic partner, we usually contribute one or more properties and/or vacant land to a newly formed entity in which we retain an equal or less than a majority interest. In exchange for our interest in the joint venture, we generally receive cash from the partner and retain some or all of the management income relating to the properties in the joint venture. The joint venture itself will frequently borrow money on its own behalf to finance the acquisition of, and/or leverage the return upon, the properties being acquired by the joint venture or to build or acquire additional buildings. Such borrowings are typically on a non-recourse or limited recourse basis. We generally are not liable for the debts of our joint ventures, except to the extent of our equity investment, unless we have directly guaranteed any of that debt. In most cases, we and/or our strategic partners are required to guarantee customary exceptions to non-recourse liability in non-recourse loans.

We have historically also sold additional Common Stock or Preferred Stock or issued Common Units to fund additional growth or to reduce our debt, but we have limited those efforts since 1998 because funds generated from our capital recycling program in recent years have provided sufficient funds to satisfy our liquidity needs. In addition, we have recently used funds from our capital recycling program to redeem Common Units and Preferred Stock for cash.

## RESULTS OF OPERATIONS

In accordance with SFAS No. 144 and as described in Note 10 to the Condensed Consolidated Financial Statements, we reclassified the operations and/or gain/(loss) from disposal of certain properties to discontinued operations for all periods presented if the operations and cash flows have been or will be eliminated from our ongoing operations and we will not have any significant continuing involvement in the operations after the disposal transaction and the properties were either sold during 2005 and the first nine months of 2006 or were held for sale at September 30, 2006. Accordingly, any properties sold during 2005 and the first nine months of 2006 that did not meet certain conditions as stipulated by SFAS No. 144 were not reclassified to discontinued operations.

**Three Months Ended September 30, 2006 and 2005**

The following table sets forth information regarding our unaudited results of operations for the three months ended September 30, 2006 and 2005 (in millions):

	Three Months Ended September 30,		\$ Change	% of Change
	2006	2005		
<b>Rental and other revenues</b>	\$ 106.3	\$ 100.1	\$ 6.2	6.2%
<b>Operating expenses:</b>				
Rental property and other expenses	40.1	37.0	3.1	8.4
Depreciation and amortization	29.0	27.7	1.3	4.7
Impairment of assets held for use	2.6	4.4	(1.8)	(40.9)
General and administrative	8.5	7.5	1.0	13.3
<b>Total operating expenses</b>	<b>80.2</b>	<b>76.6</b>	<b>3.6</b>	<b>4.7</b>
<b>Interest expense:</b>				
Contractual	23.8	24.2	(0.4)	(1.7)
Amortization of deferred financing costs	0.6	0.8	(0.2)	(25.0)
Financing obligations	0.8	1.1	(0.3)	(27.3)
	25.2	26.1	(0.9)	(3.4)
<b>Other income/(expense):</b>				
Interest and other income	1.1	2.1	(1.0)	(47.6)
Loss on debt extinguishments		(0.3)	0.3	100.0
	1.1	1.8	(0.7)	(38.9)
<b>Income/(loss) before disposition of property, minority interest and equity in earnings of unconsolidated affiliates</b>	<b>2.0</b>	<b>(0.8)</b>	<b>2.8</b>	<b>350.0</b>
Gains on disposition of property, net	3.0	9.7	(6.7)	(69.1)
Minority interest	(0.3)		(0.3)	(100.0)
Equity in earnings of unconsolidated affiliates	1.3	2.1	(0.8)	(38.1)
<b>Income from continuing operations</b>	<b>6.0</b>	<b>11.0</b>	<b>(5.0)</b>	<b>(45.5)</b>
<b>Discontinued operations:</b>				
Income from discontinued operations, net of minority interest	0.3	1.8	(1.5)	(83.3)
Net gains on sale and impairments of discontinued operations, net of minority interest	2.6	10.1	(7.5)	(74.3)
	2.9	11.9	(9.0)	(75.6)
<b>Net income</b>	<b>8.9</b>	<b>22.9</b>	<b>(14.0)</b>	<b>(61.1)</b>
Dividends on Preferred Stock	(4.1)	(6.7)	2.6	38.8
Excess of Preferred Stock redemption cost over carrying value		(4.3)	4.3	100.0
<b>Net income available for common stockholders</b>	<b>\$ 4.8</b>	<b>\$ 11.9</b>	<b>\$ (7.1)</b>	<b>(59.7)%</b>

***Rental and Other Revenues***

The increase in rental and other revenues from continuing operations was primarily the result of higher average occupancy in 2006 as compared to 2005, the contribution from developed properties placed in service in the later part of 2005 and the first nine months of 2006 and the consolidation of the Markel joint venture effective January 1, 2006, as discussed in Note 1 to the Consolidated Financial Statements. These increases were partly offset by an approximate \$0.5 million decrease in lease termination fees from 2005 to 2006 and the disposition of certain properties that did not meet the criteria to be classified as discontinued operations.

### ***Operating Expenses***

Rental and other operating expenses from continuing operations (real estate taxes, utilities, insurance, repairs and maintenance and other property-related expenses) increased \$3.1 million in the third quarter of 2006 compared to the third quarter of 2005, primarily as a result of general inflationary increases in certain operating expenses, such as salaries, benefits, utility costs and real estate taxes, expenses of developed properties placed in service in the second half of 2005 and the nine months ended September 30, 2006 and the consolidation of the Markel joint venture effective January 1, 2006, as discussed in Note 1 to the Consolidated Financial Statements. These increases were partly offset by a decrease in operating expenses as a result of the disposition of certain properties that did not meet the criteria to be classified as discontinued operations.

Rental revenues less rental and other operating expenses increased in 2006 compared to 2005. However, although the Company recovers a portion of operating costs from its tenants, which recoveries are included in rental revenues, operating costs in 2006 increased proportionately more than revenues increased, resulting in a reduction in the percentage of rental revenues less rental and other operating expenses to rental revenues compared to 2005.

The increase in depreciation and amortization is primarily a result of the contribution from developed properties placed in service in the later part of 2005 and the nine months ended September 30, 2006 and the consolidation of the Markel joint venture effective January 1, 2006, as discussed in Note 1 to the Consolidated Financial Statements. These increases were partly offset by a decrease related to the disposition of certain properties that did not meet the criteria to be classified as discontinued operations.

During the third quarter 2006, impairment of \$2.6 million was recorded with respect to an operating property with indicators of impairment where the carrying value exceeded the sum of estimated undiscounted future cash flows. During the third quarter of 2005, impairment of \$4.4 million was recorded with respect to an operating property with indicators of impairment where the carrying value exceeded the sum of estimated undiscounted future cash flows.

The \$1.0 million increase in general and administrative expenses was primarily related to higher long-term incentive compensation costs and higher salary and fringe benefit costs from annual employee wage and salary increases and inflationary effects.

### ***Interest Expense***

The decrease in contractual interest was primarily due to a decrease in average borrowings from \$1.6 billion in the three months ended September 30, 2005 to \$1.5 billion in the three months ended September 30, 2006, partially offset by an increase in weighted average interest rates on outstanding debt from 6.6% in the three months ended September 30, 2005 to 7.1% in the three months ended September 30, 2006. In addition, capitalized interest in the three months ended September 30, 2006 was approximately \$0.9 million higher compared to the three months ended September 30, 2005 due to our increased development activity.

The decrease in amortization of deferred financing costs was primarily related to obtaining the new revolving credit facility in May 2006, as discussed further in the Note 5 to the Consolidated Financial Statements, resulting in a reduction of amortization of deferred financing costs of approximately \$0.2 million from 2005 to 2006.

Interest from financing obligations decreased from the completed sale of three buildings in Richmond, Virginia (the Eastshore transaction) in the third quarter of 2005 and the elimination of the related financing obligation, which was offset by higher financing obligations in 2006 related to the SF-HIW Harborview LP.

### ***Gains on Disposition of Property; Minority Interest; Equity in Earnings of Unconsolidated Affiliates***

Net gains on dispositions of properties not classified as discontinued operations were \$3.0 million in the three months ended September 30, 2006 compared to \$9.7 million for the three months ended September 30, 2005. Gains are dependent on the specific assets sold, their historical cost basis and other factors, and can vary significantly from period to period.



The increase in minority interest expense of \$0.3 million was primarily due to (1) a corresponding increase in the Operating Partnership's income from continuing operations, after Preferred Unit distributions, and (2) the minority interest expense from the Markel joint venture.

Equity in earnings of unconsolidated affiliates decreased \$0.8 million from 2005. The decrease was primarily a result of the change in accounting for the Markel joint venture from equity method to consolidation effective January 1, 2006, as described in Note 1 to the Consolidated Financial Statements. This joint venture contributed \$0.2 million to equity in earnings of unconsolidated affiliates during the third quarter of 2005. In addition, equity in earnings of unconsolidated affiliates was approximately \$0.6 million lower during the third quarter of 2006 due to losses on debt extinguishment for certain joint ventures, which resulted from debt refinancing.

#### ***Discontinued Operations***

In accordance with SFAS No. 144, we classified net income of \$2.9 million and \$11.9 million, net of minority interest, as discontinued operations for the three months ended September 30, 2006 and 2005, respectively. These amounts relate to 6.9 million square feet of office and industrial property and 46 apartment units sold during 2005 and the third quarter of 2006 and 0.2 million square feet of property and 156 apartment units held for sale at September 30, 2006. These amounts include net gains on the sale of these properties of \$2.6 million and \$10.1 million, net of minority interest, in the three months ended September 30, 2006 and 2005, respectively.

#### ***Net Income***

We recorded net income in the three months ended September 30, 2006 of \$8.9 million, compared to \$22.9 million in the three months ended September 30, 2005, resulting from the various factors described above.

#### ***Preferred Dividends***

Preferred dividends decreased \$2.6 million due to redemptions of \$130 million and \$50 million in the third quarter of 2005 and the first quarter of 2006, respectively.

#### ***Net Income Available for Common Stockholders***

We recorded net income available for common stockholders in the three months ended September 30, 2006 of \$4.8 million, compared to \$11.9 million in the three months ended September 30, 2005; this decrease is the net result of the various factors described above.

**Nine Months Ended September 30, 2006 and 2005**

The following table sets forth information regarding our unaudited results of operations for the nine months ended September 30, 2006 and 2005 (in millions):

	<b>Nine Months Ended September 30,</b>		<b>% of</b>	
	<b>2006</b>	<b>2005</b>	<b>\$ Change</b>	<b>Change</b>
<b>Rental and other revenues</b>	\$ 313.9	\$ 300.9	\$ 13.0	4.3%
<b>Operating expenses:</b>				
Rental property and other expenses	114.6	105.4	9.2	8.7
Depreciation and amortization	86.6	84.4	2.2	2.6
Impairment of assets held for use	2.6	7.6	(5.0)	(65.8)
General and administrative	26.2	23.8	2.4	10.1
<b>Total operating expenses</b>	<b>230.0</b>	<b>221.2</b>	<b>8.8</b>	<b>4.0</b>
<b>Interest expense:</b>				
Contractual	71.8	74.0	(2.2)	(3.0)
Amortization of deferred financing costs	1.9	2.5	(0.6)	(24.0)
Financing obligations	3.2	4.1	(0.9)	(22.0)
	76.9	80.6	(3.7)	(4.6)
<b>Other income/(expense):</b>				
Interest and other income	4.3	5.5	(1.2)	(21.8)
Loss on debt extinguishments	(0.5)	(0.5)		
	3.8	5.0	(1.2)	(24.0)
<b>Income before disposition of property, minority interest and equity in earnings of unconsolidated affiliates</b>	<b>10.8</b>	<b>4.1</b>	<b>6.7</b>	<b>163.4</b>
Gains on disposition of property, net	8.3	11.5	(3.2)	(27.8)
Minority interest	(1.2)	0.4	(1.6)	(400.0)
Equity in earnings of unconsolidated affiliates	5.3	6.9	(1.6)	(23.2)
<b>Income from continuing operations</b>	<b>23.2</b>	<b>22.9</b>	<b>0.3</b>	<b>1.3</b>
Discontinued operations:				
Income from discontinued operations, net of minority interest	1.5	7.7	(6.2)	(80.5)
Net gains on sale and impairments of discontinued operations, net of minority interest	4.6	24.9	(20.3)	(81.5)
	6.1	32.6	(26.5)	(81.3)
<b>Net income</b>	<b>29.3</b>	<b>55.5</b>	<b>(26.2)</b>	<b>(47.2)</b>
Dividends on Preferred Stock	(12.9)	(22.1)	9.2	41.6
Excess of Preferred Stock redemption cost over carrying value	(1.8)	(4.3)	2.5	58.1
<b>Net income available for common stockholders</b>	<b>\$ 14.6</b>	<b>\$ 29.1</b>	<b>\$ (14.5)</b>	<b>(49.8)%</b>

**Rental and Other Revenues**

The increase in rental and other revenues from continuing operations was primarily the result of higher average occupancy in 2006 as compared to 2005, the contribution from developed properties placed in service in the later part of 2005 and the first nine months of 2006 and the consolidation of the Markel joint venture effective January 1, 2006, as discussed in Note 1 to the Consolidated Financial Statements. These increases were partly offset by an approximate \$3.0 million decrease in lease termination fees from 2005 to 2006 and the disposition of certain properties that did not meet the criteria to be classified as discontinued operations including the recognition of Eastshore as a completed sale which occurred in the third quarter of 2005.

*Operating Expenses*

Rental and other operating expenses from continuing operations (real estate taxes, utilities, insurance, repairs and maintenance and other property-related expenses) increased \$9.2 million in the nine months ended September 31, 2006 compared to the nine months ended September 30, 2005, primarily as a result of general inflationary increases in certain operating expenses, such as salaries, benefits, utility costs and real estate taxes, expenses of developed properties placed in service in the second half of 2005 and the consolidation of the Market

joint venture effective January 1, 2006, as discussed in Note 1 to the Consolidated Financial Statements. These increases were partly offset by a decrease in operating expenses as a result of the disposition of certain properties that did not meet the criteria to be classified as discontinued operations including the recognition of Eastshore as a completed sale which occurred in the third quarter of 2005.

Rental revenues less rental and other operating expenses increased in 2006 compared to 2005. However, although the Company recovers a portion of operating costs from its tenants, which recoveries are included in rental revenues, operating costs in 2006 increased proportionately more than revenues increased, resulting in a reduction in the percentage of rental revenues less rental and other operating expenses to rental revenues compared to 2005.

The increase in depreciation and amortization is primarily a result of the contribution from developed properties placed in service in the later part of 2005 and the first nine months of 2006 and the consolidation of the Markel joint venture effective January 1, 2006, as discussed in Note 1 to the Consolidated Financial Statements. These increases were partly offset by a decrease related to the disposition of certain properties that did not meet the criteria to be classified as discontinued operations including the recognition of Eastshore as a completed sale which occurred in the third quarter of 2005.

For the nine months ended September 30, 2006, one property had indicators of impairment where the carrying value exceeded the sum of the estimated undiscounted future cash flows. Therefore, an impairment loss of \$2.6 million was recorded in the nine months ended September 30, 2006. For the nine months ended September 30, 2005, one land parcel had indicators of impairment where the carrying value exceeded the sum of estimated undiscounted future cash flows. Therefore, an impairment loss of \$3.2 million was recorded in the nine months ended September 30, 2005. During the nine months ended September 30, 2005, impairment of \$4.4 million was recorded with respect to an additional operating property with indicators of impairment.

The \$2.4 million increase in general and administrative expenses was primarily related to higher long-term incentive compensation costs, higher phantom stock costs related to deferred compensation, higher salary and fringe benefit costs from annual employee wage and salary increases, inflationary effects on other general and administrative expenses and costs related to the retirement of a certain officer at June 30, 2006.

#### ***Interest Expense***

The decrease in contractual interest was primarily due to a decrease in average borrowings from \$1.5 billion in the nine months ended September 30, 2005 to \$1.4 billion in the nine months ended September 30, 2006, partially offset by an increase in weighted average interest rates on outstanding debt from 6.7% in the nine months ended September 30, 2005 to 7.0% in the nine months ended September 30, 2006. In addition, capitalized interest in 2006 was approximately \$1.1 million higher compared to 2005 due to increased development activity and higher average construction and development costs.

The decrease in amortization of deferred financing costs was primarily related to obtaining the new revolving credit facility in May 2006, as discussed further in the Note 5 to the Consolidated Financial Statements, resulting in a reduction of amortization of deferred financing costs of approximately \$0.6 million from 2005 to 2006.

The decrease in interest from financing obligations was primarily a result of the completed sale of three buildings in Richmond, Virginia (the Eastshore transaction) in the third quarter of 2005 and the elimination of the related financing obligation. Partly offsetting this decrease was an increase in 2006 related to the SF-HIW Harborview LP.

#### ***Gains on Disposition of Property; Minority Interest; Equity in Earnings of Unconsolidated Affiliates***

Net gains on dispositions of properties, net, not classified as discontinued operations were \$8.3 million in the nine months ended September 30, 2006 compared to \$11.5 million for the nine months ended September 30, 2005. Gains are dependent on the specific assets sold, their historical cost basis and other factors, and can vary significantly from period to period.

The change in minority interest in the continuing operations, after Preferred Unit distributions, was primarily due to (1) a corresponding decrease in the Operating Partnership's income from continuing operations, after Preferred Unit distributions, in 2006 versus a loss in 2005, and (2) the minority interest expense from the Markel joint venture.

Equity in earnings of unconsolidated affiliates decreased \$1.6 million from 2005. The Markel joint venture contributed \$0.6 million to equity in earnings of unconsolidated affiliates during the nine months ended September 30, 2005; the accounting for this joint venture changed from equity method to consolidation effective January 1, 2006, as described in Note 1 to the Consolidated Financial Statements. In addition, the Plaza Colonnade LLC joint venture provided an additional \$0.6 million in earnings during 2005 due to the application of FAS 67 and the related adjustments for capitalized interest. Furthermore, equity in earnings was \$0.7 million lower during the nine months ended September 30, 2006 due to losses on debt extinguishment for certain joint ventures, which resulted from debt refinancings, offset by common area maintenance true ups in various joint ventures, which contributed approximately \$0.2 million of additional equity in earnings of unconsolidated affiliates through the nine months ended September 30, 2006.

***Discontinued Operations***

In accordance with SFAS No. 144, we classified net income of \$6.1 million and \$32.6 million, net of minority interest, as discontinued operations for the nine months ended September 30, 2006 and 2005, respectively. These amounts relate to 6.9 million square feet of office and industrial property and 46 apartment units sold during 2005 and the first nine months of 2006 and 0.2 million square feet of property and 156 apartment units held for sale at September 30, 2006. These amounts include net gains on the sale of these properties of \$4.6 million and \$24.9 million, net of minority interest, in the nine months ended September 30, 2006 and 2005, respectively.

***Net Income***

We recorded net income in the nine months ended September 30, 2006 of \$29.3 million, compared to \$55.5 million in the nine months ended September 30, 2005, resulting from the various factors described above.

***Preferred Dividends***

Preferred dividends decreased \$9.2 million due to redemptions of \$130 million and \$50 million in the third quarter of 2005 and the first quarter of 2006, respectively. The excess of redemption cost over carrying value of \$1.8 million in 2006 relates to the \$50 million Preferred Stock redemption in the first quarter of 2006.

***Net Income Available for Common Stockholders***

We recorded net income available for common stockholders in the nine months ended September 30, 2006 of \$14.6 million, compared to \$29.1 million in the nine months ended September 30, 2005; this decrease is the net result of the various factors described above.

## LIQUIDITY AND CAPITAL RESOURCES

## Statement of Cash Flows

As required by GAAP, we report and analyze our cash flows based on operating activities, investing activities and financing activities. The following table sets forth the changes in our cash flows in the first nine months of 2006 as compared to the first nine months of 2005 (in thousands):

	Nine Months Ended September 30,		
	2006	2005	Change
Cash Provided By Operating Activities	\$ 109,175	\$ 122,263	\$ (13,088)
Cash Provided By Investing Activities	78,689	226,830	(148,141)
Cash Used In Financing Activities	(181,552)	(372,929)	191,377
Total Cash Flows	\$ 6,312	\$ (23,836)	\$ 30,148

In calculating cash flow from operating activities, GAAP requires us to add depreciation and amortization, which are non-cash expenses, back to net income. As a result, we have historically generated a significant positive amount of cash from operating activities. From period to period, cash flow from operations depends primarily upon changes in our net income, as discussed more fully above under Results of Operations, changes in receivables and payables, and net additions or decreases in our overall portfolio, which affect the amount of depreciation and amortization expense.

Cash provided by or used in investing activities generally relates to capitalized costs incurred for leasing and major building improvements, and our acquisition, development, disposition and joint venture activity. During periods of significant net acquisition and/or development activity, our cash used in such investing activities will generally exceed cash provided by investing activities, which typically consists of cash received upon the sale of properties and distributions of capital from our joint ventures.

Cash used in financing activities generally relates to stockholder dividends, distributions on Common Units, incurrence and repayment of debt and sales, repurchases or redemptions of Common Stock, Common Units and Preferred Stock. As discussed previously, we use a significant amount of our cash to fund stockholder dividends and Common Unit distributions. Whether or not we incur significant new debt during a period depends generally upon the net effect of our acquisition, disposition, development and joint venture activity. We use our revolving credit facility for working capital purposes, which means that during any given period, in order to minimize interest expense associated with balances outstanding under our revolving credit facility, we will likely record significant repayments and borrowings under our revolving credit facility.

The decrease of \$13.1 million in cash provided by operating activities in the nine months ended September 30, 2006 compared to the same period in 2005 was primarily the result of lower cash flows from net income adjusted for changes in depreciation and gains and impairments, partially offset by a \$1.6 million increase from net changes in operating assets and liabilities.

The decrease of \$148.1 million in cash provided by investing activities in the nine months ended September 30, 2006 compared to the same period in 2005 was primarily a result of a \$156.1 million decrease in proceeds from dispositions of real estate assets and an \$11.1 million increase in additions to real estate assets and deferred leasing costs. Partly offsetting these decreases was an increase of \$12.4 million in other investing activities that resulted from a collateral substitution on a certain secured note, pursuant to which the lender returned \$11.8 million in restricted cash and property and an increase of \$9.2 million in distributions of capital from unconsolidated affiliates as a result of a refinancing of debt, as described in Note 2 to the Consolidated Financial Statements.

The decrease of \$191.4 million in cash used in financing activities in the nine months ended September 30, 2006 was primarily a result of a decrease of \$80.0 million in redemptions of Preferred Stock from 2005 to 2006, an \$84.3 million increase in net borrowings on our revolving credit facility and mortgages and notes payable, a decrease of \$9.2 million in preferred dividend payments in connection with the Preferred Stock redemption, and an increase of \$26.6 million in net proceeds from the sale of Common Stock due to the exercise of stock options during the third quarter of 2006, as described in Note 6 to the Consolidated Financial Statements.

In 2006, we continued our capital recycling program of selectively disposing of non-core properties in order to use the net proceeds for investments or other purposes. At September 30, 2006, we had 0.2 million rentable square feet of properties, 156 apartment units and 161.3 acres of land classified as held for sale pursuant to SFAS No. 144 with a carrying value of \$47.0 million.

### Capitalization

The following table sets forth our capitalization as of September 30, 2006 and December 31, 2005 (in thousands, except per share amounts):

	September 30, 2006	December 31, 2005	
Mortgages and notes payable, at recorded book value	\$ 1,461,105	\$ 1,471,616	
Financing obligations	\$ 36,098	\$ 34,154	
Preferred Stock, at liquidation value	\$ 197,445	\$ 247,445	
Common Stock and Common Units outstanding	60,649	59,479	
Per share stock price at period end	\$ 37.21	\$ 28.45	
Market value of Common Stock and Common Units	2,256,749	1,692,178	
<b>Total market capitalization with debt</b>	<b>\$55,696</b>		
Customer backlog	17,450	(17,450)	
Land lease	11,810	(379)	11,431
Tradename	5,800		5,800
Customer list and programs	5,700	(154)	5,546
Noncompete agreement	110	(29)	81
Net identifiable intangible assets	\$ 99,370	\$ (20,816)	\$ 78,554
<b>October 1, 2004</b>	<b>Cost</b>	<b>Accumulated Amortization</b>	<b>Net</b>
Technology	\$ 58,500	\$ (1,350)	\$ 57,150
Customer backlog	17,450	(12,148)	5,302
Land lease	11,810	(181)	11,629
Tradename	4,400		4,400
Net identifiable intangible assets	\$ 92,160	\$ (13,679)	\$ 78,481

The estimated future amortization expense of purchased intangibles as of July 1, 2005 was as follows (in thousands):

Fiscal Year	Amount
2005 (remaining three months)	\$ 612
2006	2,452
2007	2,452
2008	2,452
2009	2,452
Thereafter	68,134
<b>Total</b>	<b>\$ 78,554</b>

### 10. Econco Acquisition

On October 8, 2004, the Company purchased all of the outstanding stock of Econco Broadcast Service, Inc. (Econco) of Woodland, California for cash consideration of approximately \$18.3 million. Econco is a provider of rebuilding service for VEDs, allowing broadcasters and other users of these critical products to extend the life of their devices at a cost that is lower than buying a new VED.

The Econco acquisition was accounted for using the purchase method of accounting as required by Financial Accounting Standards Board ( FASB ) Statement No. 141, Business Combinations. Accordingly, the assets and liabilities of Econco were adjusted to their fair values and the excess of the purchase price over the fair value of the assets acquired was recorded as goodwill. The allocation of the purchase price to specific assets and liabilities was based, in part, upon independent appraisals and internal estimates of cash flow and recoverability.

Under the Econco purchase agreement, the Company was required to reimburse the selling shareholders of Econco for certain costs associated with a tax election to treat the transaction as an asset sale. Included in the preliminary estimate



of the fair value of the Econco assets was an accrual for the estimated amount of the reimbursement to the selling shareholders. During the third quarter of fiscal year 2005, the shareholders were paid for costs associated with the tax election and the final estimate of the fair value of the Econco assets was computed. The final purchase price was \$0.4 million lower than the preliminary estimate. The following table summarizes the final allocation of fair value of the Econco assets acquired and liabilities assumed at October 8, 2004 (in thousands):

Cash	\$	21
Accounts receivable		1,346
Inventory, including \$351 of fair value write-up		1,919
Property, plant and equipment		3,239
Identifiable intangible assets		7,210
Goodwill		5,848
Current liabilities		(1,237)
Total	\$	18,346

The following table presents details of the purchased intangible assets acquired (dollars in thousands):

	Estimated Useful Life	Amount
Non-compete agreement	5 years	\$ 110
Tradename	indefinite	1,400
Customer list and programs	25 years	5,700
Total		\$ 7,210

The Condensed Consolidated Financial Statements include Econco's financial results from the acquisition date. Pro forma results of operations have not been presented because the effect of the Econco acquisition was not material to the Company's results.

## 11. *Stockholders Equity*

In February 2005, the Board of Directors declared a cash distribution to stockholders of approximately \$75.8 million, which was essentially a return of capital. The cash distribution was made on the basis of the stockholders' relative ownership in CPI Holdco's outstanding common stock and was paid out of the net proceeds from the issuance of the \$80 million in principal amount of FR Notes.

As a result of the cash distribution to stockholders, CPI Holdco adjusted the options outstanding under the Predecessor's 2000 Stock Option Plan and CPI Holdco's 2004 Stock Incentive Plan pursuant to the terms of those plans to reflect the distribution made to the stockholders of CPI Holdco. As a result of these adjustments, the exercise price of the options outstanding under these plans was adjusted by dividing the prior exercise price of such options by 1.781, the number of shares issuable upon exercise of those options was adjusted by multiplying the number of shares previously issuable pursuant to the options by 1.781, and the total number of shares reserved for issuance under each such plan was also increased by a factor of 1.781. These adjustments increased the number of options outstanding from approximately 526,000 to 937,000 and reduced the range of exercise prices of the options outstanding from \$1.10 to \$36.00 down to \$0.62 to \$20.21.

In accordance with FASB Interpretation 44, Accounting for Certain Transactions involving Stock Compensation, the Company determined that there were no accounting consequences for the adjustments made to the number of options issued and exercise prices. It was determined that the aggregate intrinsic value of the stock options immediately after the adjustment was not greater than aggregate intrinsic value of the stock options immediately before the adjustment and the ratio of exercise price per share to the market value was not reduced.

**12. Recent Accounting Pronouncements**

In March 2004, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 03-01, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (EITF 03-01). EITF 03-01 provides guidance on other-than-temporary impairment models for marketable debt and equity securities accounted for under SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities and non-marketable equity securities accounted for under the cost method. The EITF developed a basic three-step model to evaluate whether an investment is other-than-

temporarily impaired. The FASB issued EITF 03-01-1 in September 2004, which delayed the effective date of the recognition and measurement provisions of EITF 03-01. The Company does not expect the adoption of EITF 03-01 to have a material impact on our results of operations or financial condition.

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs* an amendment of ARB No. 43, Chapter 4, which is the result of the FASB's project to reduce differences between U.S. and international accounting standards. SFAS No. 151 requires idle facility costs, abnormal freight, handling costs, and amounts of wasted materials (spoilage) be treated as current-period costs. Under this concept, if the costs associated with the actual level of spoilage or production defects are greater than the costs associated with the range of normal spoilage or defects, the difference would be charged to current-period expense, not included in inventory costs. The Company is required to adopt SFAS No. 151 in the beginning of fiscal year 2006 and its adoption is not expected to have a significant impact on the Company's results of operations or financial condition.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets* An amendment of APB Opinion No. 29, which eliminates the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. The Company is required to adopt SFAS No. 153 for nonmonetary asset exchanges occurring in the first quarter of 2006 and its adoption is not expected to have a significant impact on the Company's results of operations or financial condition.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123R). SFAS No. 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees, but expresses no preference for a type of valuation model. SFAS No. 123R eliminates the intrinsic value-based method prescribed by Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations, that the Company currently uses. As a nonpublic entity as defined by SFAS No. 123R, the Company is required to adopt SFAS No. 123R in the beginning of fiscal year 2007. The Company has not yet determined the impact of applying the provisions of SFAS No. 123R.

In March 2005, the FASB issued Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, which clarifies that an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value can be reasonably estimated even though uncertainty exists about the timing and (or) method of settlement. The Company is required to adopt Interpretation No. 47 by the end of 2006. The Company has not yet determined the impact of applying the provisions of Interpretation No. 47.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*. SFAS No. 154 replaces APB Opinion No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statement*, and changes the requirements for the accounting for and reporting of a change in accounting principle. The Company is required to adopt SFAS No. 154 for accounting changes and error corrections in fiscal year 2007. The Company's results of operations and financial condition will only be impacted by SFAS No. 154 if it implements changes in accounting principle that are addressed by the standard or corrects accounting errors in future periods.

### **13. *Supplemental Guarantors Condensed Consolidating Financial Information (Unaudited)***

On January 23, 2004, CPI issued \$125.0 million of 8% Notes that are guaranteed by CPI Holdco and all of CPI's domestic subsidiaries. Separate financial statements of the guarantors are not presented because (i) the guarantors are wholly-owned and have fully and unconditionally guaranteed the 8% Notes on a joint and several basis, and (ii) the Company's management has determined that such separate financial statements are not material to investors. Instead, presented below are the consolidating condensed financial statements of: (a) the parent, CPI Holdco or

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Holding, (b) the issuer, CPI, (c) the guarantor subsidiaries, our domestic subsidiaries (d) the non-guarantor subsidiaries, (e) the consolidating elimination entries, and (f) the consolidated total. The Predecessor parent is Holding, and the Successor parent is CPI Holdco. The accompanying consolidating condensed financial statements should be read in connection with the consolidated financial statements of CPI Holdco.

Investments in subsidiaries are accounted for on the equity method. The principal elimination entries eliminate investments in subsidiaries, intercompany balances, intercompany transactions and intercompany sales.

## CONDENSED CONSOLIDATING BALANCE SHEET

As of July 1, 2005 (Successor)

(in thousands)

	Parent (CPI Holdco)	Issuer (CPI)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Eliminations	Consolidated Total
<b>Assets</b>						
Cash and cash equivalents	\$ 33	14,614	514	1,947		17,108
Restricted cash			1,911	108		2,019
Accounts receivable, net		25,865	6,819	15,707		48,391
Inventories		31,651	1,350	14,155		47,156
Deferred tax assets		12,499		36		12,535
Prepays and other current assets		3,241	268	1,066		4,575
Intercompany receivable		27,079	370	685	(28,134)	
Total current assets	33	114,949	11,232	33,704	(28,134)	131,784
Property, plant and equipment, net		66,194	3,188	7,930		77,312
Debt issue costs, net	3,381	8,035				11,416
Intangible assets, net		61,899	7,027	9,628		78,554
Goodwill		92,041	5,848	47,573		145,462
Other long-term assets	1,000	853				1,853
Intercompany notes receivable		9,535			(9,535)	
Investment in subsidiaries	154,074	47,690			(201,764)	
Total assets	\$ 158,488	401,196	27,295	98,835	(239,433)	446,381
<b>Liabilities and stockholders equity</b>						
Accounts payable	\$	11,373	540	5,989		17,902
Accrued expenses	2,551	20,114	925	3,810		27,400
Product warranty		3,469	176	2,386		6,031
Income taxes payable		1,187	605	4,059		5,851
Advance payments from customers		3,754	1,346	2,907		8,007
Intercompany payable	28,134				(28,134)	
Total current liabilities	30,685	39,897	3,592	19,151	(28,134)	65,191
Deferred income taxes		29,215		5,774		34,989
Advance payments from sale of San Carlos property		13,450				13,450
Long-term debt	79,218	205,000				284,218
Other long-term liabilities		84				84
Intercompany notes payable				9,535	(9,535)	
Total liabilities	109,903	287,646	3,592	34,460	(37,669)	397,932
Common stock	43					43
Additional paid-in capital	28,601					28,601
Parent investment		92,160	22,228	57,216	(171,604)	
Accumulated other comprehensive income	1,177	1,041		287	(1,464)	1,041
Retained earnings	18,764	20,349	1,475	6,872	(28,696)	18,764
Net stockholders equity	48,585	113,550	23,703	64,375	(201,764)	48,449
Total liabilities and stockholders equity	\$ 158,488	401,196	27,295	98,835	(239,433)	446,381



## CONDENSED CONSOLIDATING BALANCE SHEET

As of October 1, 2004 (Successor)

(in thousands)

	Parent (CPI Holdco)	Issuer (CPI)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Eliminations	Consolidated Total
<b>Assets</b>						
Cash and cash equivalents	\$	38,131	113	2,232		40,476
Restricted cash			2,188	91		2,279
Accounts receivable, net		21,424	3,806	10,684		35,914
Inventories		28,916	99	9,059		38,074
Deferred tax assets		12,285				12,285
Prepays and other current assets		3,066	168	570	(8)	3,796
Intercompany receivable		26,841		1,730	(28,571)	
Total current assets		130,663	6,374	24,366	(28,579)	132,824
Property, plant and equipment, net		62,162	22	7,943		70,127
Debt issue costs, net		8,910				8,910
Intangible assets, net		67,847		10,634		78,481
Goodwill		92,041		47,573		139,614
Other long-term assets		1,251				1,251
Intercompany notes receivable		13,335			(13,335)	
Investment in subsidiaries	135,688	21,073			(156,761)	
Total assets	\$ 135,688	397,282	6,396	90,516	(198,675)	431,207
<b>Liabilities and stockholders equity</b>						
Current portion of long-term debt	\$	3,944				3,944
Accounts payable		11,556	99	4,135		15,790
Accrued expenses		17,449	561	2,929		20,939
Product warranty		3,877		2,197		6,074
Income taxes payable		1,274		395	(8)	1,661
Advance payments from customers		6,463	1,012	4,556		12,031
Intercompany payable	28,094		477		(28,571)	
Total current liabilities	28,094	44,563	2,149	14,212	(28,579)	60,439
Deferred income taxes		32,936		6,182		39,118
Advance payments from sale of San Carlos property		13,450				13,450
Long-term debt		210,606				210,606
Intercompany notes payable				13,335	(13,335)	
Total liabilities	28,094	301,555	2,149	33,729	(41,914)	323,613
Common stock	43					43
Additional paid-in capital	103,534					103,534
Parent investment		91,710	3,882	56,790	(152,382)	
Accumulated other comprehensive income	1,369	1,369		54	(1,423)	1,369
Retained earnings (deficit)	2,648	2,648	365	(57)	(2,956)	2,648
Net stockholders equity	107,594	95,727	4,247	56,787	(156,761)	107,594
Total liabilities and stockholders equity	\$ 135,688	397,282	6,396	90,516	(198,675)	431,207





**CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS****For the 13-Week Period Ended July 1, 2005 (Successor)**

(in thousands)

	Parent (CPI Holdco)	Issuer (CPI)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Eliminations	Consolidated Total	
Sales	\$	61,172	12,679	32,818	(19,030)	87,639	
Cost of sales		43,244	10,214	23,420	(19,030)	57,848	
Gross profit		17,928	2,465	9,398		29,791	
Operating costs and expenses:							
Research and development		606		1,293		1,899	
Selling and marketing		1,852	876	2,016		4,744	
General and administrative		4,146	701	942		5,789	
Amortization of acquisition-related intangible assets		334	63	151		548	
Total operating costs and expenses		6,938	1,640	4,402		12,980	
Operating income		10,990	825	4,996		16,811	
Interest expense (income), net	1,832	3,600	(8)	273		5,697	
(Loss) income before income tax expense and equity in income of subsidiaries	(1,832)	7,390	833	4,723		11,114	
Income tax (benefit) expense	(733)	2,820	441	1,888		4,416	
Equity in income of subsidiaries	7,797	3,227			(11,024)		
Net income	\$	6,698	7,797	392	2,835	(11,024)	6,698

**CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS****For the 13-Week Period Ended July 2, 2004 (Successor)**

(in thousands - unaudited)

	Parent (CPI Holdco)	Issuer (CPI)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Eliminations	Consolidated Total
Sales	\$	56,223	8,901	24,935	(17,714)	72,345
Cost of sales		39,235	7,870	19,721	(17,714)	49,112
Amortization of acquisition-related inventory write-up		1,000		280		1,280
Gross profit		15,988	1,031	4,934		21,953
Operating costs and expenses:						
Research and development		555		1,314		1,869
Selling and marketing		1,813	534	1,509		3,856
General and administrative		3,964	80	967		5,011
Amortization of acquisition-related intangible assets		3,988		694		4,682
Acquired in-process research and development		(4,485)		(4,515)		(9,000)
Total operating costs and expenses		5,835	614	(31)		6,418
Operating income		10,153	417	4,965		15,535

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Interest expense (income), net		3,387	(3)	438		3,822
Income before income tax expense and equity in loss of subsidiaries		6,766	420	4,527		11,713
Income tax expense (benefit)		583	4	(345)		242
Equity in income of subsidiaries	11,471	5,288			(16,759)	
Net income	\$ 11,471	11,471	416	4,872	(16,759)	11,471

## CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

For the 39-Week Period Ended July 1, 2005 (Successor)

(in thousands)

	Parent (CPI Holdco)	Issuer (CPI)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Eliminations	Consolidated Total	
Sales	\$	174,738	33,934	88,636	(51,473)	245,835	
Cost of sales		123,035	27,507	63,843	(51,473)	162,912	
Amortization of acquisition-related inventory write-up			351			351	
Gross profit		51,703	6,076	24,793		82,572	
Operating costs and expenses:							
Research and development		1,797		3,408		5,205	
Selling and marketing		5,547	2,522	5,328		13,397	
General and administrative		10,438	1,538	3,688		15,664	
Amortization of acquisition-related intangible assets		5,751	183	1,006		6,940	
Total operating costs and expenses		23,533	4,243	13,430		41,206	
Operating income		28,170	1,833	11,363		41,366	
Interest expense (income), net	2,643	11,044	(23)	845		14,509	
(Loss) income before income tax expense and equity in income of subsidiaries	(2,643)	17,126	1,856	10,518		26,857	
Income tax (benefit) expense	(1,057)	7,151	746	3,901		10,741	
Equity in income of subsidiaries	17,702	7,727			(25,429)		
Net income	\$	16,116	17,702	1,110	6,617	(25,429)	16,116

**CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS****From January 23, 2004 to July 2, 2004 (Successor)**

(in thousands - unaudited)

	Parent (CPI Holdco)	Issuer (CPI)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Eliminations	Consolidated Total
Sales	\$	105,192	15,579	47,163	(29,948)	137,986
Cost of sales		71,809	13,815	35,243	(29,948)	90,919
Amortization of acquisition-related inventory write-up		4,300		1,200		5,500
Gross profit		29,083	1,764	10,720		41,567
Operating costs and expenses:						
Research and development		933		2,400		3,333
Selling and marketing		3,304	1,000	2,690		6,994
General and administrative		6,099	396	2,028		8,523
Amortization of acquisition-related intangible assets		7,084		994		8,078
Acquired in-process research and development		1,415		1,085		2,500
Total operating costs and expenses		18,835	1,396	9,197		29,428
Operating income		10,248	368	1,523		12,139
Interest expense (income), net		6,003	(4)	773		6,772
Income before income tax expense and equity in of subsidiaries		4,245	372	750		5,367
Income tax expense (benefit)		1,194	11	(476)		729
Equity in income of subsidiaries	4,638	1,587			(6,225)	
Net income	\$ 4,638	4,638	361	1,226	(6,225)	4,638

**CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS****From October 4, 2003 to January 22, 2004 (Predecessor)**

(in thousands - unaudited)

	Parent (CPI Holding)	Issuer (CPI)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Eliminations	Consolidated Total
Sales	\$	60,721	10,673	26,470	(17,945)	79,919
Cost of sales		43,551	9,448	21,223	(18,033)	56,189
Gross profit		17,170	1,225	5,247	88	23,730
Operating costs and expenses:						
Research and development		607		1,593		2,200
Selling and marketing		2,136	591	1,678	(53)	4,352
General and administrative	355	4,973	236	1,508	(1,039)	6,033
Merger expenses	5,074	1,300				6,374
Intercompany income	(755)	(215)	(53)		1,023	
Total operating costs and expenses	4,674	8,801	774	4,779	(69)	18,959
Operating (loss) income	(4,674)	8,369	451	468	157	4,771
Interest expense (income), net	590	7,731	(3)	584		8,902

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(Loss) income before income tax expense and equity in income of subsidiaries	(5,264)	638	454	(116)	157	(4,131)
Income tax expense		334	55	50		439
Equity in income of subsidiaries	694	321			(1,015)	
Net (loss) income	\$ (4,570)	625	399	(166)	(858)	(4,570)

**CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS****For the 39-Week Period Ended July 1, 2005 (Successor)**

(in thousands)

	Parent (CPI Holdco)	Issuer (CPI)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Eliminations	Consolidated Total
<b>OPERATING ACTIVITIES</b>						
Net cash provided by operating activities	\$ 1,097	13,519	553	114		15,283
<b>INVESTING ACTIVITIES</b>						
Expenses relating to sale of San Carlos property		(216)				(216)
Purchase of Econco's net assets, net of cash acquired		(18,325)				(18,325)
Purchase of property, plant, and equipment		(8,336)	(132)	(399)		(8,867)
Other investing activities		(16)				(16)
Net cash used in investing activities		(26,893)	(132)	(399)		(27,424)
<b>FINANCING ACTIVITIES</b>						
Proceeds from issuance of floating rate senior notes	79,200					79,200
Payments for debt issuance costs	(3,455)					(3,455)
Repayments on senior term loan		(9,550)				(9,550)
Stockholder distribution payments	(75,809)					(75,809)
Payment of collateral on interest rate swap contract	(1,000)					(1,000)
Other financing activities		(80)	(20)			(100)
Net repayments from bank overdraft		(513)				(513)
Net cash used in financing activities	(1,064)	(10,143)	(20)			(11,227)
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>						
Cash and cash equivalents at beginning of period	33	(23,517)	401	(285)		(23,368)
Cash and cash equivalents at end of period	\$ 33	14,614	514	1,947		17,108

**CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS****From January 23, 2004 to July 2, 2004 (Successor)**

(in thousands - unaudited)

	Parent (CPI Holdco)	Issuer (CPI)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Eliminations	Consolidated Total
<b>OPERATING ACTIVITIES</b>						
Net cash provided by (used in) operating activities	\$ 15,685	(11,019)	2,917	3,881		11,464
<b>INVESTING ACTIVITIES</b>						
Purchase of Predecessor's net assets, net of cash acquired	(113,760)					(113,760)
Purchase of property, plant and equipment, net		(1,102)	(13)	(107)		(1,222)
Net cash used in investing activities	(113,760)	(1,102)	(13)	(107)		(114,982)
<b>FINANCING ACTIVITIES</b>						
Retirement of debt and preferred stock:						
Senior subordinated notes		(74,000)				(74,000)
Senior redeemable preferred stock		(29,735)				(29,735)
Junior preferred stock		(32,336)				(32,336)
Dividends on senior preferred stock		(19,310)				(19,310)
Mortgage financing		(17,500)				(17,500)
Proceeds from/(payments for) the issuance of debt:						
Senior subordinated notes		125,000				125,000
Senior term loans		90,000				90,000
Debt issue costs		(9,648)				(9,648)
Proceeds from the repayment of Predecessor management loans		1,266				1,266
Net proceeds from the issuance of common stock	98,075					98,075
Repayments on senior term loan		(225)				(225)
Net proceeds from bank overdraft		2,150				2,150
Net cash provided by financing activities	98,075	35,662				133,737
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>						
		23,541	2,904	3,774		30,219
Cash and cash equivalents at beginning of period						
Cash and cash equivalents at end of period	\$	23,541	2,904	3,774		30,219

**CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS****From October 4, 2003 to January 22, 2004 (Predecessor)**

(in thousands - unaudited)

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	Parent (CPI Holding)	Issuer (CPI)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Eliminations	Consolidated Total
<b>OPERATING ACTIVITIES</b>						
Net cash provided by (used in) operating activities	\$	8,152	206	(145)		8,213
<b>INVESTING ACTIVITIES</b>						
Purchase of property, plant and equipment, net		(416)	(2)	(41)		(459)
Retirement of senior subordinated notes		(26,000)				(26,000)
Net repayment of bank overdraft		(1,639)				(1,639)
Net cash used in financing activities		(27,639)				(27,639)
<b>NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>						
Cash and cash equivalents at beginning of period		(19,903)	204	(186)		(19,885)
Cash and cash equivalents at end of period	\$	10,658	1,922	1,286		13,866



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

*Overview*



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*The following discussion and analysis should be read in conjunction with the Condensed Consolidated Financial Statements and notes thereto included elsewhere within this report and the Annual Report on Form 10-K of CPI Holdco, Inc. ( CPI Holdco or the Successor ) for the fiscal year ended October 1, 2004. References to the Company refer to Communications & Power Industries Holding Corporation ( Holding or the Predecessor ) and its subsidiaries prior to the Merger (defined below) and to the Successor and its subsidiaries post-Merger.*



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The Company is a leading designer, manufacturer and global marketer of vacuum electron devices ( VEDs ), satellite communications amplifiers, medical x-ray generators and other related products for critical defense and commercial applications. The Company's defense applications include radar, electronic warfare and communications end markets and its commercial applications include communications, medical, industrial and scientific end markets. Communications applications consist of applications for military and commercial satellite communications uses and broadcast uses. The Company defines and discusses its recorded orders and sales trends by these end markets in order to more clearly relate its business to outside investors. Internally, however, the Company is organized into six operating divisions that are differentiated based on products operating in two segments. The Company's VED segment consists of five operating divisions. The Company also has a satellite communications equipment segment that has one operating division. Segment data is included in Note 8 of the Notes to Condensed Consolidated Financial Statements.

### *Floating Rate Senior Notes*

On February 22, 2005, CPI Holdco issued \$80 million in principal amount of Floating Rate Senior Notes due 2015 (the FR Notes ). The FR Notes were issued at a 1% discount; the gross cash proceeds from the issuance of FR Notes were \$79.2 million. The proceeds from the issuance of FR Notes were used to make a distribution to stockholders of CPI Holdco of approximately \$75.8 million and to pay fees and expenses of approximately \$3.5 million associated with the issuance of FR Notes.

The FR Notes require interest payments at an annual interest rate, reset at the beginning of each semi-annual period, equal to the then six-month LIBOR plus 5.75%, payable semiannually. CPI Holdco may, at its option, elect to pay interest through the issuance of additional FR Notes for any interest payment date on or after August 1, 2006 and on or before February 1, 2010. If CPI Holdco elects to pay interest through the issuance of additional FR Notes, the annual interest rate on the FR Notes will increase by an additional 1% step-up, with the step-up increasing by an additional 1% for each interest payment made through the issuance of additional FR Notes (up to a maximum of 4%).

The FR Notes are general unsecured obligations of CPI Holdco. The FR Notes are not guaranteed by any of CPI Holdco's subsidiaries and are structurally subordinated to all existing and future indebtedness and other liabilities of CPI Holdco's subsidiaries. The FR Notes are senior in right of payment to the Company's existing and future indebtedness that is expressly subordinated to the FR Notes. See Note 6 to the Condensed Consolidated Financial Statements.

The Company's registration statement filed with the Securities and Exchange Commission relating to the offer to exchange all outstanding FR Notes due 2015 for FR Notes due 2015 that have been registered under the Securities Act of 1933, as amended, was declared effective on April 21, 2005.

### *Econco Acquisition*

On October 8, 2004, the Company purchased all of the outstanding stock of Econco Broadcast Service, Inc. ( Econco ) of Woodland, California for cash consideration of approximately \$18.3 million. Econco is a provider of rebuilding service for VEDs, allowing broadcasters and other users of these critical products to extend the life of their devices at a cost that is lower than buying a new VED. See Note 10 to the Condensed Consolidated Financial Statements for additional information about the Econco acquisition.

### *Merger*

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On January 23, 2004, CPI Holdco's wholly-owned subsidiary, CPI Merger Sub Corp. ( Merger Sub ), merged with and into Holding pursuant to the terms of the Agreement and Plan of Merger (the Merger Agreement ), dated as of November 17, 2003, by and among Holding, CPI Holdco, Merger Sub and Green Equity Investors II, L.P., as the representative of the security holders of Holding, under which CPI Holdco, Merger Sub's parent corporation and a corporation controlled by affiliates of The Cypress Group L.L.C. ( Cypress ), agreed to acquire Holding. In the Merger, each share of Holding's common stock and stock options outstanding immediately prior to the Merger, other than a portion of stock options held by certain members of management (which were converted into options to purchase shares of CPI Holdco) and other than any shares of common stock owned by Holding or CPI Holdco, were converted into the right to receive a pro rata portion of the aggregate merger consideration of \$131.7 million. In connection with the Merger, CPI Holdco received an equity contribution

of \$100.0 million before expenses from affiliates of Cypress in exchange for 4,251,122 shares of common stock of CPI Holdco. Members of management of Holding, as a result of rolling over their options to purchase common stock of Holding, received stock options to purchase 167,513 shares of common stock of CPI Holdco ( Rollover Options ). The estimated fair value of Rollover Options was \$5.0 million and was accounted for as Merger purchase price as of January 23, 2004. Members of Holding management that were residents of Canada received 1,485 stock options to purchase shares of common stock of CPI Holdco as payment of Merger escrow proceeds in respect of their options to purchase shares of Holding.

Although the Merger, which essentially resulted in the recapitalization of the Company, triggered a change in the basis of many of the Company's assets and liabilities, the underlying operations of the Company were not impacted by the Merger.

#### *San Carlos Sale Agreement*

The Company entered into an agreement to sell the land and close its facilities located in San Carlos, California. The purchase price is \$23.8 million. Under the sale agreement, the buyer has paid the Company a \$13.0 million deposit on the purchase price, which the Company is using to defray the costs of moving its San Carlos operations to its Palo Alto facility and to a new location in the Palo Alto area. The \$13.0 million deposit is nonrefundable unless the Company breaches the sale agreement. In connection with the sale agreement, the Company entered into an agreement regarding environmental conditions at the property and was named as an additional insured on a pollution liability insurance policy obtained by the purchaser that is intended to fund the remediation of the contamination of the San Carlos property to permit hospital and other unrestricted uses under the direction of the applicable environmental regulatory agency.

The closing of the sale is subject to a number of conditions, including the requirement that the Company vacate its facilities and obtain regulatory closure of certain permitted equipment located on the property. Although there can be no assurance that the sale of the San Carlos property will occur, the Company expects to close the sale of the property in the first quarter of fiscal year 2007.

Pursuant to the stock sale agreement by and between Varian Associates, Inc., the predecessor of Varian Medical Systems, Inc. ( Varian ), and the Company dated June 9, 1995, as amended, the Company had agreed to certain development restrictions affecting the San Carlos property. In connection with the San Carlos property sale agreement, Varian agreed to waive certain of the development restrictions on the San Carlos property in the event that the sale closes, subject to certain conditions, and further agreed to pay the Company \$1.0 million, of which \$0.5 million was paid as of July 1, 2005. In addition, the Company has agreed to relieve Varian of certain of its indemnity obligations to the Company for certain environmental liabilities related to the San Carlos property relating to periods prior to August 1995, and to reimburse Varian for certain potential environmental costs related to the San Carlos property that are not covered by insurance. The Company and Varian have also agreed to certain use restrictions and environmental cost-sharing provisions related to the Company's property in Beverly, Massachusetts, and the Company has relinquished its right to redevelop that property for residential or similar use.

As of July 1, 2005, the San Carlos land and building was classified as held for use in property, plant and equipment and the advance payments from the sale of the property, aggregating \$13.5 million, are classified as a long-term liability in the accompanying Condensed Consolidated Balance Sheet. As of July 1, 2005, the Company had deferred expenses of \$0.7 million relating to the sale of the San Carlos property and classified these amounts as other long-term assets in the accompanying Condensed Consolidated Balance Sheet. As of July 1, 2005, the San Carlos land and building had a net book value of \$23.7 million and the building continues to be depreciated over its remaining useful life. Based on current projections of costs, the Company does not expect to recognize a loss on the sale of the San Carlos property.

#### *Critical Accounting Policies*

Management is required to make judgments, assumptions and estimates in preparing its financial statements and related disclosures in conformity with accounting principles generally accepted in the United States. The Company's significant accounting policies are described in Note 1 of the Notes to Consolidated Financial Statements in the Annual Report on Form 10-K for the fiscal year ended October 1, 2004. The following critical accounting policies are those policies that management believes affect its more significant estimates and assumptions used in preparation of the Company's consolidated financial statements.

*Revenue Recognition*

The estimated sales values of performance under certain contracts to commercial customers and U. S. Government fixed-price contracts are recognized under the percentage of completion method of accounting. When applying the percentage of completion method, the Company relies on estimates of total expected contract revenue and costs. Recognized revenues and profit are subject to revisions as the contract progresses towards completion. Revisions in profit estimates are charged to income in the period in which they become determinable.

*Allowance for Doubtful Accounts*

The Company monitors the creditworthiness of its customers based on a variety of factors including the length of time the



receivables are past due, the financial health of the customer, economic conditions and historical experience. If collectibility is considered uncertain, then the Company will record a reserve to reduce the receivable to the amount considered collectable. If circumstances change, then further adjustments could be required.

#### *Warranty Obligations*

The Company's products are generally subject to warranties, and the Company provides for the estimated future costs of repair, replacement or customer accommodation at the time of sale as an additional cost of the sales. Management's estimates are based on historical costs for warranty, and are adjusted when circumstances indicate that future costs are expected to vary from historical levels. If actual product failure rates or material usage incurred differ from the Company's estimates, then revisions to the estimated warranty liability would be required.

#### *Inventory Valuation*

The Company reviews inventory quantities on hand and adjusts for excess and obsolete inventory based primarily on historical usage rates and its estimates of product demand and production. Actual demand may differ from our estimates, in which case the Company may have understated or overstated the provision required for obsolete and excess inventory, which would have an impact on the Company's operating results.

The Company also reviews the carrying value of inventory for lower of cost or market on an individual product or contract basis. Analyses are performed based on the estimated costs at completion and if necessary, a provision is recorded to properly reflect the inventory value of the products or contracts at the lower of cost or net realizable value (selling price less estimated cost of disposal). If estimated costs are different than originally estimated, the provision adjustment would have an impact on the Company's operating results.

#### *Goodwill and Other Intangibles Assets and Long-Lived Assets*

Goodwill represents the excess of acquisition costs over the estimated fair value of the net assets acquired. The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets", which requires that amortization of goodwill cease and that the Company evaluate the recoverability of goodwill and other intangible assets annually, or more frequently if events or changes in circumstances, such as a decline in sales, earnings or cash flows, or material adverse changes in the business climate, indicate that the carrying value of an asset might be impaired. Goodwill is considered to be impaired when the net book value of a reporting unit exceeds its estimated fair value. The Company's six operating divisions comprise the reporting units.

Fair values are established using a discounted cash flow methodology (specifically, the income approach). The determination of discounted cash flows is based on the Company's strategic plans and long-range forecasts. The revenue growth rates included in the forecasts are the Company's best estimates based on current and anticipated market conditions, and the profit margin assumptions are projected based on the current and anticipated costs structures.

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The Company performs an annual evaluation for the impairment of long-lived assets, other than goodwill, based on expectations of non-discounted future cash flows compared to the carrying value of the operating division in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. The Company's cash flow estimates are based upon historical cash flows, as well as management projections of future cash flows in connection with the annual Company wide planning process, and include a terminal valuation based upon a multiple of earnings before interest expense, depreciation and amortization expense and income taxes ( EBITDA ). The Company estimates the EBITDA multiple by reviewing comparable company information and other industry data. The Company believes that its procedures for estimating gross future cash flows, including the terminal valuation, are reasonable and consistent with current market conditions.

### *Effect of Merger on Financial Results*

As a result of the Merger, the assets acquired and liabilities assumed were adjusted to reflect fair value, and the excess of the purchase price over the fair value was recorded as goodwill. The revised fair values significantly impacted the Company's results of operations subsequent to the Merger and their comparability to the results of operations of the Predecessor. The most significant purchase accounting adjustments and their effect on results of operations are discussed below:

Customer backlog was valued at \$17.5 million. Customer backlog was amortized over the 12-month expected product delivery schedule of the contracts in backlog at the Merger closing date. Customer backlog amortization was \$12.1 million in fiscal year 2004, \$4.4 million in the first quarter of fiscal year 2005, and \$1.0 million in the second quarter of fiscal year 2005.

Property, plant and equipment valuation was increased by \$38.7 million. Operating income will be charged approximately \$3.1 million per year for the next 4 years, and at a reduced rate thereafter, for additional depreciation from the increased valuation of property, plant and equipment. Property, plant and equipment are depreciated over useful lives of 5 years to 25 years.

Technology-related intangible assets were valued at \$58.5 million. Operating income will be charged approximately \$1.9 million per year for the next 14 years, and at a reduced rate thereafter, for the amortization of technology-related intangible assets. Technology-related intangible assets are depreciated over useful lives of 15 to 50 years.

Land lease intangibles were valued at \$11.8 million. Operating income will be charged approximately \$0.3 million per year for the remaining 44 years of the land lease. The Predecessor had a land lease with a net book value of \$20.3 million that was being amortized over 55 years at a rate of \$0.5 million per year. Thus, the effect on future operating income is a reduction in amortization expense of \$0.2 million per year.

Deferred tax liabilities were increased by \$46.5 million. Merger-related deferred tax liabilities were \$37.8 million at July 1, 2005. As the revalued assets noted above are charged to operating income, their expense is not deductible for income tax purposes. The deferred tax liability is charged against the income tax provision as the revalued assets are charged to operating income. In effect, revalued assets are being charged to net income on an after-tax basis.

### *Orders*

Incoming order levels fluctuate significantly on a quarterly basis, and a particular quarter's order rate may not be indicative of future order levels. In addition, the Company's sales are highly dependent upon manufacturing scheduling, performance and shipments and, accordingly, it is not possible to accurately predict when orders will be recognized as sales.

Market segment orders are summarized as follows (in millions):

	39-Week Period Ended				
	July 1, 2005			July 2, 2004	
	Amount	Percentage of Total Orders	Amount	Percentage of Total Orders	
Radar	\$ 80.9	32%	\$ 81.4	37%	
Electronic Warfare	22.8	9%	22.6	10%	
Communications	87.1	34%	58.6	27%	
Medical	42.0	16%	32.9	15%	
Industrial	17.5	7%	15.0	7%	
Scientific	4.5	2%	9.4	4%	
Total orders	\$ 254.8	100%	\$ 219.9	100%	

Orders recorded in the 39-week period ending July 1, 2005 were \$254.8 million, an increase of \$34.9 million, or 16%, from \$219.9 million in the comparable period of fiscal year 2004. The increase primarily relates to increases in the communications, medical and industrial markets, partially offset by a decrease in the scientific market. Orders in the radar and electronic warfare markets did not change significantly from fiscal year 2004 to 2005. The Econco acquisition represents \$8.7 million of the orders increase, while the remaining increase of \$26.2 million was due

to growth from our existing business.

Orders in the communications market for the 39-week period ending July 1, 2005 increased \$28.5 million, or 49%, from the comparable period of fiscal year 2004. The increase in communications orders was attributable to the continued strength in orders for the direct-to-home broadcast market, orders for Econco products, and a large order from an international customer for traveling wave tubes used for terrestrial microwave relays. Orders in the medical market for the 39-week period ending July 1, 2005 increased \$9.1 million, or 28%, from the comparable period of fiscal year 2004. The increase in medical orders was primarily due to the continued strength in orders for VEDs used in cancer therapy and x-ray generator systems and power supply products used in x-ray imaging systems, and the acceleration of orders for our Eimac division due to its upcoming relocation from our San Carlos, CA facility to our Palo Alto, CA facility. Orders in the industrial market for the 39-week period ending July 1, 2005 increased \$2.5 million, or 17%, from the comparable period of fiscal year 2004. The increase in industrial orders was primarily attributable to orders for Econco products, partially offset by lower demand for products by semiconductor equipment companies. Orders for products sold in the scientific market for the 39-week period ending July 1, 2005 decreased \$4.9 million, or 52%, from the comparable period of fiscal year 2004. The decrease in scientific orders was primarily attributable to the receipt of a \$3.8 million order in the first 39-week period of fiscal year 2004 for high frequency, high power gyrotrons for fusion research, which did not recur in the comparable period of fiscal year 2005. Orders in the scientific market, our smallest market, are historically one-time projects and can fluctuate significantly from period to period.

Order backlog consists of firm orders for which goods and services are yet to be provided. As of July 1, 2005, the Company had an order backlog of \$190.6 million compared to an order backlog of \$176.6 million as of July 2, 2004. Order backlog decreased during the third quarter of fiscal year 2005 by \$9.4 million from \$200.0 million as of April 1, 2005. Although orders can be and sometimes are modified or terminated, the amount of modifications and terminations has historically not

been material compared to total contract volume.

### *Results of Operations*

#### *Fiscal Year*

CPI Holdco's fiscal years are the 52- or 53-week periods that end on the Friday nearest September 30. The Successor's fiscal year did not change from that of the Predecessor. Fiscal year 2005 comprises the 52-week period ending September 30, 2005, and fiscal year 2004 comprised the 52-week period ended October 1, 2004.

#### *Quarter Ended July 1, 2005 Compared to Quarter Ended July 2, 2004*

Operating results for the third quarters of fiscal year 2005 and 2004 were as follows (dollars in millions):

	Quarter Ended July 1, 2005		Quarter Ended July 2, 2004	
	Amount	Percentage of Sales	Amount	Percentage of Sales
Sales	\$ 87.6	100.0%	\$ 72.3	100.0%
Cost of sales	57.8	66.0	49.1	67.9
Amortization of acquisition related inventory write-up			1.3	1.8
Gross profit	29.8	34.0	22.0	30.4
Research and development	1.9	2.2	1.9	2.6
Selling and marketing	4.7	5.4	3.9	5.4
General and administrative	5.8	6.6	5.0	6.9
Amortization of acquisition related intangibles	0.5	0.6	4.7	6.5
Acquired in-process research and development		0.0	(9.0)	(12.4)
Operating income	16.8	19.2	15.5	21.4
Interest expense, net	5.7	6.5	3.8	5.3
Income before taxes	11.1	12.7	11.7	16.2
Income tax expense	4.4	5.0	0.2	0.3
Net income	\$ 6.7	7.6%	11.5	15.9%
Other Data:				
EBITDA (a)	\$ 19.2	21.9%	\$ 21.4	29.6%

(a) EBITDA represents earnings before provision for income taxes, interest expense, depreciation and amortization. Other companies may define EBITDA differently and, as a result, the Company's measure of EBITDA may not be directly comparable to EBITDA of other companies. Management believes that the presentation of EBITDA provides useful information to investors regarding the Company's results of operations because it assists in

analyzing and benchmarking the performance and value of the Company's business. Although management uses EBITDA as a financial measure to assess the performance of the Company's business, the use of EBITDA is limited because it does not include certain material costs, such as interest and taxes, necessary to operate the Company's business. EBITDA should be considered in addition to, and not as a substitute for, net income in accordance with Generally Accepted Accounting Principles (GAAP) as a measure of performance or net cash provided by operating activities in accordance with GAAP as a measure of liquidity. For reconciliation of EBITDA to Income before taxes, see Note 8 of the Notes to Condensed Consolidated Financial Statements.

*Sales.*

The following table compares total sales by market segment for the quarter ended July 1, 2005 to the quarter ended July 2, 2004 (dollars in millions):

	Quarter Ended			
	July 1, 2005		July 2, 2004	
	Amount	Percentage of Total Sales	Amount	Percentage of Total Sales
Radar	\$ 28.3	32%	\$ 28.7	40%
Electronic Warfare	8.5	10%	7.3	10%
Communications	29.4	34%	18.6	26%
Medical	13.6	16%	11.0	15%
Industrial	6.2	7%	4.5	6%
Scientific	1.6	2%	2.2	3%
Total sales	\$ 87.6	100%	\$ 72.3	100%

Sales for the third quarter of fiscal year 2005 of \$87.6 million were \$15.3 million, or 21%, higher than the prior year's level of \$72.3 million. The sales increase was primarily related to increases in the communications, medical and industrial markets. The Econco acquisition represents \$3.2 million of the sales increase, while the remaining increase of \$12.1 million was due to growth from our existing business.

Communications sales of \$29.4 million in the third quarter of fiscal year 2005 were \$10.8 million, or 58%, higher than the third quarter of fiscal year 2004, primarily due to the increased shipment of direct-to-home broadcast amplifiers and VED communication products. Medical sales of \$13.6 million for the third quarter of fiscal year 2005 were \$2.6 million, or 24%, higher than the third quarter of fiscal year 2004, primarily due to increased shipments of VEDs used in cancer therapy and magnetic resonance imaging systems, and x-ray generator systems and power supply products used in x-ray imaging systems. Industrial sales of \$6.2 million in the third quarter of fiscal year 2005 were \$1.7 million, or 38%, higher than the third quarter of fiscal year 2004 primarily due to additional sales from Econco.

*Gross Profit.* Gross profit of \$29.8 million, or 34.0% of sales, in the third quarter of fiscal year 2005 was \$7.8 million higher than the prior year's level of \$22.0 million, or 30.4% of sales. The increase in gross profit was primarily due to higher sales volume, incremental gross profit from the Econco operation in the third quarter of fiscal year 2005, and purchase accounting charges of \$1.3 million in the third quarter of fiscal year 2004 that did not occur in fiscal year 2005.

*Research and Development Expenses.* Research and development expenses of \$1.9 million for the third quarter of fiscal year 2005 were consistent with the \$1.9 million expense for the third quarter of fiscal year 2004.

*Selling and Marketing Expenses.* Selling and marketing expenses of \$4.7 million, or 5.4% of sales, for the third quarter of fiscal year 2005 were \$0.8 million higher than the \$3.9 million, or 5.4% of sales, for the third quarter of fiscal year 2004. The increase in selling and marketing expenses in the third quarter of fiscal year 2005 was primarily due to additional costs to support the increase in sales volume and incremental costs for the Econco operation.

*General and Administrative Expenses.* General and administrative expenses of \$5.8 million, or 6.6% of sales, for the third quarter of fiscal year 2005 were \$0.8 million higher than \$5.0 million, or 6.9% of sales, for the third quarter of fiscal year 2004. In the third quarter of fiscal year 2005, the Company incurred stock-based compensation expense for performance stock options, moving and rearranging costs associated with the relocation of the San Carlos, California manufacturing division to Palo Alto, California and incremental costs for Econco.

*Amortization of Acquisition-Related Intangibles.* Amortization of acquisition-related intangibles of \$0.5 million for the third quarter of fiscal year 2005 consists of purchase accounting charges for acquisition-related intangible assets. Amortization of acquisition-related intangibles of \$4.7 million for the third quarter of fiscal year 2004 consists of \$3.9 million for purchase accounting charges for customer backlog and \$0.8 million for amortization of other acquisition-related intangibles. Customer backlog was fully amortized in January 2005, while the other acquisition-related intangible assets will continue to be amortized over the next 4 to 49 years. Amortization of acquisition-related intangibles is expected to be approximately \$0.6 million per quarter through fiscal year 2018.

*Acquired In-Process Research and Development.* The acquired in-process research and development credit of \$9.0 million for the third quarter of fiscal year 2004 represents an adjustment to the previously estimated fair value of \$11.5 million for acquired in-process research and development projects that had not yet reached technological feasibility and had

no alternative future use as of the Merger closing date.

*EBITDA.* EBITDA for the third quarter of fiscal year 2005 was \$19.2 million, a decrease of \$2.2 million compared to \$21.4 million for the third quarter of fiscal year 2004. The decrease in EBITDA from fiscal year 2004 to 2005 resulted primarily from the a \$9.0M acquired in-process and development credit adjustment in fiscal year 2004, partially offset by higher gross profit in fiscal year 2005. For a reconciliation of EBITDA to income (loss) before taxes, see Note 8 to the Condensed Consolidated Financial Statements.

*Interest Expense, net.* Interest expense, net, of \$5.7 million, or 6.5% of sales, for the third quarter of fiscal year 2005 was \$1.9 million higher than the \$3.8 million, or 5.3% of sales, for the third quarter of fiscal year 2004. Higher interest expense for the third quarter of fiscal year 2005 compared to the third quarter of fiscal year 2004 was primarily due to interest expense for the FR Notes issued on February 22, 2005.

*Income Tax Expense.* The Company recorded income tax expense of \$4.4 million for the third quarter of fiscal year 2005, an increase of \$4.2 million, compared to \$0.2 million for the third quarter of fiscal year 2004. The effective tax rates were approximately 40% and 2% for the third quarter of fiscal years 2005 and 2004, respectively. The primary reason for the lower income tax expense in the third quarter of fiscal year 2004 was an adjustment of the second quarter tax provision related to non-deductible acquired in-process research and development, which was decreased by \$9.0 million when the purchase price allocation was finalized in the third quarter of fiscal year 2004.

*Net Income.* The Company recorded net income of \$6.7 million for the third quarter of fiscal year 2005, a decrease of \$4.8 million compared to \$11.5 million for the third quarter of fiscal year 2004. Lower net income for the third quarter of fiscal year 2005 compared to the third quarter of fiscal year 2004 is primarily due to a \$9.0M acquired in-process and development credit in fiscal year 2004, offset partially by improved operating performance in fiscal year 2005.



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Nine Months Ended July 1, 2005 Compared to the Nine Months Ended July 2, 2004

Operating results for the first nine-months of fiscal years 2005 and 2004 were as follows (dollars in millions):

	Nine-months Ended July 1, 2005		Nine-months Ended July 2, 2004 (b)	
	Amount	Percentage of Sales	Amount	Percentage of Sales
Sales	\$ 245.8	100.0%	\$ 217.9	100.0%
Cost of sales	162.9	66.3	147.1	67.5
Amortization of acquisition related inventory write-up	0.4	0.2	5.5	2.5
Gross profit	82.6	33.6	65.3	30.0
Research and development	5.2	2.1	5.5	2.5
Selling and marketing	13.4	5.5	11.3	5.2
General and administrative	15.7	6.4	14.6	6.7
Merger expenses			6.4	2.9
Amortization of acquisition related intangibles	6.9	2.8	8.1	3.7
Acquired in-process research and development			2.5	1.1
Operating income	41.4	16.8	16.9	7.8
Interest expense, net	14.5	5.9	15.7	7.2
Income before taxes	26.9	10.9	1.2	0.6
Income tax expense	10.7	4.4	1.2	0.6
Net income	\$ 16.1	6.6%	\$ 0.1	0.0%
Other Data:				
EBITDA (a)	\$ 53.1	21.6%	\$ 29.0	13.3%

(a) EBITDA represents earnings before provision for income taxes, interest expense, depreciation and amortization. Other companies may define EBITDA differently and, as a result, the Company's measure of EBITDA may not be directly comparable to EBITDA of other companies. Management believes that the presentation of EBITDA provides useful information to investors regarding the Company's results of operations because it assists in analyzing and benchmarking the performance and value of the Company's business. Although management uses EBITDA as a financial measure to assess the performance of the Company's business, the use of EBITDA is limited because it does not include certain material costs, such as interest and taxes, necessary to operate the Company's business. EBITDA should be considered in addition to, and not as a substitute for, net income in accordance with GAAP as a measure of performance or net cash provided by operating activities in accordance with GAAP as a measure of liquidity. For reconciliation of EBITDA to Income before taxes, see Note 8 of the Notes to Condensed Consolidated Financial Statements.

(b) Represents the combined pro forma results of CPI Holdco for the 23-week period ended July 2, 2004 and the Predecessor for the 16-week period ended January 22, 2004. Since the basis of accounting for CPI Holdco and the Predecessor are not the same, the combined pro forma results are not in accordance with GAAP.

Sales.

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The following table compares total sales by market segment for the nine-months ended July 1, 2005 to the nine-months ended July 2, 2004 (dollars in millions):

	Nine-months Ended			
	July 1, 2005		July 2, 2004	
	Amount	Percentage of Total Sales	Amount	Percentage of Total Sales
Radar	\$ 83.9	34%	\$ 86.2	40%
Electronic Warfare	21.3	9%	19.9	9%
Communications	76.8	31%	57.4	26%
Medical	39.3	16%	31.7	15%
Industrial	18.0	7%	14.8	7%
Scientific	6.5	3%	7.9	4%
Total sales	\$ 245.8	100%	\$ 217.9	100%

Sales for the first nine months of fiscal year 2005 of \$245.8 million were \$27.9 million, or 13%, higher than the prior year's level of \$217.9 million. The sales increase was primarily related to increases in the communications and medical markets. The Econco acquisition represents \$9.0 million of the sales increase while the remaining increase of \$18.9 million, or 9%, was due to growth from our existing business.

Communications sales of \$76.8 million in the first nine months of fiscal year 2005 were \$19.4 million, or 34%, higher than the first nine-months of fiscal year 2004, primarily due to increased shipment of direct-to-home broadcast amplifiers, VED communication products and additional sales from the Econco operation. Medical sales of \$39.3 million for the first nine-

months of fiscal year 2005 were \$7.6 million, or 24%, higher than the first nine months of fiscal year 2004, primarily due to increased shipments of VEDs used in cancer therapy and magnetic resonance imaging systems, and x-ray generator systems and power supply products used in x-ray imaging systems.

*Gross Profit.* Gross profit of \$82.6 million, or 33.6% of sales, in the first nine months of fiscal year 2005 was \$17.3 million higher than the prior year's level of \$65.3 million, or 30.0% of sales. The increase in gross profit was primarily due to higher sales volume in fiscal year 2005 and merger purchase accounting charges of \$5.5 million for amortization of acquisition-related inventory write-up in fiscal year 2004.

*Research and Development Expenses.* Research and development expenses of \$5.2 million, or 2.1% of sales, for the first nine months of fiscal year 2005 were \$0.3 million lower than fiscal year 2004 due to additional engineering efforts on customer-funded development contracts rather than Company-funded research and development programs in fiscal year 2005.

*Selling and Marketing Expenses.* Selling and marketing expenses of \$13.4 million, or 5.5% of sales, for the first nine months of fiscal year 2005 were \$2.1 million higher than the \$11.3 million, or 5.2% of sales, for the first nine months of fiscal year 2004. The increase in selling and marketing expenses in fiscal year 2005 was primarily due to additional costs to support the increase in sales volume and incremental costs for the Econco operation.

*General and Administrative Expenses.* General and administrative expenses of \$15.7 million, or 6.4% of sales, for the first nine months of fiscal year 2005 were \$1.1 million higher than \$14.6 million, or 6.7% of sales, for the first nine months of fiscal year 2004. During fiscal year 2005, the Company incurred incremental costs for the Econco operation, and moving and rearranging costs associated with the relocation of the San Carlos, California manufacturing division to Palo Alto, California.

*Merger Expenses.* Merger expenses of \$6.4 million for the first nine months of fiscal year 2004 consisted of fees paid to investment bankers, legal expenses, transaction bonuses for management, and transaction fees paid pursuant to the Management Services Agreement with Leonard, Green & Partners, L.P., an affiliate of the former holder of a majority of the common stock of the Predecessor. These expenses were incurred in connection with the Merger.

*Amortization of Acquisition-Related Intangibles.* Amortization of acquisition-related intangibles of \$6.9 million for the first nine months of fiscal year 2005 is \$1.2 million lower than the first nine months of fiscal year 2004. Amortization of acquisition-related intangibles consists of purchase accounting charges, primarily for customer backlog and other intangible assets. Customer backlog was fully amortized in January 2005 while the other acquisition-related intangible assets will continue to be amortized over the next 4 to 49 years. Amortization of acquisition-related intangibles is expected to be approximately \$0.6 million per quarter through fiscal year 2018.

*Acquired In-Process Research and Development.* Acquired in-process research and development expense of \$2.5 million for the first nine months of fiscal year 2004 represents the estimated fair value of acquired in-process research and development projects that had not yet reached technological feasibility and had no alternative future use as of the Merger closing date.

*EBITDA.* EBITDA for the first nine months of fiscal year 2005 was \$53.1 million, an increase of \$24.1 million compared to \$29.0 million for the first nine months of fiscal year 2004. The increase in EBITDA from fiscal year 2004 to 2005 resulted primarily from higher gross profit in fiscal year 2005 and the write-off of acquired in-process research and development and Merger expenses in fiscal year 2004. For a reconciliation of EBITDA to income (loss) before taxes, see Note 8 to the Condensed Consolidated Financial Statements.

*Interest Expense, net.* Interest expense, net, of \$14.5 million, or 5.9% of sales, for the first nine months of fiscal year 2005 was \$1.2 million lower than the \$15.7 million, or 7.2% of sales, for the first nine months of fiscal year 2004. The decrease in interest expense in fiscal year 2005 is primarily due to fiscal year 2004 interest costs associated with the early redemption of the Predecessor's 12% Notes and the write-off of capitalized debt issue costs related to outstanding debt at the time of the Merger, partially offset by additional interest expense for the FR Notes issued on February 22, 2005.

*Income Tax Expense.* The Company recorded income tax expense of \$10.7 million for the first nine months of fiscal year 2005, an increase of \$9.5 million, compared to income tax expense of \$1.2 million for the first nine months of fiscal year 2004. The effective income tax rates were 40% and 95% for the first nine months of fiscal year 2005 and 2004, respectively. The change in income tax expense is primarily due to non-deductible acquired in-process research and development and other purchase accounting charges related to the Merger recorded in the first nine months of fiscal year 2004.

*Net Income.* The Company recorded net income of \$16.1 million for the first nine months of fiscal year 2005, an increase of \$16.0 million compared to \$0.1 million for the first nine months of fiscal year 2004. Higher net income for the first nine months of fiscal year 2005 compared to fiscal year 2004 is primarily due to higher gross profit due to increased sales in fiscal year 2005 and merger expenses in fiscal year 2004, partially offset by higher income tax expense recorded in fiscal year 2005.

#### ***Financial Condition***

The Company generated net cash from operating activities of \$15.3 million for the first nine months of fiscal year 2005,

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compared to \$19.7 million for the first nine months of fiscal year 2004. The \$4.4 million decrease in net cash from operating activities for the first nine months of fiscal year 2005 compared to the first nine months of fiscal year 2004 was primarily due to increases in inventory and accounts receivable in fiscal year 2005, partially offset by the increase in net income, excluding non-cash charges in fiscal year 2005. The increase in accounts receivable was due to increased sales, and the increase in inventory was due to increased product delivery requirements in fiscal year 2005, each as compared to fiscal year 2004.

Investing activities used net cash of \$27.4 million for the first nine months of fiscal year 2005, compared to \$115.4 million for the first nine months of fiscal year 2004. Investing activities for first nine months of fiscal year 2005 include \$18.3 million for the purchase of Econco and \$8.9 million for the purchases of property, plant and equipment, primarily in connection with the relocation of the San Carlos production facility to Palo Alto, California. Investing activities for the first nine months of fiscal year 2004 consists primarily of the purchase of the Predecessor's net assets.

The Company's continuing operations typically do not have large capital expenditure requirements. Capital expenditures are generally made to replace existing assets, increase productivity, facilitate cost reductions or meet regulatory requirements. Excluding fiscal year 2005 anticipated capital expenditures of approximately \$12 to \$14 million related to the relocation of the San Carlos, California facility to Palo Alto, California, the Company expects the level of capital expenditures in fiscal year 2005 to be consistent with fiscal year 2004 levels.

Financing activities used net cash of \$11.2 million for the first nine months of fiscal year 2005, compared to \$106.1 million provided by financing activities for the first nine months of fiscal year 2004. Financing activities for the first nine months of fiscal year 2005 consist primarily of a \$75.8 million distribution to stockholders of CPI Holdco, \$9.6 million repayments on CPI's senior term loans, \$3.5 million of debt costs incurred to issue the FR Notes and \$1.0 million paid as collateral under the interest rate swap contract, partially offset by the \$79.2 million of gross proceeds from the issuance of FR Notes. The term loan repayments included \$3.9 million of required annual repayments and an optional prepayment of \$5.7 million.

Working capital was \$66.6 million at July 1, 2005 compared to \$72.4 million at October 1, 2004, representing a decrease of \$5.8 million during the first three quarters of fiscal year 2005. The decrease in working capital was primarily due to the \$18.3 million paid to purchase Econco's common stock and higher interest payable, partially offset by increases in accounts receivable and inventory.

On July 1, 2005, CPI had \$17.1 million in cash and cash equivalents, compared to \$40.5 million on October 1, 2004. Cash balances in excess of operating requirements are invested daily in federal securities.

The following table summarizes future minimum principal payments on outstanding debt and minimum rentals due for certain facilities and other leased assets under long-term non-cancelable operating leases as of July 1, 2005 (in thousands):

Description	Due in Fiscal Years						Total
	2005	2006	2007	2008	2009	Thereafter	
Debt obligations	\$				16,044	268,956	285,000
Noncancelable operating leases		309	610	427	356	338	5,878
Total cash obligations	\$	309	610	427	356	16,382	290,878
Standby letters of credit	\$	4,710					4,710

The Company uses forward exchange contracts to address the foreign currency risk associated with anticipated manufacturing costs in Canada. As of July 1, 2005, CPI had outstanding forward contract commitments to purchase Canadian dollars for an aggregate U.S. notional amount of \$18.1 million; the last forward contract expires on March 10, 2006. At July 1, 2005, the fair value of unrealized foreign currency forward contracts was \$1.8 million and the unrealized gain was approximately \$1.2 million, net of related tax expense. The Company anticipates recognizing the entire unrealized gain in operating earnings within the next twelve months.

In April 2005, the Company expanded its use of derivatives to address the interest rate risk associated with the FR Notes which mature on February 1, 2015. On April 15, 2005, the Company entered into an \$80 million interest rate swap contract ( the Swap ) to receive variable rate 6-month LIBOR interest and pay 4.15% fixed rate interest. The Swap is for semi-annual interest payments, beginning with interest payments due on February 1, 2006, and the contract matures on January 31, 2008. The Swap is designated as a cash flow hedge under SFAS No. 133, and the gain and loss from changes in fair value is expected to be highly effective at offsetting the gain or loss from changes in fair value of the FR Notes attributable to changes in interest rates over the contract period. As of July 1, 2005, the Company had paid \$1.0 million as collateral for the Swap, which is included as Other Long-term Assets in the accompanying Condensed Consolidated Balance Sheets. The amount of collateral fluctuates based on the fair value of the Swap. The unrealized gains and losses from the Swap contract are included in Accumulated Other Comprehensive Income in the Condensed Consolidated Balance Sheet. At July 1, 2005 the fair value of the Swap was not material. The Company anticipates recognizing the unrealized gain or loss on the Swap over the contract

period to effectively replace the variable interest rate on the FR Notes with the fixed interest rate of the Swap.

The Company's liquidity is affected by many factors, some of which are based on normal ongoing operations of our business and others related to uncertainties in the markets in which we compete and global economies. We believe that cash and cash equivalents on hand, cash expected to be generated from operations and borrowing capability under our senior credit facility will be sufficient to meet the Company's cash requirements for the next 12 months.

### ***Recent Accounting Pronouncements***

In March 2004, the Emerging Issues Task Force ( EITF ) reached a consensus on Issue No. 03-01, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* ( EITF 03-01 ). EITF 03-01 provides guidance on other-than-temporary impairment models for marketable debt and equity securities accounted for under SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* and non-marketable equity securities accounted for under the cost method. The EITF developed a basic three-step model to evaluate whether an investment is other-than-temporarily impaired. The Financial Accounting Standards Board ( FASB ) issued EITF 03-01-1 in September 2004, which delayed the effective date of the recognition and measurement provisions of EITF 03-01. The Company does not expect the adoption of EITF 03-01 to have a material impact on our results of operations or financial condition.

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs* an amendment of ARB No. 43, Chapter 4 , which is the result of the FASB's project to reduce differences between U.S. and international accounting standards. SFAS No. 151 requires idle facility costs, abnormal freight, handling costs, and amounts of wasted materials (spoilage) be treated as current-period costs. Under this concept, if the costs associated with the actual level of spoilage or production defects are greater than the costs associated with the range of normal spoilage or defects, the difference would be charged to current-period expense, not included in inventory costs. The Company is required to adopt SFAS No. 151 in the beginning of fiscal year 2006 and its adoption is not expected to have a significant impact on the Company's results of operations or financial condition.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets* An amendment of APB Opinion No. 29, which eliminates the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. The Company is required to adopt SFAS No. 153 for nonmonetary asset exchanges occurring in the first quarter of 2006 and its adoption is not expected to have a significant impact on the Company's results of operations or financial condition.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* ( SFAS No. 123R ). SFAS No. 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees, but expresses no preference for a type of valuation model. SFAS No. 123R eliminates the intrinsic value-based method prescribed by Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* , and related interpretations, that the Company currently uses. As a nonpublic entity as defined by SFAS No. 123R, the Company is required to adopt SFAS No. 123R in the beginning of fiscal year 2007. The Company has not yet determined the impact of applying the provisions of SFAS No. 123R.

In March 2005, the FASB issued Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, which clarifies that an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value can be reasonably estimated even though uncertainty exists about the timing and (or) method of settlement. The Company is required to adopt Interpretation No. 47 by the end of 2006. The Company has not yet determined the impact of applying the provisions of Interpretation No. 47.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections. SFAS No. 154 replaces APB Opinion No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statement, and changes the requirements for the accounting for and reporting of a change in accounting principle. The Company is required to adopt SFAS No. 154 for accounting changes and error corrections in fiscal year 2007. The Company's results of operations and financial condition will only be impacted by SFAS No. 154 if it implements changes in accounting principle that are addressed by the standard or corrects accounting errors in future periods.

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





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The Company operates in a dynamic and rapidly changing environment that involves numerous risks and uncertainties. The following section describes some, but not all, of these risks and uncertainties that we believe may adversely affect our business, financial condition or results of operations. This section should be read in conjunction with the unaudited Condensed Consolidated Financial Statements and Notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations contained elsewhere in the Form 10-Q.

The company does not enter into derivative financial instruments for trading or speculative purposes.

### **Interest Rate Risk**

The Company's exposure to market risk for changes in interest rates relates primarily to the fair value of long-term fixed interest rate debt and the interest rate swap contract. Generally, the fair value of fixed-interest rate debt will increase as interest rates fall and decrease as interest rates rise. The Company has an \$80 million interest rate swap contract (the Swap) to receive variable rate 6-month LIBOR interest and pay 4.15% fixed rate interest. The Swap is for semi-annual interest payments, beginning with interest payments due on February 1, 2006, and the contract matures on January 31, 2008. As of July 1, 2005, the fair value of the Company's long-term fixed rate debt was approximately the same as the carrying value and the unrealized loss on the swap contract was not material.

### **Foreign Currency Exchange Rate Risk**

The majority of the Company's revenue and expense activities are transacted in U.S. dollars. However, the Company incurs expenses, and receives limited revenue, in other currencies, primarily the Canadian dollar, the British pound, the Euro, the Australian dollar and the Swiss franc. The Company's results of operations can be impacted through foreign currency exchange rate risk (a) to the balance sheet components (assets and liabilities) and (b) through its impact to foreign denominated expenses, primarily in Canada. The Company limits its foreign currency exchange rate risk to the balance sheet components primarily through natural hedging (offsetting foreign currency payables with foreign currency receivables). The most significant exposure to foreign denominated expenses is in Canada, where the Company enters into forward contracts in an effort to reduce, but not eliminate, the impact of foreign currency rate movements. The fair value of forward contracts is subject to foreign currency risk.

## **ITEM 4: CONTROLS AND PROCEDURES**

Management, including the Company's principal executive officer and principal financial officer, has evaluated, as of the end of the period covered by this report, the effectiveness of the design and operation of the Company's disclosure controls and procedures with respect to the information generated for use in this report. Based upon, and as of the date of that evaluation, the principal executive officer and principal financial officer concluded that the disclosure controls and procedures were effective to provide reasonable assurances that information required to be disclosed in the reports filed or submitted under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

There have been no changes in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II: OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS.**

None.

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



None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES.**





None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.**



None.

**ITEM 5. OTHER INFORMATION.**



None.

**ITEM 6. EXHIBITS.**

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**Exhibit**

<b>No.</b>	<b>Description</b>
31	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350.



**SIGNATURES**



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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.

CPI HOLDCO, INC.

By: */s/ O. Joe Caldarelli*  
O. Joe Caldarelli  
Chief Executive Officer  
Date: August 12, 2005

By: */s/ Joel Littman*  
Joel Littman  
Chief Financial Officer, Treasurer and Secretary  
(Principal Financial and Accounting Officer)  
Date: August 12, 2005