PS BUSINESS PARKS INC/CA
Form 10-Q
October 28, 2016
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2016

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from ____________ to ____________

Commission File Number 1-10709

PS BUSINESS PARKS, INC.

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| California | 95-4300881 |
| (State or Other Jurisdiction | (I.R.S. Employer |

of Incorporation) Identification Number)

701 Western Avenue, Glendale, California 91201-2397

(Address of principal executive offices) (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of October 24, 2016, the number of shares of the registrant's common stock, $0.01 par value per share, outstanding was 27,120,001.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

PS BUSINESS PARKS, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

| | September 30, 2016 (Unaudited) | December 31, 2015 |
|---|---|---|
| ASSETS | | |
| Cash and cash equivalents | $ 5,016 | $ 188,912 |
| Real estate facilities, at cost: | | |
| Land | 799,207 | 793,569 |
| Buildings and improvements | 2,238,804 | 2,215,515 |
| | 3,038,011 | 3,009,084 |
| Accumulated depreciation | (1,147,187) | (1,082,603) |
| | 1,890,824 | 1,926,481 |
| Land held for future development | 6,081 | 6,081 |
| | 1,896,905 | 1,932,562 |
| Investment in and advances to unconsolidated joint venture | 55,536 | 26,736 |
| Rent receivable, net | 2,013 | 2,234 |
| Deferred rent receivable, net | 29,717 | 28,327 |
| Other assets | 10,597 | 7,887 |
| Total assets | $ 1,999,784 | $ 2,186,658 |
| LIABILITIES AND EQUITY | | |
| Accrued and other liabilities | $ 83,093 | $ 76,059 |
| Credit facility | 60,000 | — |
| Mortgage note payable | — | 250,000 |
| Total liabilities | 143,093 | 326,059 |

| | | |
|---|---|---|
| Commitments and contingencies | | |
| Equity: | | |
| PS Business Parks, Inc.'s shareholders' equity: | | |
| Preferred stock, $0.01 par value, 50,000,000 shares authorized, 36,800 shares issued and outstanding at September 30, 2016 and December 31, 2015 | 920,000 | 920,000 |
| Common stock, $0.01 par value, 100,000,000 shares authorized, 27,120,001 and 27,034,073 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively | 270 | 269 |
| Paid-in capital | 729,957 | 722,009 |
| Cumulative net income | 1,467,323 | 1,375,421 |
| Cumulative distributions | (1,459,633) | (1,357,203) |
| Total PS Business Parks, Inc.'s shareholders' equity | 1,657,917 | 1,660,496 |
| Noncontrolling interests: | | |
| Common units | 198,774 | 200,103 |
| Total noncontrolling interests | 198,774 | 200,103 |
| Total equity | 1,856,691 | 1,860,599 |
| Total liabilities and equity | $ 1,999,784 | $ 2,186,658 |

See accompanying notes.

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PS BUSINESS PARKS, INC.

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited, in thousands, except per share data)

| | For The Three Months Ended September 30, | | For The Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Revenues: | | | | |
| Rental income | $ 97,340 | $ 93,322 | $ 289,272 | $ 278,585 |
| Facility management fees | 130 | 130 | 389 | 410 |
| Total operating revenues | 97,470 | 93,452 | 289,661 | 278,995 |
| Expenses: | | | | |
| Cost of operations | 30,796 | 30,448 | 92,440 | 92,251 |
| Depreciation and amortization | 24,631 | 25,985 | 74,886 | 79,243 |
| General and administrative | 2,970 | 3,276 | 11,982 | 10,172 |
| Total operating expenses | 58,397 | 59,709 | 179,308 | 181,666 |
| Other income and (expense): | | | | |
| Interest and other income | 76 | 154 | 551 | 406 |
| Interest and other expense | (155) | (3,368) | (5,507) | (10,029) |
| Total other income and (expense) | (79) | (3,214) | (4,956) | (9,623) |
| Gain on sale of real estate facilities | — | 15,748 | — | 28,235 |
| Net income | $ 38,994 | $ 46,277 | $ 105,397 | $ 115,941 |
| | | | | |
| Net income allocation: | | | | |
| Net income allocable to noncontrolling interests: | | | | |
| Noncontrolling interests—common units | $ 5,315 | $ 6,087 | $ 13,495 | $ 14,467 |
| Total net income allocable to noncontrolling interests | 5,315 | 6,087 | 13,495 | 14,467 |
| Net income allocable to PS Business Parks, Inc.: | | | | |
| Preferred shareholders | 13,833 | 17,609 | 41,498 | 47,853 |
| Restricted stock unit holders | 128 | 97 | 387 | 237 |
| Common shareholders | 19,718 | 22,484 | 50,017 | 53,384 |
| Total net income allocable to PS Business Parks, Inc. | 33,679 | 40,190 | 91,902 | 101,474 |
| Net income | $ 38,994 | $ 46,277 | $ 105,397 | $ 115,941 |
| | | | | |
| Net income per common share: | | | | |
| Basic | $ 0.73 | $ 0.83 | $ 1.85 | $ 1.98 |
| Diluted | $ 0.72 | $ 0.83 | $ 1.84 | $ 1.97 |

| | | | | |
|---|---|---|---|---|
| Weighted average common shares outstanding: | | | | |
| Basic | 27,103 | 26,985 | 27,076 | 26,956 |
| Diluted | 27,201 | 27,049 | 27,166 | 27,034 |
| Dividends declared per common share | $ 0.75 | $ 0.60 | $ 2.25 | $ 1.60 |

See accompanying notes.

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PS BUSINESS PARKS, INC.

CONSOLIDATED STATEMENT OF EQUITY

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2016

(Unaudited, in thousands, except share data)

| | Preferred Stock | | Common Stock | | Paid-in | Cumulative | Cumulative | Total PS Business Parks, Inc.'s Shareholders' | Noncontr |
|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Capital | Net Income | Distributions | Equity | Interests |
| Balances at December 31, 2015 | 36,800 | $ 920,000 | 27,034,073 | $ 269 | $ 722,009 | $ 1,375,421 | $ (1,357,203) | $ 1,660,496 | $ 200,10 |
| Exercise of stock options | — | — | 49,882 | 1 | 2,955 | — | — | 2,956 | — |
| Stock compensation, net | — | — | 36,046 | — | 6,606 | — | — | 6,606 | — |
| Net income | — | — | — | — | — | 91,902 | — | 91,902 | 13,495 |
| Distributions: | | | | | | | | | |
| Preferred stock | — | — | — | — | — | — | (41,498) | (41,498) | — |
| Common stock | — | — | — | — | — | — | (60,932) | (60,932) | — |
| Noncontrolling interests | — | — | — | — | — | — | — | — | (16,437 |
| Adjustment to noncontrolling interests in underlying operating partnership | — | — | — | — | (1,613) | — | — | (1,613) | 1,613 |
| Balances at September 30, 2016 | 36,800 | $ 920,000 | 27,120,001 | $ 270 | $ 729,957 | $ 1,467,323 | $ (1,459,633) | $ 1,657,917 | $ 198,77 |

See accompanying notes.

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PS BUSINESS PARKS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, in thousands)

| | For The Nine Months Ended September 30, | | | |
|---|---|---|---|---|
| | 2016 | | 2015 | |
| Cash flows from operating activities: | | | | |
| Net income | $ | 105,397 | $ | 115,941 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | |
| Depreciation and amortization expense | | 74,886 | | 79,243 |
| In-place lease adjustment | | (437) | | (1,004) |
| Tenant improvement reimbursements, net of lease incentives | | (1,253) | | (1,418) |
| Gain on sale of real estate facilities | | — | | (28,236) |
| Stock compensation | | 8,933 | | 6,949 |
| Increase in receivables and other assets | | (4,248) | | (4,258) |
| Increase in accrued and other liabilities | | 4,395 | | 11,398 |
| Total adjustments | | 82,276 | | 62,674 |
| Net cash provided by operating activities | | 187,673 | | 178,615 |
| Cash flows from investing activities: | | | | |
| Capital expenditures to real estate facilities | | (24,230) | | (35,067) |
| Capital expenditures to land held for development | | — | | (2,809) |
| Investment in and advances to unconsolidated joint | | (28,800) | | — |

| | | | | |
|---|---|---|---|---|
| venture | | | | |
| Acquisition of real estate facilities | | (12,628) | | — |
| Proceeds from sale of real estate facilities | | — | | 55,160 |
| Net cash (used in) provided by investing activities | | (65,658) | | 17,284 |
| Cash flows from financing activities: | | | | |
| Borrowings on credit facility | | 116,000 | | — |
| Repayment of borrowings on credit facility | | (56,000) | | — |
| Repayment of mortgage note payable | | (250,000) | | — |
| Proceeds from the exercise of stock options | | 2,956 | | 3,987 |
| Distributions paid to preferred shareholders | | (41,498) | | (45,366) |
| Distributions paid to noncontrolling interests | | (16,437) | | (11,689) |
| Distributions paid to common shareholders | | (60,932) | | (43,156) |
| Net cash used in financing activities | | (305,911) | | (96,224) |
| Net (decrease) increase in cash and cash equivalents | | (183,896) | | 99,675 |
| Cash and cash equivalents at the beginning of the period | | 188,912 | | 152,467 |
| Cash and cash equivalents at the end of the period | $ | 5,016 | $ | 252,142 |
| | | | | |
| Supplemental schedule of non-cash investing and financing activities: | | | | |
| Adjustment to noncontrolling interests in underlying operating partnership: | | | | |
| Noncontrolling interests—common units | $ | 1,613 | $ | 2,149 |
| Paid-in capital | $ | (1,613) | $ | (2,149) |
| Non-cash distributions related to the redemption of preferred stock: | | | | |
| Paid-in capital | $ | — | $ | 2,487 |
| Cumulative distributions | $ | — | $ | (2,487) |
| Preferred stock called for redemption: | | | | |
| Preferred stock called for redemption and reclassified to liabilities | $ | — | $ | 75,000 |

| | | | | |
|---|---|---|---|---|
| Preferred stock called for redemption and reclassified from equity | $ | — | $ | (75,000) |

See accompanying notes.

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PS BUSINESS PARKS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2016

## 1. Organization and description of business

PS Business Parks, Inc. (“PSB”) was incorporated in the state of California in 1990. As of September 30, 2016, PSB owned 77.9% of the common partnership units (the “common partnership units”) of PS Business Parks, L.P. (the “Operating Partnership”). The remaining common partnership units are owned by Public Storage (“PS”). PSB, as the sole general partner of the Operating Partnership, has full, exclusive and complete responsibility and discretion in managing and controlling the Operating Partnership. PSB and its subsidiaries, including the Operating Partnership, are collectively referred to as the “Company.” Assuming issuance of the Company’s common stock upon redemption of its common partnership units, PS would own 42.0% (or 14.5 million shares) of the outstanding shares of the Company’s common stock.

The Company is a fully-integrated, self-advised and self-managed real estate investment trust (“REIT”) that owns, operates, acquires and develops commercial properties, primarily multi-tenant flex, office and industrial space. As of September 30, 2016, the Company owned and operated 28.2 million rentable square feet of commercial space in six states. The Company also manages 737,000 rentable square feet on behalf of PS.

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

## 2. Summary of significant accounting policies

### Basis of presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by

GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ended December 31, 2016. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

Consolidation and Equity Method of Accounting

The Company accounts for its investment in a joint venture that it has significant influence over, but does not control, using the equity method of accounting eliminating intra-entity profits and losses as if the joint venture were a consolidated subsidiary.

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

The Company consolidates all variable interest entities (each a "VIE") for which it is the primary beneficiary. Generally, a VIE is a legal entity in which the equity investors do not have the characteristics of a controlling financial interest or the equity investors lack sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. A limited partnership may be considered a VIE if the limited partners do not participate in operating decisions. Under this criteria, the Operating Partnership is considered a VIE. The Company's significant asset is its investment in the Operating Partnership, and consequently, substantially all of the Company's assets and

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liabilities represent those assets and liabilities of the Operating Partnership. All of the Company's debt is an obligation of the Operating Partnership.

Noncontrolling interests

The Company's noncontrolling interests are reported as a component of equity separate from the parent's equity. Purchases or sales of equity interests that do not result in a change in control are accounted for as equity transactions. In addition, net income attributable to the noncontrolling interests is included in consolidated net income on the face of the income statement and, upon a gain or loss of control, the interests purchased or sold, as well as any interests retained, are recorded at fair value with any gain or loss recognized in earnings. At the end of each reporting period, the Company determines the amount of equity (book value of net assets) which is allocable to the noncontrolling interests based upon the ownership interest, and an adjustment is made to the noncontrolling interests, with a corresponding adjustment to paid-in capital, to reflect the noncontrolling interests' equity interest in the Company.

Use of estimates

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

Allowance for doubtful accounts

The Company monitors the collectability of its receivable balances including the deferred rent receivable on an ongoing basis. Based on these reviews, the Company maintains an allowance for doubtful accounts for estimated losses resulting from the possible inability of tenants to make contractual rent payments to the Company. A provision for doubtful accounts is recorded during each period. The allowance for doubtful accounts is netted against tenant and other receivables on the consolidated balance sheets. Tenant receivables are net of an allowance for uncollectible accounts totaling $400,000 at September 30, 2016 and December 31, 2015. Deferred rent receivable is net of an allowance for uncollectible accounts totaling $919,000 and $909,000 at September 30, 2016 and December 31, 2015, respectively.

Financial instruments

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

* Level 1—quoted prices for identical instruments in active markets;
* Level 2—quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which significant inputs and significant value drivers are observable in active markets; and
* Level 3—fair value measurements derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

Financial assets that are exposed to credit risk consist primarily of cash and cash equivalents and receivables. The Company considers all highly liquid investments with a remaining maturity of three months or less at the date of

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purchase to be cash equivalents. Cash and cash equivalents, which consist primarily of money market investments, are only invested in entities with an investment grade rating. Receivables are comprised of balances due from a large number of customers. Balances that the Company expects to become uncollectible are reserved for or written off. Due to the short period to maturity of the Company's cash and cash equivalents, accounts receivable, other assets and accrued and other liabilities, the carrying values as presented on the consolidated balance sheets are reasonable estimates of fair value.

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

Real estate facilities

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

Land held for future development

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

Properties held for disposition

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

Intangible assets/liabilities

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

As of September 30, 2016, the value of in-place leases resulted in net intangible assets of $1.2 million, net of $9.0 million of accumulated amortization with a weighted average amortization period of 9.2 years, and net intangible liabilities of $990,000, net of $9.8 million of accumulated amortization with a weighted average amortization period of 6.3 years. As of December 31, 2015, the value of in-place leases resulted in net intangible assets of $1.7 million, net of $8.6 million of accumulated amortization and net intangible liabilities of $1.8 million, net of $9.0 million of accumulated amortization.

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The Company recorded net increases in rental income of $106,000 and $341,000 for the three months ended September 30, 2016 and 2015, respectively, and $437,000 and $1.0 million for the nine months ended September 30, 2016 and 2015, respectively, due to the amortization of net intangible liabilities resulting from the above-market and below-market lease values.

Evaluation of asset impairment

The Company evaluates its assets used in operations for impairment by identifying indicators of impairment and by comparing the sum of the estimated undiscounted future cash flows for each asset to the asset's carrying value. When indicators of impairment are present and the sum of the estimated undiscounted future cash flows is less than the carrying value of such asset, an impairment loss is recorded equal to the difference between the asset's current carrying value and its value based on discounting its estimated future cash flows. In addition, the Company evaluates its assets held for disposition for impairment. Assets held for disposition are reported at the lower of their carrying value or fair value, less cost of disposition. At September 30, 2016, the Company did not consider any assets to be impaired.

Stock compensation

All share-based payments to employees, including grants of employee stock options, are recognized as stock compensation in the Company's income statement based on their grant date fair values. See Note 12.

Revenue and expense recognition

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

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

Gains from sales of real estate facilities

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

General and administrative expenses

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

Income taxes

The Company has qualified and intends to continue to qualify as a REIT, as defined in Section 856 of the Internal Revenue Code of 1986, as amended. As a REIT, the Company is not subject to federal income tax to the extent that it distributes its REIT taxable income to its shareholders. A REIT must distribute at least 90% of its taxable income each

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year. In addition, REITs are subject to a number of organizational and operating requirements. The Company may be subject to certain state and local taxes on its income and property and to federal income and excise taxes on its undistributed taxable income. The Company believes it met all organization and operating requirements to maintain its REIT status during 2015 and intends to continue to meet such requirements for 2016. Accordingly, no provision for income taxes has been made in the accompanying consolidated financial statements.

The Company can recognize a tax benefit only if it is "more likely than not" that a particular tax position will be sustained upon examination or audit. To the extent that the "more likely than not" standard has been satisfied, the benefit associated with a position is measured as the largest amount that is greater than 50% likely of being recognized upon settlement. As of September 30, 2016, the Company did not recognize any tax benefit for uncertain tax positions.

Accounting for preferred equity issuance costs

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

Net income allocation

Net income was allocated as follows (in thousands):

| | For The Three Months | | For The Nine Months | |
|---|---|---|---|---|
| | Ended September 30, | | Ended September 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Net income allocable to noncontrolling interests: | | | | |
| Noncontrolling interests—common units | $ 5,315 | $ 6,087 | $ 13,495 | $ 14,467 |
| Total net income allocable to noncontrolling interests | 5,315 | 6,087 | 13,495 | 14,467 |
| Net income allocable to PS Business Parks, Inc.: | | | | |
| Preferred shareholders | | | | |
| Distributions to preferred shareholders | 13,833 | 15,122 | 41,498 | 45,366 |
| Non-cash distributions related to the redemption of | | | | |

| | | | | |
|---|---|---|---|---|
| preferred stock | — | 2,487 | — | 2,487 |
| Total net income allocable to preferred shareholders | 13,833 | 17,609 | 41,498 | 47,853 |
| Restricted stock unit holders | 128 | 97 | 387 | 237 |
| Common shareholders | 19,718 | 22,484 | 50,017 | 53,384 |
| Total net income allocable to PS Business Parks, Inc. | 33,679 | 40,190 | 91,902 | 101,474 |
| Net income | $ 38,994 | $ 46,277 | $ 105,397 | $ 115,941 |

Net income per common share

Per share amounts are computed using the number of weighted average common shares outstanding. “Diluted” weighted average common shares outstanding includes the dilutive effect of stock options and restricted stock units under the treasury stock method. “Basic” weighted average common shares outstanding excludes such effect. The Company's restricted stock units are participating securities and are included in the computation of basic and diluted weighted average common shares outstanding. The Company’s restricted stock unit holders are paid non-forfeitable dividends in excess of the expense recorded which results in a reduction in net income allocable to common shareholders and unit holders.

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Earnings per share has been calculated as follows (in thousands, except per share amounts):

| | For The Three Months Ended September 30, | | For The Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Net income allocable to common shareholders | $ 19,718 | $ 22,484 | $ 50,017 | $ 53,384 |
| Weighted average common shares outstanding: | | | | |
| Basic weighted average common shares outstanding | 27,103 | 26,985 | 27,076 | 26,956 |
| Net effect of dilutive stock compensation—based on treasury stock method using average market price | 98 | 64 | 90 | 78 |
| Diluted weighted average common shares outstanding | 27,201 | 27,049 | 27,166 | 27,034 |
| Net income per common share—Basic | $ 0.73 | $ 0.83 | $ 1.85 | $ 1.98 |
| Net income per common share—Diluted | $ 0.72 | $ 0.83 | $ 1.84 | $ 1.97 |

No options were excluded from the computation of diluted net income per share for the three months ended September 30, 2016 as no options were considered anti-dilutive. Options to purchase 25,000 shares were excluded from the computation of diluted net income per share for the nine months ended September 30, 2016 as such options were considered anti-dilutive. Options to purchase 46,000 shares were excluded from the computation of diluted net income per share for the three and nine months ended September 30, 2015 as such options were considered anti-dilutive.

Segment reporting

The Company views its operations as one segment.

Reclassifications

Certain reclassifications have been made to the consolidated financial statements for 2015 in order to conform to the 2016 presentation.

Recently issued accounting standards

In May, 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standard Update (“ASU”) 2014-09, Revenue from Contracts with Customers, which amended the existing accounting standards for revenue recognition. The new accounting guidance establishes principles for recognizing revenue upon the transfer of promised goods or services to customers, in an amount that reflects the expected consideration received in exchange for those goods or services. This guidance is currently effective for the Company’s fiscal year beginning January 1, 2018. Early adoption is permitted for the Company’s fiscal year beginning January 1, 2017. The amendment allows for full retrospective adoption applied to all periods presented or modified retrospective adoption with the cumulative effect of initially applying the standard recognized at the date of initial application. The Company is currently in the process of evaluating the impact of adoption of the new accounting guidance on its consolidated financial statements.

In August, 2014, the FASB issued ASU 2014-15, Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern, which is intended to define management’s responsibility to evaluate whether there is substantial doubt about an organization’s ability to continue as a going concern for a period of one year after the date that the financial statements are issued. This guidance is effective for annual periods ending after December 15, 2016 and interim periods within annual periods beginning after December 15, 2016. Early adoption is permitted. The Company anticipates no impact upon adoption of the new accounting guidance on its consolidated financial statements.

In February, 2015, the FASB issued ASU 2015-02, Consolidation – Amendments to the Consolidation Analysis, which amended the existing accounting standards for consolidation under both the variable interest model and the voting model. On January 1, 2016, the Company adopted this guidance and as the Operating Partnership is already

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consolidated in the balance sheets of the Company, the identification of this entity as a VIE has no impact on the consolidated financial statements of the Company. Additionally, the Company’s accounting for its investment in its joint venture was not impacted by the adoption of this guidance.

In February, 2016, the FASB issued ASU 2016-02, Leases, which amends the existing accounting standards for lease accounting. The accounting applied by a lessor is largely unchanged under this guidance. However, the guidance requires lessees to recognize assets and liabilities for most leases on the balance sheet. This guidance is effective for annual periods beginning after December 15, 2018 and interim periods within annual periods beginning after December 15, 2018. Early adoption is permitted. The guidance must be adopted using a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. The Company is currently in the process of evaluating the impact of adoption of the new accounting guidance on its consolidated financial statements.

In March, 2016, the FASB issued ASU 2016-09, Improvements to Employee Share-Based Payment Accounting, to amend the accounting guidance for share-based payment accounting. The guidance is intended to simplify the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. This guidance is effective for annual periods beginning after December 15, 2016 and interim periods within those annual periods and early adoption is permitted. The Company is currently assessing the impact of the guidance on its consolidated financial statements.

3. Real estate facilities

The activity in real estate facilities for the nine months ended September 30, 2016 is as follows (in thousands):

| | Land | Buildings and Improvements | Accumulated Depreciation | Total |
|---|---|---|---|---|
| Balances at December 31, 2015 | $ 793,569 | $ 2,215,515 | $ (1,082,603) | $ 1,926,481 |
| Acquisition of real estate facilities | 5,638 | 7,637 | — | 13,275 |
| Capital expenditures, net | — | 25,954 | — | 25,954 |
| Disposals | — | (10,302) | 10,302 | — |
| Depreciation and amortization | — | — | (74,886) | (74,886) |
| Balances at September 30, 2016 | $ 799,207 | $ 2,238,804 | $ (1,147,187) | $ 1,890,824 |

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

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

On September 28, 2016, the Company acquired two multi-tenant office buildings aggregating 226,000 square feet in Rockville, Maryland, for a purchase price of $13.3 million. The buildings are located within Shady Grove Executive Park, where the Company owns three other buildings comprised of 352,000 square feet.

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The following table summarizes the assets acquired and liabilities assumed for the nine months ended September 30, 2016 (in thousands):

| | 2016 |
|---|---|
| Land | $ 5,638 |
| Buildings and improvements | 7,637 |
| Below-market in-place lease value | (25) |
| Total purchase price | 13,250 |
| Net operating assets acquired and liabilities assumed | (622) |
| Total cash paid | $ 12,628 |

During the nine months ended September 30, 2015, the Company completed the sale of assets in Tempe, Arizona, Sacramento, California, Milwaukie, Oregon and Redmond, Washington. The assets sold aggregated 574,000 square feet and generated net proceeds of $55.2 million, which resulted in an aggregate gain of $28.2 million.

4. Investment in and advances to unconsolidated joint venture

In 2013, the Company entered into a joint venture known as Amherst JV LLC (the “Joint Venture”), in which it has a 95.0% economic interest, with an unrelated real estate development company for the purpose of developing a 395-unit multi-family building on a five-acre site within its Westpark Business Park in Tysons, Virginia. The Company contributed the site, along with capitalized improvements, to the Joint Venture on October 5, 2015. Demolition, site preparation and construction commenced in October, 2015. The Company’s partner in the Joint Venture serves as the managing member, with mutual consent from both the Company and the managing member required for all significant decisions. As such, the Company accounts for its investment in the Joint Venture using the equity method.

Along with the equity capital the Company has committed to the Joint Venture, the Company has also agreed to provide the Joint Venture with a construction loan in the amount of $75.0 million. The Joint Venture will pay interest under the construction loan at a rate equal to the London Interbank Offered Rate (“LIBOR”) plus 2.25%. The loan will mature on April 5, 2019. The Company has reflected the aggregate value of the contributed site, its’ equity contributions, capitalized interest and loan advances to date as investment in and advances to unconsolidated joint venture. The aggregate amount of development costs are estimated to be $105.6 million (excluding unrealized land appreciation), of which the Company is committed to funding $75.0 million through a construction loan in addition to total equity and capital contributions of $28.5 million, which includes a land basis of $15.3 million, to the Joint Venture.

The Company’s investment in and advances to unconsolidated joint venture was $55.5 million and $26.7 million as of September 30, 2016 and December 31, 2015, respectively. For the nine months ended September 30, 2016, the Company made loan advances of $22.3 million, capital contributions of $5.7 million and capitalized $854,000 of interest. For the nine months ended September 30, 2015, the Company capitalized costs of $2.8 million related to this development, of which $813,000 was related to capitalized interest. The Company made no loan advances to the Joint Venture in 2015.

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5. Leasing activity

The Company leases space in its real estate facilities to tenants primarily under non-cancelable leases generally ranging from one to 10 years. Future minimum rental revenues, excluding recovery of operating expenses under these leases, are as follows as of September 30, 2016 (in thousands):

| | |
|---|---|
| 2016 | $ 73,197 |
| 2017 | 257,375 |
| 2018 | 193,217 |
| 2019 | 130,527 |
| 2020 | 84,301 |
| Thereafter | 157,499 |
| Total | $ 896,116 |

In addition to minimum rental payments, certain tenants reimburse the Company for their pro rata share of specified operating expenses. Such reimbursements amounted to $20.3 million and $19.5 million for the three months ended September 30, 2016 and 2015, respectively, and $61.6 million and $59.5 million for the nine months ended September 30, 2016 and 2015, respectively. These amounts are included as rental income in the accompanying consolidated statements of income.

Leases accounting for 3.3% of total leased square footage are subject to termination options, of which 1.5% of total leased square footage have termination options exercisable through December 31, 2016. In general, these leases provide for termination payments should the termination options be exercised. The future minimum rental revenues in the above table assume such options are not exercised.

6. Bank loans

The Company has a line of credit (the “Credit Facility”) with Wells Fargo Bank, National Association (“Wells Fargo”). The Credit Facility has a borrowing limit of $250.0 million and expires May 1, 2019. The rate of interest charged on borrowings is based on the LIBOR plus 0.875% to LIBOR plus 1.70% depending on the Company’s credit ratings. Currently, the Company’s rate under the Credit Facility is LIBOR plus 0.875%. In addition, the Company is required to pay an annual facility fee ranging from 0.125% to 0.30% of the borrowing limit depending on the Company’s credit ratings (currently 0.125%). As of September 30, 2016, the Company had $60.0 million outstanding on the Credit Facility at an interest rate of 1.36%. Subsequent to September 30, 2016, the Company repaid the outstanding balance in full. The Company had no balance outstanding on the Credit Facility at December 31, 2015. The Company had $596,000 and $769,000 of unamortized commitment fees as of September 30, 2016 and December 31, 2015, respectively, which is included in other assets in the accompanying consolidated balance sheets. The Credit Facility requires the Company to meet certain covenants, all of which the Company was in compliance with as of September 30, 2016. Interest on outstanding borrowings is payable monthly.

7. Mortgage note payable

On June 1, 2016, the Company repaid in full the $250.0 million mortgage note which had a fixed interest rate of 5.45%.

8. Noncontrolling interests

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

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Common partnership units

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

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

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

At September 30, 2016, there were 7,305,355 common units owned by PS, which are accounted for as noncontrolling interests. Combined with PS's existing common stock ownership, on a fully converted basis, PS has a combined ownership of 42.0% (or 14.5 million shares) of the Company's common equity.

9. Related party transactions

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

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

The property management contract with PS is for a seven-year term with the agreement automatically extending for an additional one-year period upon each one-year anniversary of its commencement (unless cancelled by either party). Either party can give notice of its intent to cancel the agreement upon expiration of its current term. Management fee revenues under this contract were $130,000 for the three months ended September 30, 2016 and 2015 and $389,000 and $410,000 for the nine months ended September 30, 2016 and 2015, respectively.

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

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

Either the Company or PS can cancel the property management contract upon 60 days' notice. Management fee expenses under the contract were $22,000 and $21,000 for the three months ended September 30, 2016 and 2015, respectively, and $64,000 and $59,000 for the nine months ended September 30, 2016 and 2015, respectively.

Pursuant to a cost sharing and administrative services agreement, the Company shares costs with PS for certain administrative services and rental of corporate office space, which are allocated to PS in accordance with a methodology intended to fairly allocate those costs. These costs totaled $123,000 and $117,000 for the three months ended September 30, 2016 and 2015, respectively, and $370,000 and $352,000 for the nine months ended September 30, 2016 and 2015, respectively.

The Company had net amounts due to PS of $131,000 at September 30, 2016 and due from PS of $57,000 at December 31, 2015, respectively, for these contracts, as well as for certain operating expenses paid by the Company on behalf of PS.

## 10. Shareholders' equity

### Preferred stock

As of September 30, 2016 and December 31, 2015, the Company had the following series of preferred stock outstanding:

| Series | Issuance Date | Earliest Potential Redemption Date | Dividend Rate | Shares Outstanding | Amount |
|---|---|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| | | | | | (in thousands) |
| Series S | January, 2012 | January, 2017 | 6.450% | 9,200 | $ 230,000 |
| Series T | May, 2012 | May, 2017 | 6.000% | 14,000 | 350,000 |
| Series U | September, 2012 | September, 2017 | 5.750% | 9,200 | 230,000 |
| Series V | March, 2013 | March, 2018 | 5.700% | 4,400 | 110,000 |
| Total | | | | 36,800 | $ 920,000 |

On October 20, 2016, the Company issued $189.8 million or 7,590,000 depositary shares, each representing 1/1,000 of a share of the 5.20% Cumulative Preferred Stock, Series W, at $25.00 per depositary share. The 5.20% Series W Cumulative Redeemable Preferred Units are non-callable for five years and have no mandatory redemption.

During the three months ended September 30, 2015, the Company called for the redemption of its 6.875% Cumulative Preferred Stock, Series R, at its par value of $75.0 million and subsequently completed the redemption on October 15, 2015. The Company reported the non-cash distributions of $2.5 million, representing the original issuance costs, as a reduction of net income allocable to common shareholders and unit holders for the three and nine months ended September 30, 2015.

The Company recorded $13.8 million and $17.6 million in distributions to its preferred shareholders for the three months ended September 30, 2016 and 2015, respectively, and $41.5 million and $47.9 million in distributions to its preferred shareholders for the nine months ended September 30, 2016 and 2015, respectively.

Holders of the Company’s preferred stock will not be entitled to vote on most matters, except under certain conditions. In the event of a cumulative arrearage equal to six quarterly dividends, the holders of the preferred stock will have the right to elect two additional members to serve on the Company’s Board of Directors until all events of default have been cured. At September 30, 2016, there were no dividends in arrears.

Except under certain conditions relating to the Company’s qualification as a REIT, the preferred stock is not redeemable prior to the previously noted redemption dates. On or after the respective redemption dates, the respective series of preferred stock will be redeemable, at the option of the Company, in whole or in part, at $25.00 per depositary share, plus any accrued and unpaid dividends. The Company had $29.3 million of deferred costs in connection with the issuance of preferred stock as of September 30, 2016 and December 31, 2015, which the Company will report as additional non-cash distributions upon notice of its intent to redeem such shares.

Common stock

No shares of common stock were repurchased under the board-approved common stock repurchase program during either of the nine months ended September 30, 2016 and 2015.

The Company paid $20.3 million ($0.75 per common share) and $16.2 million ($0.60 per common share) in distributions to its common shareholders for the three months ended September 30, 2016 and 2015, respectively, and $60.9 million ($2.25 per common share) and $43.2 million ($1.60 per common share) in distributions to its common shareholders for the nine months ended September 30, 2016 and 2015, respectively.

Equity stock

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

11. Commitments and contingencies

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

12. Stock compensation

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

The weighted average grant date fair value of options granted during the nine months ended September 30, 2016 and 2015 was $9.05 per share and $8.49 per share, respectively. The Company has calculated the fair value of each option grant on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants during the nine months ended September 30, 2016 and 2015, respectively: a dividend yield of 2.9% and 2.5%; expected volatility of 15.5% and 16.1%; expected life of five years; and risk-free interest rates of 1.1% and 1.4%.

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The weighted average grant date fair value of restricted stock units granted during the nine months ended September 30, 2016 and 2015 was $87.45 and $82.78, respectively. The Company calculated the fair value of each restricted stock unit grant using the market value on the date of grant.

At September 30, 2016, there was a combined total of 1.2 million options and restricted stock units authorized to be granted.

Information with respect to outstanding options and nonvested restricted stock units granted under the 2003 Plan and 2012 Plan is as follows:

| Options: | Number of Options | Weighted Average Exercise Price | Weighted Average Remaining Contract Life | Aggregate Intrinsic Value (in thousands) |
|---|---|---|---|---|
| Outstanding at December 31, 2015 | 258,674 | $ 60.76 | | |
| Granted | 39,000 | $ 102.58 | | |
| Exercised | (49,882) | $ 59.26 | | |
| Forfeited | — | $ — | | |
| Outstanding at September 30, 2016 | 247,792 | $ 67.64 | 5.41 Years | $ 11,380 |
| Exercisable at September 30, 2016 | 169,498 | $ 57.69 | 4.00 Years | $ 9,472 |

| Restricted Stock Units: | Number of Units | Weighted Average Grant Date Fair Value |
|---|---|---|
| Nonvested at December 31, 2015 | 78,652 | $ 78.44 |
| Granted | 119,950 | $ 87.45 |
| Vested | (47,779) | $ 80.45 |
| Forfeited | (5,430) | $ 74.79 |
| Nonvested at September 30, 2016 | 145,393 | $ 58.71 |

Effective March, 2014, the Company entered into a performance-based restricted stock unit program, the Senior Management Long-Term Equity Incentive Program for 2014-2017 ("LTEIP"), with certain employees of the Company. Under the LTEIP, the Company established three levels of targeted restricted stock unit awards for certain employees, which would be earned only if the Company achieved one of three defined targets during 2014 to 2017. Under the LTEIP there is an annual award following the end of each of the four years in the program, with the award subject to and based on the achievement of total return targets during the previous year, as well as an award based on achieving total return targets during the cumulative four-year period 2014-2017. In the event the minimum defined target is not achieved for an annual award, the restricted stock units allocated to be awarded for such year are added to the restricted stock units that may be received if the four-year target is achieved. All restricted stock unit awards under the LTEIP vest in four equal annual installments beginning from the date of award. Up to 99,150 restricted stock units would be awarded for each of the four years assuming achievement was met and up to 92,900 restricted stock units would be awarded for the cumulative four-year period assuming achievement was met. Compensation expense is recognized based on the restricted stock units expected to be awarded based on the target level that is expected to be achieved. Net compensation expense of $1.6 million and $1.7 million related to the LTEIP was recognized during the three months ended September 30, 2016 and 2015, respectively, and $8.1 million and $6.2 million for the nine months ended September 30, 2016 and 2015, respectively.  Included in the 2016 year to date amount, the Company recorded a net non-cash stock compensation charge of $2.0 million during the second quarter of 2016 related to a change in senior management and the future issuance of restricted stock units our former Chief Executive Officer will receive under the Company's LTEIP.

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In connection with the LTEIP, targets for 2015 were achieved at the highest threshold total return level. As such, 99,150 restricted stock units were granted during the nine months ended September 30, 2016 at a weighted average grant date fair value of $83.59.

Included in the Company's consolidated statements of income for the three months ended September 30, 2016 and 2015, was $51,000 and $42,000, respectively, in net compensation expense related to stock options. Net compensation expense of $229,000 and $218,000 related to stock options was recognized during the nine months ended September 30, 2016 and 2015, respectively. Net compensation expense of $1.7 million and $1.8 million related to restricted stock units was recognized during the three months ended September 30, 2016 and 2015, respectively. Net compensation expense of $8.5 million and $8.7 million related to restricted stock units was recognized during the nine months ended September 30, 2016 and 2015, respectively.

As of September 30, 2016, there was $588,000 of unamortized compensation expense related to stock options expected to be recognized over a weighted average period of 3.7 years. As of September 30, 2016, there was $15.3 million of unamortized compensation expense related to restricted stock units expected to be recognized over a weighted average period of 3.9 years.

Cash received from 49,882 stock options exercised during the nine months ended September 30, 2016 was $3.0 million. Cash received from 78,790 stock options exercised during the nine months ended September 30, 2015 was $4.0 million. The aggregate intrinsic value of the stock options exercised was $2.4 million and $2.0 million during the nine months ended September 30, 2016 and 2015, respectively.

During the nine months ended September 30, 2016, 47,779 restricted stock units vested; in settlement of these units, 28,046 shares were issued, net of shares applied to payroll taxes. The aggregate fair value of the shares vested for the nine months ended September 30, 2016 was $4.7 million. During the nine months ended September 30, 2015, 25,384 restricted stock units vested; in settlement of these units, 15,734 shares were issued, net of shares applied to payroll taxes. The aggregate fair value of the shares vested for the nine months ended September 30, 2015 was $2.0 million.

In April, 2015, the shareholders of the Company approved the issuance of up to 130,000 shares of common stock under the Retirement Plan for Non-Employee Directors (the "Director Plan"). Under the Director Plan, the Company grants 1,000 shares of common stock for each year served as a director up to a maximum of 8,000 shares issued upon retirement. The Company recognizes compensation expense over the requisite service period. As a result, included in the Company's consolidated statements of income was $85,000 and $79,000 in compensation expense for the three months ended September 30, 2016 and 2015, respectively, and $254,000 and $237,000 for the nine months ended September 30, 2016 and 2015, respectively. As of September 30, 2016 and 2015, there was $972,000 and $1.3 million, respectively, of unamortized compensation expense related to these shares. In April, 2016, the Company issued 8,000 shares to a director upon retirement with an aggregate fair value of $775,000. No shares were issued during the nine months ended September 30, 2015.

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

Forward-Looking Statements: Forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995, are made throughout this Quarterly Report on Form 10-Q. For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, the words "may," "believes," "anticipates," "plans," "expects," "seeks," "estimates," "intends," and sim expressions are intended to identify forward-looking statements. There are a number of important factors that could cause the results of the Company to differ materially from those indicated by such forward-looking statements, including but not limited to: (a) changes in general economic and business conditions; (b) decreases in rental rates or increases in vacancy rates/failure to renew or replace expiring leases; (c) tenant defaults; (d) the effect of the recent credit and financial market conditions; (e) our failure to maintain our status as a real estate investment trust ("REIT"); (f) the economic health of our tenants; (g) increases in operating costs; (h) casualties to our properties not covered by insurance; (i) the availability and cost of capital; (j) increases in interest rates and its effect on our stock price; and (k) other factors discussed under the heading "Part I, Item 1A. Risk Factors" in our annual report on Form 10-K for the year ended December 31, 2015. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by us or any other person that our objectives and plans will be achieved. Moreover, we assume no obligation to update these forward-looking statements to reflect actual results, changes in assumptions or changes in other factors affecting such forward-looking statements, except as required by law.

Overview

As of September 30, 2016, the Company owned and operated 28.2 million rentable square feet of multi-tenant flex, industrial and office properties concentrated primarily in six states. All operating metrics discussed in this section as of and for the three and nine months ended September 30, 2015 exclude sold assets. Management believes excluding the results of such assets provides the most relevant perspective on the ongoing operations of the Company. Please refer to "Part I, Item 1. Financial Statements" included in this Quarterly Report on Form 10-Q for financial metrics that include results from sold assets.

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

During the first nine months of 2016, the Company executed leases comprising 5.5 million square feet of space including 3.8 million square feet of renewals of existing leases and 1.7 million square feet of new leases. Overall, the change in rental rates for the Company continued to improve. See further discussion of operating results below.

Critical Accounting Policies and Estimates: Our accounting policies are described in Note 2 to the consolidated financial statements included in this Quarterly Report on Form 10-Q. We believe our most critical accounting policies relate to revenue recognition, property acquisitions, allowance for doubtful accounts, impairment of long-lived assets, depreciation, accruals of operating expenses and accruals for contingencies, each of which are more fully described in "Part I, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" in our annual report on Form 10-K for the year ended December 31, 2015.

Effect of Economic Conditions on the Company's Operations: During the first nine months of 2016, most markets continued to reflect favorable conditions allowing for stable and improving occupancy as well as increasing rental rates. With the exception of the Virginia and Maryland markets, new rental rates for the Company improved

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over expiring rental rates on executed leases as economic conditions and tenant demand remained healthy. The Virginia and Maryland markets continue to experience soft market conditions as evidenced by continued pressure on occupancy and rental rates. In these markets, rental rates on executed leases declined 7.7% and 5.2%, respectively, over expiring rents for the nine months ended September 30, 2016. Given lease expirations of 1.2 million square feet in Virginia and 418,000 square feet in Maryland through December 31, 2017, the Company may continue to experience a decrease in rental income in these markets.

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

| | For The Nine Months Ended September 30, | |
|---|---|---|
| | 2016 | 2015 |
| Write-offs of uncollectible rent | $ 457 | $ 584 |
| Write-offs as a percentage of rental income | 0.2% | 0.2% |
| Square footage of leases terminated prior to their scheduled expiration due to business failures/bankruptcies | 281 | 415 |
| Accelerated depreciation and amortization related to unamortized tenant improvements and lease commissions associated with early terminations | $ 438 | $ 539 |

As of October 24, 2016, the Company had 12,000 square feet of leased space occupied by tenants that are protected by Chapter 11 of the U.S. Bankruptcy Code. From time to time, tenants contact us, requesting early termination of their lease, reductions in space under lease, or rent deferment or abatement. At this time, the Company cannot anticipate what impact, if any, the ultimate outcome of these discussions will have on our future operating results.

Company Performance and Effect of Economic Conditions on Primary Markets: During the nine months ended September 30, 2016, initial rental rates on new and renewed leases within the Company's total portfolio increased 5.2% over expiring rents, an improvement from the year ended December 31, 2015 in which initial rental rates on new and renewed leases increased 4.4%. The Company's Same Park (defined below) occupancy rate at September 30, 2016 was 94.5%, compared to 93.7% at September 30, 2015. The Company's operations are substantially concentrated in eight regions. Each of the eight regions in which the Company owns assets is subject to its own unique market influences. See "Supplemental Property Data and Trends" below for more information on regional operating data.

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

On September 28, 2016, the Company acquired two multi-tenant office buildings aggregating 226,000 square feet in Rockville, Maryland, for a purchase price of $13.3 million. The buildings, which were 18.5% leased at the time of acquisition, are located within Shady Grove Executive Park, where the Company owns three other buildings comprised of 352,000 square feet, which were 86.4% leased as of September 30, 2016.

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As of September 30, 2016, the blended occupancy rate of the