Hudson Pacific Properties, Inc.
Form 10-Q
May 12, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2014

o 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 001-34789

Hudson Pacific Properties, Inc.
(Exact name of Registrant as specified in its charter)

Maryland (State or other jurisdiction of incorporation or organization)	27-1430478 (I.R.S. Employer Identification Number)
11601 Wilshire Blvd., Sixth Floor Los Angeles, California	90025
(Address of principal executive offices)	(Zip Code)

(310) 445-5700
(Registrant’s telephone number, including area code)
(Former name, former address and
former fiscal year if changed since last report)

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

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

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

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

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

The number of shares of common stock outstanding at May 1, 2014 was 67,029,422.

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PART I—FINANCIAL INFORMATION

HUDSON PACIFIC PROPERTIES, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	March 31, 2014 (Unaudited)	December 31, 2013
ASSETS		
REAL ESTATE ASSETS		
Land	$622,880	$578,787
Building and improvements	1,292,169	1,250,752
Tenant improvements	112,848	107,628
Furniture and fixtures	14,491	14,396
Property under development	78,040	70,128
Total real estate held for investment	2,120,428	2,021,691
Accumulated depreciation and amortization	(126,483)	(114,866)
Investment in real estate, net	1,993,945	1,906,825
Cash and cash equivalents	29,063	30,356
Restricted cash	17,714	16,750
Accounts receivable, net	6,673	8,909
Straight-line rent receivables	24,026	21,538
Deferred leasing costs and lease intangibles, net	110,042	111,398
Deferred finance costs, net	8,028	8,582
Interest rate contracts	33	192
Goodwill	8,754	8,754
Prepaid expenses and other assets	5,143	5,170
Assets associated with real estate held for sale	12,768	12,801
TOTAL ASSETS	$2,216,189	$2,131,275
LIABILITIES AND EQUITY		
Notes payable	$827,438	$931,308
Accounts payable and accrued liabilities	22,545	27,490
Below-market leases, net	46,853	45,439
Security deposits	6,147	5,941
Prepaid rent	10,565	7,623
Interest rate contracts	475	—
Obligations associated with real estate held for sale	170	133
TOTAL LIABILITIES	914,193	1,017,934
6.25% series A cumulative redeemable preferred units of the Operating Partnership	10,177	10,475
EQUITY		
Hudson Pacific Properties, Inc. stockholders' equity:		
Preferred stock, $0.01 par value, 10,000,000 authorized; 8.375% series B cumulative redeemable preferred stock, $25.00 liquidation preference, 5,800,000 shares outstanding at March 31, 2014 and December 31, 2013, respectively	145,000	145,000
Common stock, $0.01 par value, 490,000,000 authorized, 66,795,071 shares and 57,230,199 shares outstanding at March 31, 2014 and December 31, 2013,	668	572

respectively		
Additional paid-in capital	1,093,774	903,984
Accumulated other comprehensive loss	(1,529)	(997)
Accumulated deficit	(43,784)	(45,113)
Total Hudson Pacific Properties, Inc. stockholders’ equity	1,194,129	1,003,446
Non-controlling interest—members in Consolidated Entities	44,224	45,683
Non-controlling common units in the Operating Partnership	53,466	53,737
TOTAL EQUITY	1,291,819	1,102,866
TOTAL LIABILITIES AND EQUITY	$2,216,189	$2,131,275

The accompanying notes are an integral part of these consolidated financial statements.

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HUDSON PACIFIC PROPERTIES, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(in thousands, except share and per share amounts)

	Three Months Ended March 31,	
	2014	2013
Revenues		
Office		
Rental	$36,010	$26,796
Tenant recoveries	5,571	5,749
Parking and other	4,479	3,927
Total office revenues	46,060	36,472
Media & entertainment		
Rental	5,449	5,768
Tenant recoveries	320	418
Other property-related revenue	3,634	4,490
Other	133	236
Total media & entertainment revenues	9,536	10,912
Total revenues	55,596	47,384
Operating expenses		
Office operating expenses	15,927	13,265
Media & entertainment operating expenses	6,005	5,568
General and administrative	5,776	4,989
Depreciation and amortization	16,668	18,431
Total operating expenses	44,376	42,253
Income from operations	11,220	5,131
Other expense (income)		
Interest expense	6,524	5,592
Interest income	(9)	(150)
Acquisition-related expenses	105	—
Other expenses	1	45
	6,621	5,487
Income (loss) from continuing operations	4,599	(356)
Net (loss) income from discontinued operations	(66)	673
Net income	4,533	317
Net income attributable to preferred stock and units	(3,200)	(3,231)
Net income attributable to restricted shares	(69)	(79)
Net loss (income) attributable to non-controlling interest in Consolidated Entities	43	(10)
Net (income) loss attributable to common units in the Operating Partnership	(47)	131
Net income (loss) attributable to Hudson Pacific Properties, Inc. common stockholders	$1,260	$(2,872)
Basic and diluted per share amounts:		
Net income (loss) from continuing operations attributable to common stockholders	0.02	(0.07)
Net income from discontinued operations	—	0.01
	$0.02	$(0.06)

Net income (loss) attributable to common stockholders' per share—basic and diluted		
Weighted average shares of common stock outstanding—basic and diluted	63,625,751	52,184,280
Dividends declared per share of common stock	$0.1250	$0.1250

The accompanying notes are an integral part of these consolidated financial statements.
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HUDSON PACIFIC PROPERTIES, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited)
(in thousands, except share and per share amounts)

	Three Months Ended March 31,	
	2014	2013
Net income	$4,533	$317
Other comprehensive (loss) income: cash flow hedge adjustment	(552)	17
Comprehensive income	3,981	334
Comprehensive income attributable to preferred stock and units	(3,200)	(3,231)
Comprehensive income attributable to restricted shares	(69)	(79)
Comprehensive loss (income) attributable to non-controlling interest in consolidated real estate entities	43	(10)
Comprehensive (income) loss attributable to common units in the Operating Partnership	(27)	130
Comprehensive income (loss) attributable to Hudson Pacific Properties, Inc. stockholders	$728	$(2,856)

The accompanying notes are an integral part of these consolidated financial statements.

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HUDSON PACIFIC PROPERTIES, INC.
CONSOLIDATED STATEMENTS OF EQUITY
(Unaudited)
(in thousands, except share and per share amounts)

	Hudson Pacific Properties, Inc. Stockholders' Equity									
	Shares of Common Stock	Stock Amount	Series B Cumulative Redeemable Preferred Stock	Additional Paid in Capital	Accumulated Deficit	Accumulated Other Comprehensive (Deficit) Income	Non-controlling Interests — Common units in the Operating Partnership	Non-controlling Interest — Members in Consolidated Entities	Total Equity	Non-controlling Interests — Series A Cumulative Redeemable Preferred Units
Balance, January 1, 2013	47,496,732	$475	$145,000	$726,605	$(30,580)	$(1,287)	$55,549	$1,460	$897,222	$12,475
Contributions	—	—	—	—	—	—	—	45,704	45,704	—
Distributions	—	—	—	—	—	—	—	(1,160)	(1,160)	—
Proceeds from sale of common stock, net of underwriters' discount	9,812,644	98	—	202,444	—	—	—	—	202,542	—
Common stock issuance transaction costs	—	—	—	(577)	—	—	—	—	(577)	—
Issuance of unrestricted stock	5,756	—	—	—	—	—	—	—	—	—
Issuance of restricted stock	44,219	—	—	—	—	—	—	—	—	—
Forfeiture of restricted stock	(3,415)						—	—	—	
Shares repurchased	(125,737)	—	—	(2,755)	—	—	—	—	(2,756)	—
Declared Dividend	—	—	(12,144)	(28,415)	—	—	(1,192)	—	(41,751)	(749)
Amortization of stock-based compensation	—	—	—	6,682	—	—	—	—	6,682	—
Net income (loss)	—	—	12,144	—	(14,533)		(633)	(321)	(3,343)	749
	—	—	—	—	—	290	13	—	303	—

Cash Flow Hedge Adjustment										
Balance, December 31, 2013	57,230,199	$572	$145,000	$903,984	$(45,113)	$(997)	$53,737	$45,683	$1,102,866	$10,475
Distributions	—	—	—	—	—	—	—	(1,416)	(1,416)	—
Proceeds from sale of common stock, net of underwriters' discount	9,563,500	96	—	197,372	—	—	—	—	197,468	—
Common stock issuance transaction costs	—	—	—	(580)	—	—	—	—	(580)	—
Redemption of Series A Cumulative Redeemable Preferred Units	—	—	—	—	—	—	—	—	—	(298)
Issuance of unrestricted stock	1,372	—	—	—	—	—	—	—	—	—
Declared Dividend	—	—	(3,036)	(8,378)	—	—	(298)		(11,712)	(164)
Amortization of stock-based compensation	—	—	—	1,376	—	—	—	—	1,376	—
Net income (loss)	—	—	3,036		1,329	—	47	(43)	4,369	164
Cash Flow Hedge Adjustment	—	—	—	—	—	(532)	(20)	—	(552)	—
Balance, March 31, 2014	66,795,071	$668	$145,000	$1,093,774	$(43,784)	$(1,529)	$53,466	$44,224	$1,291,819	$10,177

The accompanying notes are an integral part of these consolidated financial statements.
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HUDSON PACIFIC PROPERTIES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(in thousands)

	Three Months Ended March 31, 2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$4,533	$317
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	16,668	18,905
Amortization of deferred financing costs and loan premium, net	79	298
Amortization of stock-based compensation	1,277	1,726
Straight-line rent receivables	(2,685)	(1,448)
Amortization of above-market leases	658	690
Amortization of below-market leases	(1,902)	(2,209)
Amortization of lease incentive costs	53	22
Bad debt expense	83	31
Amortization of ground lease	62	62
Change in operating assets and liabilities:		
Restricted cash	(964)	1
Accounts receivable	2,317	(1,514)
Deferred leasing costs and lease intangibles	(819)	(6,073)
Prepaid expenses and other assets	(13)	1,208
Accounts payable and accrued liabilities	(3,086)	5,126
Security deposits	206	265
Prepaid rent	2,934	(2,302)
Net cash provided by operating activities	19,401	15,105
CASH FLOWS FROM INVESTING ACTIVITIES		
Additions to investment property	(25,099)	(19,542)
Property acquisitions	(75,580)	—
Net cash used in investing activities	(100,679)	(19,542)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from notes payable	52,843	8,692
Payments of notes payable	(156,147)	(60,564)
Proceeds from issuance of common stock	197,468	189,888
Common stock issuance transaction costs	(580)	(305)
Dividends paid to common stock and unit holders	(8,676)	(7,385)
Dividends paid to preferred stock and unit holders	(3,200)	(3,231)
Redemption of 6.25% series A cumulative redeemable preferred units	(298)	—
Distribution to non-controlling member in consolidated real estate entity	(1,416)	—
Payment of loan costs	(9)	—
Net cash provided by financing activities	79,985	127,095
Net (decrease) increase in cash and cash equivalents	(1,293)	122,658
Cash and cash equivalents—beginning of period	30,356	18,904
Cash and cash equivalents—end of period	$29,063	$141,562

The accompanying notes are an integral part of these consolidated financial statements.

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HUDSON PACIFIC PROPERTIES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS—(Continued)
(Unaudited)
(in thousands)

	Three Months Ended March 31,	
	2014	2013
SUPPLEMENTAL CASH FLOWS INFORMATION:		
Cash paid for interest, net of amounts capitalized	$7,363	$5,331
NON-CASH INVESTING ACTIVITIES:		
Accounts payable and accrued liabilities for investment in property	$2,285	$2,489
Assumption of other (assets) and liabilities in connection property acquisitions, net (Note 3)	$(449)	$—

The accompanying notes are an integral part of these consolidated financial statements.

Notes to Consolidated Financial Statements
(Unaudited and in thousands, except square footage and share data or as otherwise noted)

1. Organization

Hudson Pacific Properties, Inc. (which is referred to in these financial statements as the “Company,” “we,” “us,” or “our”) is a Maryland corporation formed on November 9, 2009 that did not have any meaningful operating activity until the consummation of our initial public offering and the related acquisition of our predecessor and certain other entities on June 29, 2010 (“IPO”).

Since the completion of the IPO, the concurrent private placement, and the related formation transactions, we have been a fully integrated, self-administered, and self-managed real estate investment trust (“REIT”). Through our controlling interest in Hudson Pacific Properties, L.P. (our “Operating Partnership”) and its subsidiaries, we own, manage, lease, acquire and develop real estate, consisting primarily of office and media and entertainment properties. As of March 31, 2014, we owned a portfolio of 26 office properties and two media and entertainment properties. These properties are located in California and Washington. The results of operations for properties acquired after our IPO are included in our consolidated statements of operations from the date of each such acquisition.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements of the Company are prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). The effect of all significant intercompany balances and transactions has been eliminated.

The accompanying unaudited interim financial statements have been prepared pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in the financial statements prepared in accordance with accounting principles generally accepted in the United States may have been condensed or omitted pursuant to SEC rules and regulations, although we believe that the disclosures are adequate to make their presentation not misleading. The accompanying unaudited financial statements include, in our opinion, all adjustments, consisting of normal recurring adjustments, necessary to present fairly the financial information set forth therein. The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the year ended December 31, 2014. The interim financial statements should be read in conjunction with the consolidated financial statements in our 2013 Annual Report on Form 10-K and the notes thereto. Any reference to the number of properties and square footage are unaudited and outside the scope of our independent registered public accounting firm’s review of our financial statements in accordance with the standards of the United States Public Company Accounting Oversight Board.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of commitments and contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, the Company evaluates its estimates, including those related to acquiring, developing and assessing the carrying values of its real estate properties, its accrued liabilities, and its performance-based equity compensation awards. The Company bases its estimates on historical experience, current market conditions, and various other assumptions that are believed to be reasonable under the circumstances. Actual results could materially differ from these estimates.

Investment in Real Estate Properties

The properties are carried at cost less accumulated depreciation and amortization. The Company assigns the cost of an acquisition, including the assumption of liabilities, to the acquired tangible assets and identifiable intangible assets and liabilities based on their estimated fair values in accordance with GAAP. The Company assesses fair value based on estimated cash flow projections that utilize discount and/or capitalization rates and available market information. Estimates of future cash flows are based on a number of factors including historical operating results, known and anticipated trends, and market and economic conditions. The fair value of tangible assets of an acquired property considers the value of the property as if it was vacant.

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Notes to Consolidated Financial Statements—(Continued)
(Unaudited and in thousands, except square footage and share data)

Acquisition-related expenses associated with acquisition of operating properties are expensed in the period incurred.

The Company records acquired "above and below" market leases at fair value using discount rates that reflect the risks associated with the leases acquired. The amount recorded is based on the present value of the difference between (i) the contractual amounts to be paid pursuant to each in-place lease and (ii) management's estimate of fair market lease rates for each in-place lease, measured over a period equal to the remaining term of the lease for above-market leases and the initial term plus the extended term for any leases with below-market renewal options. Other intangible assets acquired include amounts for in-place lease values that are based on the Company's evaluation of the specific characteristics of each tenant's lease. Factors considered include estimates of carrying costs during hypothetical expected lease-up periods, market conditions and costs to execute similar leases. In estimating carrying costs, the Company includes estimates of lost rents at market rates during the hypothetical expected lease-up periods, which are dependent on local market conditions. In estimating costs to execute similar leases, the Company considers leasing commissions, legal and other related costs.

The Company capitalizes direct construction and development costs, including predevelopment costs, interest, property taxes, insurance and other costs directly related and essential to the acquisition, development or construction of a real estate project. Indirect development costs, including salaries and benefits, office rent, and associated costs for those individuals directly responsible for and who spend their time on development activities are also capitalized and allocated to the projects to which they relate. Capitalized personnel costs were approximately $0.6 million and approximately $0.5 million for the three months ended March 31, 2014 and 2013, respectively. Interest is capitalized on the construction in progress at a rate equal to the Company's weighted average cost of debt. Capitalized interest was approximately $1.6 million and $0.8 million for the three months ended March 31, 2014 and 2013, respectively. Construction and development costs are capitalized while substantial activities are ongoing to prepare an asset for its intended use. The Company considers a construction project as substantially complete and held available for occupancy upon the completion of tenant improvements but no later than one year after cessation of major construction activity. Costs incurred after a project is substantially complete and ready for its intended use, or after development activities have ceased, are expensed as they are incurred. Costs previously capitalized related to abandoned acquisitions or developments are charged to earnings. Expenditures for repairs and maintenance are expensed as they are incurred.

The Company computes depreciation using the straight-line method over the estimated useful lives of 39 years for building and improvements, 15 years for land improvements, 5 or 7 years for furniture and fixtures and equipment, and over the shorter of asset life or life of the lease for tenant improvements. Above- and below-market lease intangibles are amortized to revenue over the remaining non-cancellable lease terms and bargain renewal periods, if applicable. Other in-place lease intangibles are amortized to expense over the remaining non-cancellable lease term. Depreciation is discontinued when a property is identified as held for sale.

Impairment of Long-Lived Assets

The Company assesses the carrying value of real estate assets and related intangibles whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable in accordance with GAAP. Impairment losses are recorded on real estate assets held for investment when indicators of impairment are present and the future undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying amount. The Company recognizes impairment losses to the extent the carrying amount exceeds the fair value of the properties. Properties held for sale are recorded at the lower of cost or estimated fair value less cost to sell. There is one property held for sale at March 31, 2014 (which is presented as held for sale at December 31, 2013 for comparative purposes) and no properties were held for sale at December 31, 2013. No impairment indicators have been noted during the three months ended March 31, 2014 and 2013.

Goodwill

Goodwill represents the excess of acquisition cost over the fair value of net tangible and identifiable intangible assets acquired and liabilities assumed in business combinations. Our goodwill balance as of March 31, 2014 was $8,754. We do not amortize this asset but instead analyze it on an annual basis for impairment. No impairment indicators have been noted during the three months ended March 31, 2014 and 2013.

Cash and Cash Equivalents

Cash and cash equivalents are defined as cash on hand and in banks, plus all short-term investments with a maturity of three months or less when purchased.

(Unaudited and in thousands, except square footage and share data)

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The Company maintains some of its cash in bank deposit accounts that, at times, may exceed the federally insured limit. No losses have been experienced related to such accounts.

Restricted Cash

Restricted cash consists of amounts held by lenders to provide for future real estate taxes and insurance expenditures, repairs and capital improvements reserves, general and other reserves and security deposits.

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable consist of amounts due for monthly rents and other charges. The Company maintains an allowance for doubtful accounts for estimated losses resulting from tenant defaults or the inability of tenants to make contractual rent and tenant recovery payments. The Company monitors the liquidity and creditworthiness of its tenants and operators on an ongoing basis. This evaluation considers industry and economic conditions, property performance, credit enhancements and other factors. For straight-line rent amounts, the Company's assessment is based on amounts estimated to be recoverable over the term of the lease. At March 31, 2014 and December 31, 2013 the Company has reserved $516 and $328, respectively, of straight-line receivables. The Company evaluates the collectability of accounts receivable based on a combination of factors. The allowance for doubtful accounts is based on specific identification of uncollectible accounts and the Company's historical collection experience. The Company recognizes an allowance for doubtful accounts based on the length of time the receivables are past due, the current business environment and the Company's historical experience. Historical experience has been within management's expectations. The Company recognized $83 and $31 of bad debt expense for the three months ended March 31, 2014 and 2013.

The following summarizes our accounts receivable net of allowance for doubtful accounts as of:

	March 31, 2014		December 31, 2013	
Accounts receivable	7,763		10,152	
Allowance for doubtful accounts	(1,090	)	(1,243	)
Accounts receivable, net	6,673		8,909	

Revenue Recognition

The Company recognizes rental revenue from tenants on a straight-line basis over the lease term when collectability is reasonably assured and the tenant has taken possession or controls the physical use of the leased asset. If the lease provides for tenant improvements, the Company determines whether the tenant improvements, for accounting purposes, are owned by the tenant or the Company. When the Company is the owner of the tenant improvements, the tenant is not considered to have taken physical possession or have control of the physical use of the leased asset until the tenant improvements are substantially completed. When the tenant is the owner of the tenant improvements, any tenant improvement allowance that is funded is treated as a lease incentive and amortized as a reduction of revenue over the lease term. Tenant improvement ownership is determined based on various factors including, but not limited to:

- whether the lease stipulates how and on what a tenant improvement allowance may be spent;

- whether the tenant or landlord retains legal title to the improvements at the end of the lease term;
- whether the tenant improvements are unique to the tenant or general-purpose in nature; and
- whether the tenant improvements are expected to have any residual value at the end of the lease.

Certain leases provide for additional rents contingent upon a percentage of the tenant’s revenue in excess of specified base amounts or other thresholds. Such revenue is recognized when actual results reported by the tenant, or estimates of tenant results, exceed the base amount or other thresholds. Such revenue is recognized only after the contingency has been removed (when the related thresholds are achieved), which may result in the recognition of rental revenue in periods subsequent to when such payments are received.

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Other property-related revenue is revenue that is derived from the tenants' use of lighting, equipment rental, parking, power, HVAC and telecommunications (phone and Internet). Other property-related revenue is recognized when these items are provided.

Tenant recoveries related to reimbursement of real estate taxes, insurance, repairs and maintenance, and other operating expenses are recognized as revenue in the period during which the applicable expenses are incurred. The reimbursements are recognized and presented gross, as the Company is generally the primary obligor with respect to purchasing goods and services from third-party suppliers, has discretion in selecting the supplier and bears the associated credit risk.

The Company recognizes gains on sales of properties upon the closing of the transaction with the purchaser. Gains on properties sold are recognized using the full accrual method when (i) the collectability of the sales price is reasonably assured, (ii) the Company is not obligated to perform significant activities after the sale, (iii) the initial investment from the buyer is sufficient and (iv) other profit recognition criteria have been satisfied. Gains on sales of properties may be deferred in whole or in part until the requirements for gain recognition have been met.

Deferred Financing Costs

Deferred financing costs are amortized over the term of the respective loan.

Derivative Financial Instruments

The Company manages interest rate risk associated with borrowings by entering into interest rate derivative contracts. The Company recognizes all derivatives on the consolidated balance sheet at fair value. Derivatives that are not hedges are adjusted to fair value and the changes in fair value are reflected as income or expense. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives are either offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings, or recognized in other comprehensive income, which is a component of equity. The ineffective portion of a derivative's change in fair value is immediately recognized in earnings.

The Company held three interest rate contracts as of March 31, 2014 and December 31, 2013, respectively, all of which have been accounted for as cash flow hedges as more fully described in note 6 below.

Stock-Based Compensation

Accounting Standard Codification, or ASC, Topic 718, Compensation—Stock Compensation (referred to as ASC Topic 718 and formerly known as FASB 123R), requires us to recognize an expense for the fair value of equity-based compensation awards. Grants of stock options, restricted stock, restricted stock units and performance units under our equity incentive award plans are accounted for under ASC Topic 718. Our compensation committee will regularly consider the accounting implications of significant compensation decisions, especially in connection with decisions that relate to our equity incentive award plans and programs.

Income Taxes

Our taxable income prior to the completion of our IPO is reportable by the members of the limited liability companies that comprise our predecessor. Our property-owning subsidiaries are limited liability companies and are treated as pass-through entities for income tax purposes. Accordingly, no provision has been made for federal income taxes in the accompanying consolidated financial statements for the activities of these entities.

We have elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended (the “Code”) commencing with our initial taxable year. To qualify as a REIT, we are required to distribute at least 90% of our REIT taxable income to our stockholders and meet the various other requirements imposed by the Code relating to such matters as operating results, asset holdings, distribution levels and diversity of stock ownership. Provided we qualify for taxation as a REIT, we are generally not subject to corporate level income tax on the earnings distributed currently to our stockholders that we derive from our REIT qualifying activities. If we fail to qualify as a REIT in any taxable year, and are unable to avail ourselves of certain savings provisions set forth in the Code, all of our taxable income would be subject to federal income tax at regular corporate rates, including any applicable alternative minimum tax.

We have elected, together with one of our subsidiaries, to treat such subsidiary as a taxable REIT subsidiary (“TRS”) for federal income tax purposes. Certain activities that we undertake must be conducted by a TRS, such as non-customary services for our tenants, and holding assets that we cannot hold directly. A TRS is subject to federal and state income taxes.

The Company is subject to the statutory requirements of the states in which it conducts business.

The Company periodically evaluates its tax positions to determine whether it is more likely than not that such positions would be sustained upon examination by a tax authority for all open tax years, as defined by the statute of limitations, based on their technical merits. As of March 31, 2014, the Company has not established a liability for uncertain tax positions.

Fair Value of Assets and Liabilities

Under GAAP, the Company is required to measure certain financial instruments at fair value on a recurring basis. In addition, the Company is required to measure other financial instruments and balances at fair value on a non-recurring basis (e.g., carrying value of impaired real estate and long-lived assets). Fair value is defined as the price that would be received upon the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The GAAP fair value framework uses a three-tiered approach. Fair value measurements are classified and disclosed in one of the following three categories:

- Level 1: unadjusted quoted prices in active markets that are accessible at the measurement date for identical assets or liabilities;

- 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: prices or valuation techniques where little or no market data is available that requires inputs that are both significant to the fair value measurement and unobservable.

When available, the Company utilizes quoted market prices from an independent third-party source to determine fair value and classifies such items in Level 1 or Level 2. In instances where the market for a financial instrument is not active, regardless of the availability of a nonbinding quoted market price, observable inputs might not be relevant and could require the Company to make a significant adjustment to derive a fair value measurement. Additionally, in an inactive market, a market price quoted from an independent third party may rely more on models with inputs based on information available only to that independent third party. When the Company determines the market for a financial instrument owned by the Company to be illiquid or when market transactions for similar instruments do not appear orderly, the Company uses several valuation sources (including internal valuations, discounted cash flow analysis and quoted market prices) and establishes a fair value by assigning weights to the various valuation sources.

Changes in assumptions or estimation methodologies can have a material effect on these estimated fair values. In this regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, may not be realized in an immediate settlement of the instrument.

The Company considers the following factors to be indicators of an inactive market: (i) there are few recent transactions, (ii) price quotations are not based on current information, (iii) price quotations vary substantially either over time or among market makers (for example, some brokered markets), (iv) indexes that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability, (v) there is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the Company’s estimate of expected cash flows, considering all available market data about credit and other nonperformance risk for the asset or liability, (vi) there is a wide bid-ask spread or significant increase in the bid-ask spread, (vii) there is a significant decline or absence of a market for new issuances (that is, a primary market) for the asset or liability or similar assets or liabilities, and (viii) little information is released publicly (for example, a principal-to-principal market).

The Company considers the following factors to be indicators of non-orderly transactions: (i) there was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions, (ii) there was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant, (iii) the seller is in or near

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bankruptcy or receivership (that is, distressed), or the seller was required to sell to meet regulatory or legal requirements (that is, forced), and (iv) the transaction price is an outlier when compared with other recent transactions for the same or similar assets or liabilities.

The Company's interest rate contract agreements are classified as Level 2 and their fair value is derived from estimated values obtained from observable market data for similar instruments.

As of March 31, 2014, the Company had the following outstanding interest rate derivatives that were designated as cash flow hedges of interest rate risk:

Interest Rate Derivative	Number of Instruments	Notional Amount
Interest Rate Caps	2	$97.0 million
Interest Rate Swaps	1	$64.5 million

Non-designated Hedges

For the three months ended March 31, 2014 and 2013, all of the Company's derivatives were designated as cash flow hedges.

Tabular Disclosure of Fair Values of Derivative Instruments on the Balance Sheet

The table below presents a gross presentation, the effects of offsetting, and a net presentation of the Company's derivatives as of March 31, 2014 and December 31, 2013. The net amounts of derivative assets or liabilities can be reconciled to the tabular disclosure of fair value. The tabular disclosure of fair value provides the location that derivative assets and liabilities are presented on the consolidated balance sheets.

	Asset Derivatives			Liability Derivatives		
		Fair Value as of			Fair Value as of	
	Balance Sheet Location	March 31, 2014	December 31, 2013	Balance Sheet Location	March 31, 2014	December 31, 2013
Derivatives designated as hedging instruments:						
Interest rate products	Interest rate contracts	$33	$ 192	Interest rate contracts	$475	—
Total		$33	$ 192		$475	—

Tabular Disclosure of the Effect of Derivative Instruments on the Income Statement

The tables below present the effect of the Company's derivative financial instruments on the Statement of Operations for the three months ended March 31, 2014 and 2013.

	Three Months Ended March 31,	
	2014	2013
Beginning Balance of OCI related to interest rate contracts	1,162	1,465

Unrealized Loss Recognized in OCI Due to Change in Fair Value of interest rate contracts	634	7
Loss Reclassified from OCI into Income (as Interest Expense)	(82)	(24)
Net Change in OCI	552	(17)
Ending Balance of Accumulated OCI Related to Derivatives	1,714	1,448

Credit-Risk-Related Contingent Features

As of March 31, 2014, the Company had one derivative that was in a net liability position.

(Unaudited and in thousands, except square footage and share data)

Recently Issued Accounting Literature

Changes to GAAP are established by the FASB in the form of ASUs. We consider the applicability and impact of all ASUs. Recently issued ASUs not listed below are not expected to have a material impact on our consolidated financial position and results of operations, because either the ASU is not applicable or the impact is expected to be immaterial.

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

3. Investment in Real Estate

Acquisitions

During the first quarter of 2014, we acquired the following: Merrill Place and 3402 Pico. The results of operations for each of these acquisitions are included in our consolidated statements of operations from the date of acquisition. The following table represents our purchase price accounting for each of these acquisitions:

Date of Acquisition	Merrill Place February 12, 2014	3402 Pico Blvd February 28, 2014	Total
Consideration paid			
Cash consideration	$57,034	$18,546	$75,580
Total consideration	$57,034	$18,546	$75,580
Allocation of consideration paid			
Investment in real estate, net	$57,508	$18,500	$76,008
Above-market leases	173	—	173
Deferred leasing costs and lease intangibles, net	3,163	—	3,163
Below-market leases	(3,315)	—	(3,315)
Other (liabilities) asset assumed, net	(495)	46	(449)
Total consideration paid	$57,034	$18,546	$75,580

During 2013, we acquired the following: 3401 Exposition, Pinnacle II, the Seattle portfolio and 1861 Bundy. The results of operations for each of these acquisitions are included in our consolidated statements of operations from the date of acquisition. The following table represents our purchase price accounting for each of these acquisitions:

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	3401 Exposition	Pinnacle II	Seattle Portfolio	1861 Bundy	
Date of Acquisition	May 22, 2013	June 14, 2013	July 31, 2013	September 26, 2013	Total
Consideration paid					
Cash consideration	$8,489	$1,505	$368,389	$11,500	$389,883
Notes Receivable	4,000	—	—	—	4,000
Debt Assumed	13,233	89,066	—	—	102,299
Non-controlling interest in consolidated real estate entity	—	45,704	—	—	45,704
Total consideration	$25,722	$136,275	$368,389	$11,500	$541,886
Allocation of consideration paid					
Investment in real estate, net	$25,439	$134,289	$367,094	$11,500	$538,322
Deferred leasing costs and lease intangibles, net	—	12,637	21,619	—	34,256
Fair market unfavorable debt value	—	(5,820)	—	—	(5,820)
Below-market leases	—	(7,783)	(14,666)	—	(22,449)
Other (liabilities) asset assumed, net	283	2,952	(5,658)	—	(2,423)
Total consideration paid	$25,722	$136,275	$368,389	$11,500	$541,886

The table below shows the pro forma financial information for the three months ended March 31, 2014 and 2013 as if these properties had been acquired as of January 1, 2013.

	Three Months Ended March 31,	
	2014	2013
Total revenues	$56,348	$48,888
Net loss	$4,504	$262

Dispositions

During the quarter ended March 31, 2014, the Company began to market its Tierrasanta office property for sale and therefore reclassified its assets and liabilities to held for sale as the March 31, 2014 and December 31, 2013.

On May 31, 2013, the Company entered into an agreement to sell its City Plaza property for approximately $56.0 million (before certain credits, prorations, and closing costs). The transaction closed on July 12, 2013. The transaction resulted in an approximately $5.6 million impairment loss which was recorded in the second quarter of 2013. The Company reclassified City Plaza's results of operations for the three months ended March 31, 2014 and 2013 to discontinued operations on its consolidated statements of operations.

The following table sets forth the discontinued operations for the three months ended March 31, 2014 and 2013 for City Plaza:

	Three Months Ended March 31,	
	2014	2013
Total office revenues	$—	$1,997
Office operating expenses	(66)	(851)

Depreciation and amortization	—	(473)
Loss from discontinued operations	$(66)	$673

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4. Lease Intangibles

The following summarizes our deferred leasing cost and lease intangibles as of:

	March 31, 2014	December 31, 2013
Above-market leases	$16,392	$16,517
Leases in place	88,673	86,417
Below-market ground leases	7,513	7,513
Other lease intangibles	37,807	37,162
Lease buy-out costs	3,107	3,107
Deferred leasing costs	30,704	29,759
	$184,196	$180,475
Accumulated amortization	(74,154)	(69,077)
Deferred leasing costs and lease intangibles, net	$110,042	$111,398
Below-market leases	$70,829	$67,513
Accumulated accretion	(23,976)	(22,074)
Below-market leases, net	$46,853	$45,439

5. Notes Payable

Senior Unsecured Revolving Credit Facility

On August 3, 2012, we replaced our $200.0 million secured revolving credit facility with a $250.0 million unsecured revolving credit facility with a group of lenders for which Wells Fargo Bank, N.A. acts as administrative agent and its affiliate acts as joint lead arranger, Bank of America, N.A. acts as joint lead arranger and, together with Barclays Capital, acts as joint syndication agent, and Keybank, N.A., acts as documentation agent. Our Operating Partnership is the borrower under our new unsecured revolving credit facility. The facility is required to be guaranteed by us and all of our subsidiaries that own unencumbered properties. The facility includes an accordion feature that allows us to increase the availability by $150.0 million, to $400.0 million, under specified circumstances and subject to receiving commitments from lenders.

Our facility bears interest at a rate per annum equal to LIBOR plus 155 basis points to 220 basis points, depending on our leverage ratio. If the Company obtains a credit rating for its senior unsecured long-term indebtedness, it may make an irrevocable election to change the interest rate for the facility to a rate per annum equal to LIBOR plus 100 basis points to 185 basis points, depending on the credit rating. Our facility is subject to a facility fee in an amount equal to our unused commitments multiplied by a rate per annum equal to 25 basis points to 35 basis points, depending on our usage of the facility, or, if we make the credit rating election, in an amount equal to the aggregate amount of our commitments multiplied by a rate per annum equal to 15 basis points to 45 basis points, depending upon the credit rating. The amount available for us to borrow under the facility is subject to compliance with certain covenants, including the following financial covenants:

- a maximum leverage ratio (defined as consolidated total indebtedness plus our pro rata share of indebtedness of unconsolidated affiliates to total asset value) of 0.60:1.00;

- a minimum fixed charge coverage ratio (defined as consolidated earnings before interest, taxes, depreciation and amortization (“EBITDA”) plus our pro rata share of EBITDA of unconsolidated affiliates to fixed charges) of 1.50:1.00;
- a maximum secured indebtedness leverage ratio (defined as consolidated secured indebtedness plus our pro rata share of secured indebtedness of unconsolidated affiliates to total asset value) of 0.60:1:00 through and including August 3, 2014 and 0.55:1:00 thereafter;
- a maximum unencumbered leverage ratio (defined as consolidated unsecured indebtedness plus our pro rata share of unsecured indebtedness of unconsolidated affiliates to total unencumbered asset value) of 0.60:1:00;

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- a minimum unsecured interest coverage ratio (defined as consolidated net operating income from unencumbered properties plus our pro rata share of net operating income from unencumbered properties to unsecured interest expense) of 1.60:1.00; and

- a maximum recourse debt ratio (defined as recourse indebtedness other than indebtedness under the revolving credit facility but including unsecured lines of credit to total asset value) of 0.15:1.00.

In addition to these covenants, the facility also includes certain limitations on dividend payouts and distributions, limits on certain types of investments outside of our primary business, and other customary affirmative and negative covenants. Our ability to borrow under the facility is subject to continued compliance with these covenants.

As of March 31, 2014, we were in compliance with our facility's financial covenants. As of March 31, 2014, we had $250.0 million of total capacity under our unsecured revolving credit facility, of which $40.0 million had been drawn.

The following table sets forth information as of March 31, 2014 with respect to our outstanding indebtedness.

Debt	Outstanding March 31, 2014	December 31, 2013	Interest Rate(1)	Maturity Date
Unsecured Revolving Credit Facility	$40,000	$ 155,000	LIBOR+1.55% to 2.20%	8/3/2016
Mortgage loan secured by 3401 Exposition Boulevard(2)	13,233	13,233	LIBOR+3.80%	6/9/2014
Mortgage loan secured by 6922 Hollywood Boulevard(3)	40,151	40,396	5.58%	1/1/2015
Mortgage loan secured by 275 Brannan	15,000	15,000	LIBOR+2.00%	10/5/2015
Mortgage loan secured by Pinnacle II(4)	88,248	88,540	6.313%	9/6/2016
Mortgage loan secured by 901 Market(5)	49,600	49,600	LIBOR+2.25%	10/31/2016
Mortgage loan secured by Element LA(6)	13,287	566	LIBOR+1.95%	11/1/2017
Mortgage loan secured by Sunset Gower/Sunset Bronson(7)	97,000	97,000	LIBOR+2.25%	2/11/2018
Mortgage loan secured by Rincon Center(8)	105,544	105,853	5.134%	5/1/2018
Mortgage loan secured by First & King(9)	95,000	95,000	LIBOR+1.60%	8/31/2018
Mortgage loan secured by Met Park North(10)	64,500	64,500	LIBOR+1.55%	8/1/2020
Mortgage loan secured by First Financial(11)	42,933	43,000	4.580%	2/1/2022
Mortgage loan secured by 10950 Washington(8)	29,188	29,300	5.316%	3/11/2022
Mortgage loan secured by Pinnacle I(12)	129,000	129,000	3.954%	11/7/2022