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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

Number of shares outstanding of each of the issuer's classes of common stock, as of: MAY 6, 2008

COMMON STOCK, \$.01 PAR VALUE PER SHARE 19,092,473

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PART I: FINANCIAL INFORMATION

ITEM 1. Financial Statements

NAPCO SECURITY SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

| ASSETS ----- | March 31, 2008 (unaudited) ----- (in thousand) |
|---|---|
| Current Assets: | |
| Cash and cash equivalents | \$ 2,060 |
| Accounts receivable, less reserve for doubtful accounts | 21,808 |
| Inventories, net | 26,057 |
| Prepaid expenses and other current assets | 1,291 |
| Income taxes receivable | 443 |
| Deferred income taxes | 765 |
| | ----- |
| Total Current Assets | 52,424 |
| Inventories - non-current, net | 8,623 |
| Property, plant and equipment, net | 8,950 |
| Goodwill, net | 9,686 |
| Other assets | 306 |
| | ----- |
| Total Assets | \$ 79,989 ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY ----- | |
| Current Liabilities: | |
| Accounts payable | \$ 6,173 |
| Accrued expenses | 1,062 |
| Accrued salaries and wages | 2,149 |
| Accrued income taxes | - |
| | ----- |
| Total Current Liabilities | 9,384 |
| Long-term debt | 13,900 |
| Accrued income taxes | 288 |
| Deferred income taxes | 1,680 |
| Minority interest in subsidiary | 147 |
| | ----- |
| Total Liabilities | 25,399 ----- |

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Stockholders' Equity:

| | |
|---|--------------------------|
| Common stock, par value \$.01 per share; 40,000,000 shares authorized, 20,092,473 and 20,090,313 shares issued and 19,092,473 and 19,665,141 shares outstanding, respectively | 201 13,366 |
| Additional paid-in capital | 46,638 |
| Retained earnings | ----- 60,205 |
| Less: Treasury Stock, at cost (1,000,000 and 425,172 shares, respectively) | (5,615) ----- |
| Total stockholders' equity | ----- 54,590 ----- |
| Total Liabilities and Stockholders' Equity | \$ 79,989 ===== |

See accompanying notes to condensed consolidated financial statements

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NAPCO SECURITY SYSTEMS, INC. AND SUBSIDIARIES CONDENSED CONSOLIDATED STATEMENTS OF INCOME (unaudited)

| | | Three ----- 2008 ----- (in thousand per |
|--|----|--|
| Net sales | \$ | 16,222 |
| Cost of sales | | 10,699 ----- |
| Gross Profit | | 5,523 |
| Selling, general and administrative expenses | | 3,955 ----- |
| Operating Income | | 1,568 ----- |
| Interest expense, net | | 216 |
| Other expenses, net | | 12 ----- |
| Other expenses | | 228 ----- |
| Income Before Minority Interest and (Benefit) Provision for Income Taxes | | 1,340 |
| Minority interest in loss of subsidiary | | 33 |

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| | |
|---|------------|
| | ----- |
| Income Before (Benefit) Provision for Income Taxes | 1,373 |
| (Benefit) provision for income taxes | (1,904) |
| | ----- |
| Net Income | \$ 3,277 |
| | ===== |
| Earnings per common share: | |
| Basic | \$ 0.17 |
| | ===== |
| Diluted | \$ 0.17 |
| | ===== |
| Weighted average number of common shares outstanding: | |
| Basic | 19,092,487 |
| | ===== |
| Diluted | 19,626,043 |
| | ===== |

See accompanying notes to condensed consolidated financial statements

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NAPCO SECURITY SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (unaudited)

| | | |
|--|--------------|------|
| | ----- | Nine |
| | 2008 | |
| | ----- | |
| | (in thousand | |
| | per | |
| | ----- | |
| Net sales | \$ 46,264 | |
| Cost of sales | 30,356 | |
| | ----- | |
| Gross Profit | 15,908 | |
| Selling, general and administrative expenses | 12,252 | |
| | ----- | |
| Operating Income | 3,656 | |
| | ----- | |

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| | |
|--|------------|
| Interest expense, net | 635 |
| Other expenses, net | 30 |
| | ----- |
| Other expenses | 665 |
| | ----- |
| Income Before Minority Interest and (Benefit) Provision for Income Taxes | 2,991 |
| Minority interest in loss of subsidiary | 92 |
| | ----- |
| Income Before (Benefit) Provision for Income Taxes | 3,083 |
| (Benefit) Provision for income taxes | (1,741) |
| | ----- |
| Net Income | \$ 4,824 |
| | ===== |
| Earnings per common share: | |
| Basic | \$ 0.25 |
| | ===== |
| Diluted | \$ 0.24 |
| | ===== |
| Weighted average number of common shares outstanding: | |
| Basic | 19,319,967 |
| | ===== |
| Diluted | 19,873,655 |
| | ===== |

See accompanying notes to condensed consolidated financial statements

NAPCO SECURITY SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

| | |
|---|----------|
| | Nine |
| | ----- |
| | 2008 |
| | ----- |
| | (in |
| Cash Flows from Operating Activities: | |
| Net income | \$ 4,824 |
| Adjustments to reconcile net income to net cash and cash equivalents provided by (used in) operating activities: | |
| Depreciation and amortization | 854 |

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| | |
|--|----------|
| Provision for (Recovery of) doubtful accounts | 40 |
| Change to inventory obsolescence reserve | 150 |
| Deferred income taxes | 730 |
| Non-cash stock based compensation expense | 216 |
| Changes in operating assets and liabilities: | |
| Accounts receivable | 3,731 |
| Inventories | (6,607) |
| Prepaid expenses and other current assets | (120) |
| Income tax receivable | (443) |
| Other assets | (113) |
| Accounts payable, accrued expenses, accrued salaries and wages, and accrued income taxes | (2,061) |
| | ----- |
| Net Cash Provided by (Used in) Operating Activities | 1,201 |
| | ----- |
| Cash Flows Used in Investing Activities: | |
| Purchases of property, plant and equipment | (668) |
| | ----- |
| Cash Flows from Financing Activities: | |
| Proceeds from exercise of employee stock options | 4 |
| Proceeds from long-term debt borrowings | 5,000 |
| Principal payments on long-term debt | (2,000) |
| Cash paid for purchase of treasury stock | (3,225) |
| | ----- |
| Net Cash (Used in) Provided by Financing Activities | (221) |
| | ----- |
| Net increase (decrease) in Cash and Cash Equivalents | 312 |
| Cash and Cash Equivalents, Beginning of Period | 1,748 |
| | ----- |
| Cash and Cash Equivalents, End of Period | \$ 2,060 |
| | ===== |
| | |
| Cash Paid During the Period for: | |
| ----- | |
| Interest | \$ 589 |
| | ===== |
| Income taxes | \$ 102 |
| | ===== |
| Non-cash Investing activities: | |
| ----- | |
| Adjustment to Retained earnings relating to adoption of FIN 48 | \$ 485 |
| | ===== |

See accompanying notes to condensed consolidated financial statements

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NAPCO SECURITY SYSTEMS, INC AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1.) Summary of Significant Accounting Policies and Other Disclosures

The accompanying Condensed Consolidated Financial Statements are unaudited. In management's opinion, all adjustments (consisting of only normal recurring accruals) necessary for a fair presentation have been made. The results of operations for the period ended March 31, 2008 are not necessarily indicative of results that may be expected for any other interim period or for the full year.

The unaudited Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and related notes contained in the Company's Annual Report on Form 10-K for the year ended June 30, 2007. The accounting policies used in preparing these unaudited Condensed Consolidated Financial Statements are consistent with those described in the June 30, 2007 Consolidated Financial Statements. However, for interim financial statements, inventories are calculated using a gross profit percentage.

The consolidated financial statements include the accounts of Napco Security Systems, Inc. and all of its wholly-owned subsidiaries. The Company has also consolidated a 51%-owned joint venture. The 49% interest, held by a third party, is reflected as minority interest. All inter-company balances and transactions have been eliminated in consolidation.

The Company has made a number of estimates and assumptions relating to the assets and liabilities, the disclosure of contingent assets and liabilities and the reporting of revenues and expenses to prepare these financial statements in conformity with accounting principles generally accepted in the United States. Actual results could differ from those estimates.

Seasonality

The Company's fiscal year begins on July 1 and ends on June 30. Historically, the end users of Napco's products want to install its products prior to the summer; therefore sales of its products peak in the period April 1 through June 30, the Company's fiscal fourth quarter, and are reduced in the period July 1 through September 30, the Company's fiscal first quarter. To a lesser degree, sales in Europe are also adversely impacted in the Company's first fiscal quarter because of European vacation patterns, i.e., many distributors and installers are closed for the month of August. In addition, demand is affected by the housing and construction markets.

Advertising and Promotional Costs

Advertising and promotional costs are included in "Selling, General and Administrative" expenses in the condensed consolidated statements of income and are expensed as incurred. Advertising expense for the three months ended March 31, 2008 and 2007 was \$100,000 and \$402,000, respectively. Advertising expense for the nine months ended March 31, 2008 and 2007 was \$817,000 and \$1,100,000, respectively. The decrease in the three and nine months in fiscal 2008 was due to the timing of a major tradeshow. In the prior year this tradeshow occurred in March of 2007 but it did not occur until April of 2008 in the current fiscal year.

Research and Development Costs

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Research and development costs are included in "Cost of Sales" in the condensed consolidated statements of income and are expensed as incurred. Research and development expense for the three months ended March 31, 2008 and 2007 was \$1,375,000 and \$1,325,000, respectively. Research and development expense for the nine months ended March 31, 2008 and 2007 was \$4,097,000 and \$3,938,000, respectively.

Business Concentration and Credit Risk

An entity is more vulnerable to concentrations of credit risk if it is exposed to risk of loss greater than it would have had if it mitigated its risk through diversification of customers. Such risks of loss manifest themselves differently, depending on the nature of the concentration, and vary in significance.

The Company had two customers with accounts receivable balances that aggregated 42% and 38% of the Company's accounts receivable at March 31, 2008 and June 30, 2007, respectively. Sales to neither of these customers exceeded 10% of net sales in any of the past three fiscal years.

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In the ordinary course of business, the Company has established a reserve for doubtful accounts and customer deductions in the amount of \$405,000 and \$365,000 as of March 31, 2008 and June 30, 2007, respectively. The Company's reserve for doubtful accounts is a subjective critical estimate that has a direct impact on reported net earnings. This reserve is based upon the evaluation of accounts receivable agings, specific exposures and historical trends.

Stock Options

During the three and nine months ended March 31, 2008 the Company granted 0 and 40,000 stock options under its 2002 Employee Incentive Stock Option Plan, respectively. These grants have exercise prices between \$5.35 and \$5.89, a fair value of approximately \$145,000 and vest over a four-year period from the date of grant. 1,080 options were exercised under the 2002 Plan with proceeds of approximately \$2,000 during the three months ended March 31, 2008 and 2,160 options were exercised with proceeds of approximately \$4,000 under the 2002 Plan during the nine months ended March 31, 2008. No options were granted or exercised under the Company's 2000 Non-employee Incentive Stock Option Plan.

Recent Accounting Pronouncements

In March 2008, the Financial Accounting Standards Board ("FASB") issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133. This statement changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. SFAS No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008. The Company's adoption of SFAS No. 161 is not expected to have a material effect on its condensed consolidated financial statements.

In February 2008, the FASB issued FASB Staff Position ("FSP") No. FAS

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157-1, "Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13." This FSP amends SFAS No. 157 to exclude certain leasing transactions accounted for under previously existing accounting guidance. However, this scope exception does not apply to assets acquired and liabilities assumed in a business combination, regardless of whether those assets and liabilities are related to leases.

In February 2008, the FASB issued FSP No. FAS 157-2, "Effective Date of FASB Statement No. 157". This FSP delays the effective date of SFAS No. 157, "Fair Value Measurements", for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). This FSP defers the effective date of SFAS No. 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of this FSP.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" ("SFAS No. 141(R)"). SFAS No. 141(R) replaces SFAS No. 141, "Business Combinations," however, it retains the fundamental requirements of the former Statement that the acquisition method of accounting (previously referred to as the purchase method) be used for all business combinations and for an acquirer to be identified for each business. SFAS No. 141(R) defines the acquirer as the entity that obtains control of one or more businesses in the business combination and establishes the acquisition date as the date that the acquirer achieves control. Among other requirements, SFAS No. 141(R) requires the acquiring entity in a business combination to recognize the identifiable assets acquired, liabilities assumed and any non-controlling interest in the acquiree at their acquisition-date fair values, with limited exceptions; acquisition-related costs generally will be expensed as incurred. SFAS No. 141(R) requires certain financial statement disclosures to enable users to evaluate and understand the nature and financial effects of the business combination. SFAS No. 141(R) must be applied prospectively to business combinations that are consummated beginning in the Company's fiscal 2010. The Company's adoption of SFAS No. 141(R) is not expected to have a material effect on its condensed consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, "Non-controlling Interests in Consolidated Financial Statements, an Amendment of ARB No. 51" ("SFAS No. 160") to establish accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. Among other requirements, SFAS No. 160 clarifies that a non-controlling interest in a subsidiary, which is sometimes referred to as minority interest, is to be reported as a separate component of equity in the consolidated financial statements. SFAS No. 160 also requires consolidated net income to include the amounts attributable to both the parent and the non-controlling interest and to disclose those amounts on the face of the consolidated statement of income. SFAS No. 160 must be

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applied prospectively for fiscal years, and interim periods within those fiscal years, beginning in the Company's fiscal 2010, except for the presentation and disclosure requirements, which will be applied retrospectively for all periods. The Company's adoption of SFAS No. 160 is not expected to have a material effect on its condensed consolidated financial statements.

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In December 2007, the U.S. Securities and Exchange Commission issued Staff Accounting Bulletin No. 110 ("SAB 110"). This staff accounting bulletin ("SAB") expresses the views of the staff regarding the use of a "simplified" method, as discussed in SAB No. 107 ("SAB 107"), in developing an estimate of expected term of "plain vanilla" share options in accordance with SFAS No. 123 (revised 2004), Share-Based Payment. In particular, the staff indicated in SAB 107 that it will accept a company's election to use the simplified method, regardless of whether the company has sufficient information to make more refined estimates of expected term. At the time SAB 107 was issued, the staff believed that more detailed external information about employee exercise behavior (e.g., employee exercise patterns by industry and/or other categories of companies) would, over time, become readily available to companies. Therefore, the staff stated in SAB 107 that it would not expect a company to use the simplified method for share option grants after December 31, 2007. The staff understands that such detailed information about employee exercise behavior may not be widely available by December 31, 2007. Accordingly, the staff will continue to accept, under certain circumstances, the use of the simplified method beyond December 31, 2007. The Company's adoption of SAB 111 is not expected to have a material effect on its condensed consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities". SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Most of the provisions of this Statement apply only to entities that elect the fair value option. However, the amendment to SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities", applies to all entities with available-for-sale and trading securities. Some requirements apply differently to entities that do not report net income. SFAS No. 159 will become effective for the Company in its fiscal year ending June 30, 2009. The Company's adoption of SFAS No. 159 is not expected to have a material effect on its condensed consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements". SFAS No. 157 provides guidance for using fair value to measure assets and liabilities. In addition, this statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. Where applicable, this statement simplifies and codifies related guidance within generally accepted accounting principles. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company's adoption of SFAS No. 157 is not expected to have a material effect on its condensed consolidated financial statements.

2.) Stock-based Compensation

The Company has established two share incentive programs as discussed in more detail in the Consolidated Financial Statements and related notes contained in the Company's annual report on Form 10-K for the year ended June 30, 2007. The Company accounts for its stock options and share units granted in accordance with SFAS No. 123(R), "Share-Based Payment" ("SFAS No. 123(R)") which requires that all stock-based compensation must be recognized as an expense in the financial statements and that cost be measured at the fair market value of the award. SFAS No. 123(R) also requires that excess tax benefits related to stock option exercises be

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reflected as financing cash inflows instead of operating cash inflows. Stock-based compensation costs of \$64,000 and \$107,000 were recognized in three months ended March 31, 2008 and 2007, respectively. Stock-based compensation costs of \$216,000 and \$336,000 were recognized in nine months ended March 31, 2008 and 2007, respectively. Unearned stock-based compensation cost was \$509,000 as of March 31, 2008.

3.) Inventories

For interim financial statements, inventories are calculated using a gross profit percentage. The Company regularly reviews parts and finished goods inventories on hand and, when necessary, records a reserve for excess or obsolete inventories. As of March 31, 2008 and June 30, 2007, balances in these reserves amounted to \$1,350,000 and \$1,200,000, respectively. The Company also regularly reviews the period over which its inventories will be converted to sales. Any inventories expected to convert to sales beyond 12 months from the balance sheet date are classified as non-current.

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| | | |
|---|------------------|-------------------|
| Inventories, net of reserves consist of the following (in thousands): | | March 31, 2008 |
| | | ----- |
| | Component parts | \$ 18,603 |
| | Work-in-process | 3,857 |
| | Finished product | 12,220 |
| | | ----- |
| | | \$ 34,680 |
| | | ===== |
| Classification of inventories, net of reserves: | | |
| | Current | \$ 26,057 |
| | Non-current | 8,623 |
| | | ----- |
| | | \$ 34,680 |
| | | ===== |

4.) Earnings Per Common Share

The Company follows the provisions of SFAS No. 128, "Earnings Per Share". In accordance with SFAS No. 128, earnings per common share amounts ("Basic EPS") were computed by dividing earnings by the weighted average number of common shares outstanding for the period. Earnings per common share amounts, assuming dilution ("Diluted EPS"), were computed by reflecting the potential dilution from the exercise of stock options. SFAS No. 128 requires the presentation of both Basic EPS and Diluted EPS on the face of the condensed consolidated statements of income.

A reconciliation between the numerators and denominators of the Basic and Diluted EPS computations for earnings is as follows (in thousands except per share data):

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| | Three months ended March 31, | |
|---|------------------------------|-------------------------|
| | Net Income (numerator) | Shares (denominator) |
| Basic EPS ----- | | |
| Net income, as reported | \$ 3,277 | 19,092 |
| Effect of dilutive securities ----- | | |
| Employee Stock Options | \$ - | 534 |
| Diluted EPS ----- | | |
| Net income, as reported and assumed option exercises | \$ 3,277 ===== | 19,626 ===== |

196,000 options to purchase shares of common stock in the three months ended March 31, 2008 computation of Diluted EPS because the exercise prices were in excess of the average market and their inclusion would be anti-dilutive.

| | Three months ended March 31, | |
|---|------------------------------|-------------------------|
| | Net Income (numerator) | Shares (denominator) |
| Basic EPS ----- | | |
| Net income, as reported | \$ 1,132 | 20,079 |
| Effect of dilutive securities ----- | | |
| Employee Stock Options | \$ - | 498 |
| Diluted EPS ----- | | |
| Net income, as reported and assumed option exercises | \$ 1,132 ===== | 20,577 ===== |

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154,000 options to purchase shares of common stock in the three months ended March 31, 2007 computation of Diluted EPS because the exercise prices were in excess of the average market and their inclusion would be anti-dilutive.

| | Nine months ended March 31, | |
|--------------------|-----------------------------|-------------------------|
| | Net Income (numerator) | Shares (denominator) |
| Basic EPS ----- | | |

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| | | | |
|---|----|-------|--------|
| Net income, as reported | \$ | 4,824 | 19,320 |
| Effect of dilutive securities | | | |
| ----- | | | |
| Employee Stock Options | \$ | - | 554 |
| ----- | | | |
| Diluted EPS | | | |
| ----- | | | |
| Net income, as reported and assumed option exercises | \$ | 4,824 | 19,874 |
| ===== | | | |

187,000 options to purchase shares of common stock in the nine months ended March 31, 2008 were excluded from the computation of Diluted EPS because the exercise prices were in excess of the average market price.

| | Nine months ended March 31, | |
|---|-----------------------------|-------------------------|
| | Net Income (numerator) | Shares (denominator) |
| | ----- | ----- |
| Basic EPS | | |
| ----- | | |
| Net income, as reported | \$ | 3,228 |
| Effect of dilutive securities | | |
| ----- | | |
| Employee Stock Options | \$ | - |
| ----- | | |
| Diluted EPS | | |
| ----- | | |
| Net income, as reported and assumed option exercises | \$ | 3,228 |
| ===== | | |

82,000 options to purchase shares of common stock in the nine months ended March 31, 2007 were excluded from the computation of Diluted EPS because the exercise prices were in excess of the average market price and their inclusion would be anti-dilutive.

5.) Long Term Debt

Long-term debt consists of a revolving credit and term loan facility with outstanding borrowings of \$13,900,000 at March 31, 2008 and \$10,900,000 at June 30, 2007. In September 2007, the Company amended its secured revolving credit agreement with its primary bank. The Company's borrowing capacity under the amended agreement was increased to \$25,000,000 from \$18,000,000. The amended revolving credit agreement is secured by all the accounts receivable, inventory, the Company's headquarters in Amityville, New York and certain other assets of Napco Security Systems, Inc. and the common stock of three of the Company's subsidiaries. The revolving credit agreement bears interest at either the Prime Rate less 1/4% or an alternate rate based on LIBOR as described in the agreement. As of March 31, 2008 the interest rate on the outstanding portion of this facility was 5.3%. The September 2007 amendment also extended the revolving credit agreement to September 2011. Any outstanding borrowings are to be repaid or refinanced on or before that time. The agreement contains various restrictions and covenants including, among others, restrictions on payment of dividends, restrictions on borrowings, restrictions on capital expenditures, the maintenance of minimum amounts of tangible net worth, and compliance with other certain financial ratios, as defined in the agreement.

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6.) Geographical Data

The Company is engaged in one major line of business: the development, manufacture, and distribution of security alarm products and door security devices for commercial and residential use. Sales to unaffiliated customers are primarily shipped from the United States. The Company has customers worldwide with major concentrations in North America, Europe, and South America.

The Company observes the provisions of SFAS No. 131. The following represents selected consolidated geographical data for the three and nine months ended March 31, 2008 and 2007 (in thousands):

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| | Three Months ended March 31, | | Nine Months ended |
|---|------------------------------|---------------|-------------------|
| | 2008 | 2007 | 2008 |
| <hr style="border-top: 1px dashed black;"/> | | | |
| Sales to external customers(1): | | | |
| <hr style="border-top: 1px dashed black;"/> | | | |
| Domestic | \$ 13,288 | \$ 13,407 | \$ 38,255 |
| Foreign | 2,934 | 2,159 | 8,009 |
| <hr style="border-top: 1px dashed black;"/> | | | |
| Total Net Sales | \$ 16,222 | \$ 15,566 | \$ 46,264 |
| <hr style="border-top: 3px double black;"/> | | | |
| As of | | | |
| <hr style="border-top: 1px dashed black;"/> | | | |
| | March 31, 2008 | June 30, 2007 | |
| <hr style="border-top: 1px dashed black;"/> | | | |
| Identifiable assets: | | | |
| <hr style="border-top: 1px dashed black;"/> | | | |
| United States | \$ 47,236 | \$ 47,636 | |
| Dominican Republic (2) | 25,156 | 21,246 | |
| Other foreign countries | 7,597 | 7,903 | |
| <hr style="border-top: 1px dashed black;"/> | | | |
| Total Identifiable Assets | \$ 79,989 | \$ 76,785 | |
| <hr style="border-top: 3px double black;"/> | | | |

(1) All of the Company's sales occur in the United States and are shipped primarily from the United States and United Kingdom. There were no sales into any one foreign country in excess of 10% of total sales.

(2) Consists primarily of inventories (\$20,060,000 and \$16,088,000) and fixed assets (\$4,949,000 and \$4,949,000) at the Company's principal manufacturing facility in the Dominican Republic as of March 31, 2008 and June 30, 2007, respectively.

7.) Commitments and Contingencies

In the normal course of business, the Company is a party to claims and/or litigation. Management believes that the settlement of such claims and/or litigation, considered in the aggregate, will not have a material adverse effect on the Company's financial position and results of operations.

8.) Income Taxes

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In March 2003, Napco Security Systems, Inc. timely filed its income tax return for the fiscal year ended June 30, 2002. This return included an election to treat one of the Company's foreign subsidiaries as if it were a domestic corporation beginning July 1, 2001. This election was based on a then recently enacted Internal Revenue Code ("Code") provision. As a result of this election, this subsidiary is treated, for Federal income tax purposes, as transferring all of its assets to a domestic corporation in connection with an exchange. Although this type of transfer usually results in the recognition of taxable income to the extent of any untaxed earnings and profits, the Code provision provides an exemption for applicable corporations. The Company qualifies as an applicable corporation pursuant to this Code section, and based on this Code exemption, the Company treated the transfer of approximately \$27,000,000 of this subsidiary's untaxed earnings and profits as nontaxable.

The Internal Revenue Service has issued a Revenue Procedure that is inconsistent with the Code exemption described above. The Code is the actual law; a Revenue Procedure is the IRS's interpretation of the law. The Code has a higher level of authority than a Revenue Procedure. Management believes that it has appropriately relied on the guidance in the Code when filing its income tax return. If challenged, the Company believes that the potential liability would have ranged from \$0 to \$9,450,000. However, the Company also believes there were other mitigating factors that would limit the amount of the potential liability, and as a result, management accrued a liability of \$2,243,000 as of June 30, 2002. As a result of the lapse in the applicable statute of limitations, the Company reversed \$407,000 of this accrued liability during fiscal 2007, resulting in a long-term accrued income tax liability of \$1,836,000 as of June 30, 2007.

As a result of the implementation of FIN48 as of July 1, 2007, the Company increased its accrued income tax liability by \$715,000, from \$1,836,000 to \$2,551,000, to provide for additional reserves for uncertain income tax positions, relating to the fiscal years 2004 through 2007, the only periods

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subject to examination by the taxing authorities. The increase in the accrued income tax liability of \$715,000 was offset in part by a \$230,000 increase in a related deferred income tax asset, resulting in a net reduction to retained earnings of \$485,000 (representing the cumulative effect of adopting FIN 48).

During the nine months ended March 31, 2008, the Company decreased its reserve for uncertain income tax positions by \$1,888,000, excluding the related deferred tax benefit (representing interest on unrecognized income tax positions), resulting in a long-term accrued income tax liability of \$249,000. The Company's practice is to recognize interest and/or penalties related to income tax matters in income tax expense and accrued income taxes. As of March 31, 2008, the Company had accrued interest totaling \$39,000, excluding the related deferred tax asset. As of March 31, 2008, the Company had, approximately \$190,000 of unrecognized net tax benefits (including the related accrued interest and net of the related deferred income tax benefit of \$98,000) that, if recognized, would favorably affect the effective income tax rate in any future periods.

During the quarter ended March 31, 2008, the Company recognized a net tax benefit to income tax expense of \$2,131,000 (a \$2,263,000 liability reversal, including interest, less a reversal of \$132,000 of the related deferred tax asset). This benefit resulted primarily from the Company's

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domestication election, which has expired as the result of the expiration of the related statute of limitations. For the three months ended March 31, 2008, the total accrued liability related to the Company's domestication election has been reversed into income as a result of this expiration. Additionally, a state tax exposure for the 2004 fiscal year has been reversed due to the expiration of the statute of limitations. These reversals resulted in a net benefit to income tax expense of \$2,197,000 (consisting of a reversal of the accrued liability, including interest, at December 31, 2007 of \$2,365,000 less the related \$168,000 reversal of the deferred tax asset) during the three months ended March 31, 2008.

During the quarter ended December 31, 2007 the Company completed a corporate restructuring for which new offshore companies were formed (Napco DR, S.A. and Napco Americas). These newly formed wholly-owned subsidiaries are included in the Company's condensed consolidated financial statements. The existing US-based companies ("Napco US") and these newly formed offshore companies entered into technology licenses and research and development cost sharing agreements. Also, Napco DR, S.A. purchased the majority of the operating assets previously held by the existing Dominican subsidiary. Napco DR, S.A. is doing business in a Free Zone Park in the Dominican Republic and as such is not subject to Dominican corporate income taxes. Napco US plans to permanently reinvest a substantial portion of its foreign earnings and as such has not provided US corporate taxes on the permanently reinvested earnings. Due to the restructuring, the Company's effective tax rate is lower in the second and third quarters and is projected to be lower than the US statutory rates in the fourth quarter as well.

The difference between the statutory U.S. Federal income tax rate and the Company's effective tax rate as reflected in the consolidated statements of income for the nine months ended March 31, 2008 is as follows (dollars in thousands):

| | Amount | % of Pre-tax Income |
|---|-----------|---------------------------|
| | ----- | ----- |
| Tax at Federal statutory rate | \$ 1,048 | 34.0% |
| Increases (decreases) in taxes resulting from: | | |
| Reserve for uncertain tax positions | (2,131) | (69.1) |
| Stock based compensation expense | 73 | 2.4 |
| Adjustment for adoption of FIN48 | 66 | 2.1 |
| U.S. benefit on foreign source income | (721) | (23.4) |
| Other, net | (76) | (2.5) |
| | ----- | ----- |
| (Benefit) for income taxes | \$(1,741) | (56.5)% |
| | ===== | ===== |

9.) Treasury Stock

On March 16, 2007, the Company announced that its Board of Directors authorized the repurchase of up to one million (1,000,000) shares of its common stock. As of March 31, 2008, the Company has repurchased all 1,000,000 of these shares at a weighted average price of \$5.62 per share.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results ----- of Operations -----

Napco Security Systems, Inc.

Management's Discussion and Analysis of Financial Condition and Results of
Operations

This Quarterly Report on Form 10-Q and the information incorporated by reference may include "Forward-Looking Statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Exchange Act of 1934. The Company intends the Forward-Looking Statements to be covered by the Safe Harbor Provisions for Forward-Looking Statements. All statements regarding the Company's expected financial position and operating results, its business strategy, its financing plans and the outcome of any contingencies are Forward-Looking Statements. The Forward-Looking Statements are based on current estimates and projections about our industry and our business. Words such as "anticipates," "expects," "intends," "plans," "believes," "seeks," "estimates," or variations of such words and similar expressions are intended to identify such Forward-Looking Statements. The Forward-Looking Statements are subject to risks and uncertainties that could cause actual results to differ materially from those set forth or implied by any Forward-Looking Statements. For example, the Company is highly dependent on its Chief Executive Officer for strategic planning. If he is unable to perform his services for any significant period of time, the Company's ability to continue growing could be adversely affected. In addition, factors that could cause actual results to differ materially from the Forward-Looking Statements include, but are not limited to, adverse tax consequences of offshore operations, significant fluctuations in the exchange rate between the Dominican Peso and the U.S. Dollar, distribution problems, unforeseen environmental liabilities and the uncertain military, political and economic conditions in the world.

Overview

The Company is a diversified manufacturer of security products, encompassing intrusion and fire alarms, building access control systems and electronic locking devices. These products are used for commercial, residential, institutional, industrial and governmental applications, and are sold worldwide principally to independent distributors, dealers and installers of security equipment. International sales accounted for approximately 17% and 14% of our revenues for the nine months ended March 31, 2008 and 2007, respectively.

The Company owns and operates manufacturing facilities in Amityville, New York and the Dominican Republic. A significant portion of our operating costs are fixed, and do not fluctuate with changes in customer demand or utilization of our manufacturing capacity. As product demand rises and factory utilization increases, the fixed costs are spread over increased output, which should improve profit margins. Conversely, when sales decline our fixed costs are spread over reduced levels, thereby decreasing margins.

In February 2004 the Company entered into a joint venture with an unrelated company to sell security-related products, including those manufactured by the Company, in the Middle East. The Company owns 51% of the newly formed company, an LLC organized in New York, which has its main operations in the United Arab Emirates. Revenues generated by this joint venture were approximately 6% of our revenues for the nine months ended March 31, 2008.

The security products market is characterized by constant incremental innovation in product design and manufacturing technologies. Generally, the Company devotes

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7-8% of revenues to research and development (R&D) on an annual basis. Products resulting from our R&D investments in the three months ended March 31, 2008 did not contribute materially to revenue during this period, but should benefit the Company over future periods. In general, the new products introduced by the Company are initially shipped in limited quantities, and increase over time. Prices and manufacturing costs tend to decline over time as products and technologies mature.

Economic and Other Factors

The post-September 11 era has generally been characterized by increased demand for electronic security products and services. The Company believes the security equipment market is likely to continue to exhibit growth, particularly in industrial sectors, due to ongoing concerns over the adequacy of security safeguards. The Company's business is also affected by the housing markets. Demand for the Company's intrusion products, which accounted for approximately 50% of Net sales in the first nine months of Fiscal 2008, has a direct correlation to demand in the housing market.

Seasonality

The Company's fiscal year begins on July 1 and ends on June 30. Historically, the end users of Napco's products want to install its products prior to the summer; therefore sales of its products peak in the period April 1 through June 30, the Company's fiscal fourth quarter, and are reduced in the period July 1

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through September 30, the Company's fiscal first quarter. To a lesser degree, sales in Europe are also adversely impacted in the Company's first fiscal quarter because of European vacation patterns, i.e., many distributors and installers are closed for the month of August. In addition, demand is affected by the housing and construction markets.

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses reported in those financial statements. These judgments can be subjective and complex, and consequently actual results could differ from those estimates. Our most critical accounting policies relate to revenue recognition; concentration of credit risk; inventory; goodwill; and income taxes.

Revenue Recognition

Revenues from merchandise sales are recorded at the time the product is shipped or delivered to the customer pursuant to the terms of sale. We report our sales levels on a net sales basis, which is computed by deducting from gross sales the amount of actual sales returns and allowances and an amount established for anticipated sales returns and allowances.

Our accrual for sales returns and allowances is a subjective critical estimate that has a direct impact on reported net sales and income. This accrual is calculated based on a history of gross sales and actual sales returns and allowances, as well as management's estimate of anticipated sales returns and allowances. As a percentage of gross sales, sales returns, rebates and other

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allowances were 7% and 8% for the three months ended March 31, 2008 and 2007, respectively and 6% and 8% for the nine months ended March 31, 2008 and 2007, respectively.

Concentration of Credit Risk

An entity is more vulnerable to concentrations of credit risk if it is exposed to risk of loss greater than it would have had if it mitigated its risk through diversification of customers. Such risks of loss manifest themselves differently, depending on the nature of the concentration, and vary in significance.

The Company had two customers with accounts receivable balances that aggregated 42% and 38% of the Company's accounts receivable at March 31, 2008 and June 30, 2007, respectively. Sales to neither of these customers exceeded 10% of net sales in any of the past three fiscal years.

In the ordinary course of business, we have established a reserve for doubtful accounts and customer deductions in the amount of \$405,000 and \$365,000 as of March 31, 2008 and June 30, 2007, respectively. Our reserve for doubtful accounts is a subjective critical estimate that has a direct impact on reported net earnings. This reserve is based upon the evaluation of accounts receivable agings, specific exposures and historical trends.

Inventories

For interim financial statements, inventories are calculated using a gross profit percentage. This valuation method is based, in part, on subjective estimates and approximations and actual results could differ from those estimates.

In addition, the Company records an inventory obsolescence reserve, which represents the difference between the cost of the inventory and its estimated market value, based on various product sales projections. This reserve is calculated using an estimated obsolescence percentage applied to the inventory based on age, historical trends, requirements to support forecasted sales, and the ability to find alternate applications of its raw materials and to convert finished product into alternate versions of the same product to better match customer demand. There is inherent professional judgment and subjectivity made by both production and engineering members of management in determining the estimated obsolescence percentage. In addition, and as necessary, the Company may establish specific reserves for future known or anticipated events. As of March 31, 2008 and June 30, 2007, balances in these reserves amounted to \$1,350,000 and \$1,200,000, respectively.

The Company also regularly reviews the period over which its inventories will be converted to sales. Any inventories which are expected to convert to sales beyond 12 months from the balance sheet date are classified as non-current.

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Goodwill

In accordance with SFAS No. 142, intangible assets, including purchased goodwill, are evaluated by the Company for impairment. Those intangible assets that are classified as goodwill or as other intangibles with indefinite lives are not amortized. Impairment testing is performed in two steps: (i) the Company determines impairment by comparing the fair value of a reporting unit with its carrying value, and (ii) if there is an impairment, the Company measures the amount of impairment loss by comparing the implied fair value of goodwill with

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the carrying amount of that goodwill. At the close of Fiscal 2007, the Company performed its annual impairment evaluation required by this standard and determined that its goodwill is not impaired.

Income Taxes

In March 2003, Napco Security Systems, Inc. timely filed its income tax return for the fiscal year ended June 30, 2002. This return included an election to treat one of the Company's foreign subsidiaries as if it were a domestic corporation beginning July 1, 2001. This election was based on a then recently enacted Internal Revenue Code ("Code") provision. As a result of this election, this subsidiary is treated, for Federal income tax purposes, as transferring all of its assets to a domestic corporation in connection with an exchange. Although this type of transfer usually results in the recognition of taxable income to the extent of any untaxed earnings and profits, the Code provision provides an exemption for applicable corporations. The Company qualifies as an applicable corporation pursuant to this Code section, and based on this Code exemption, the Company treated the transfer of approximately \$27,000,000 of this subsidiary's untaxed earnings and profits as nontaxable.

The Internal Revenue Service has issued a Revenue Procedure which is inconsistent with the Code exemption described above. The Code is the actual law; a Revenue Procedure is the IRS's interpretation of the law. The Code has a higher level of authority than a Revenue Procedure. Management believes that it has appropriately relied on the guidance in the Code when filing its income tax return. If challenged, the Company believes that the potential liability would have ranged from \$0 to \$9,450,000. However, the Company also believes there were other mitigating factors that would limit the amount of the potential liability, and as a result, management accrued a liability of \$2,243,000 as of June 30, 2002. As a result of the lapse in the applicable statute of limitations, the Company reversed \$407,000 of this accrued liability during fiscal 2007, resulting in a long-term accrued income tax liability of \$1,836,000 as of June 30, 2007.

As a result of the implementation of FIN48 as of July 1, 2007, the Company increased its accrued income tax liability by \$715,000, from \$1,836,000 to \$2,551,000, to provide for additional reserves for uncertain income tax positions, relating to the fiscal years 2004 through 2007, the only periods subject to examination by the taxing authorities. The increase in the accrued income tax liability of \$715,000 was offset in part by a \$230,000 increase in a related deferred income tax asset, resulting in a net reduction to retained earnings of \$485,000 (representing the cumulative effect of adopting FIN 48).

During the nine months ended March 31, 2008, the Company decreased its reserve for uncertain income tax positions by \$1,888,000, excluding the related deferred tax benefit (representing interest on unrecognized income tax positions), resulting in a long-term accrued income tax liability of \$249,000. The Company's practice is to recognize interest and/or penalties related to income tax matters in income tax expense and accrued income taxes. As of March 31, 2008, the Company had accrued interest totaling \$39,000, excluding the related deferred tax asset. As of March 31, 2008, the Company had, approximately \$190,000 of unrecognized net tax benefits (including the related accrued interest and net of the related deferred income tax benefit of \$98,000) that, if recognized, would favorably affect the effective income tax rate in any future periods.

During the quarter ended March 31, 2008, the Company recognized a net tax benefit to income tax expense of \$2,131,000 (a \$2,263,000 liability reversal, including interest, less a reversal of \$132,000 of the related deferred tax asset). This benefit resulted primarily from the Company's domestication election, which has expired as the result of the expiration of the related statute of limitations. For the three months ended March 31, 2008, the total accrued liability related to the Company's domestication election has been

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reversed into income as a result of this expiration. Additionally, a state tax exposure for the 2004 fiscal year has been reversed due to the expiration of the statute of limitations. These reversals resulted in a net benefit to income tax expense of \$2,197,000 (consisting of a reversal of the accrued liability, including interest, at December 31, 2007 of \$2,365,000 less the related \$168,000 reversal of the deferred tax asset) during the three months ended March 31, 2008.

During the quarter ended December 31, 2007 the Company completed a corporate restructuring for which new offshore companies were formed (Napco DR, S.A. and Napco Americas). These newly formed wholly-owned subsidiaries are included in the Company's condensed consolidated financial statements. The existing US-based companies ("Napco US") and these newly formed offshore companies entered into

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technology licenses and research and development cost sharing agreements. Also, Napco DR, S.A. purchased the majority of the operating assets previously held by the existing Dominican subsidiary. Napco DR, S.A. is doing business in a Free Zone Park in the Dominican Republic and as such is not subject to Dominican corporate income taxes. Napco US plans to permanently reinvest a substantial portion of its foreign earnings and as such has not provided US corporate taxes on the permanently reinvested earnings. Due to the restructuring, the Company's effective tax rate is lower in the second and third quarters and is projected to be lower than the US statutory rates in the fourth quarter as well.

Results of Operations

| | Three months ended March 31, (dollars in thousands) | | | Nine months ended | |
|---|---|-----------|---------------------------|-------------------|-----------|
| | 2008 | 2007 | % Increase/ (decrease) | 2008 | 2007 |
| Net sales | \$ 16,222 | \$ 15,566 | 4.2% | \$ 46,264 | \$ 43,800 |
| Gross profit | 5,523 | 5,494 | 0.5% | 15,908 | 15,800 |
| Gross profit as a % of net sales | 34.0% | 35.3% | (1.3)% | 34.4% | 36.1% |
| Selling, general and administrative | 3,955 | 4,226 | (6.4)% | 12,252 | 12,800 |
| Selling, general and administrative as a percentage of net sales | 24.4% | 27.1% | (2.7)% | 26.5% | 29.2% |
| Operating income | 1,568 | 1,268 | (23.7)% | 3,656 | 3,200 |
| Interest expense, net | 216 | 168 | 28.6% | 635 | 500 |
| Other expense | 12 | 4 | 200.0% | 30 | 10 |
| Minority interest in net loss of subsidiary, net | 33 | 41 | (19.5)% | 92 | 100 |
| (Benefit) Provision for income taxes | (1,904) | 5 | (38,180.0)% | (1,741) | (1,741) |
| Net income | 3,277 | 1,132 | 189.5% | 4,824 | 3,200 |

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Sales for the three months ended March 31, 2008 increased by approximately 4% to \$16,222,000 as compared to \$15,566,000 for the same period a year ago. Sales for the nine months ended March 31, 2008 increased approximately 1% to \$46,264,000 as compared to \$45,672,000 for the same period a year ago. The increase in sales for the three months was due primarily to increases in the Company's international sales and its door-locking products as partially offset by a decrease in intrusion detection products. The increase in sales for the nine months was due primarily to increases in the Company's international sales as partially offset by a decrease in intrusion detection products.

The Company's gross profit for the three months ended March 31, 2008 remained relatively constant at \$5,523,000 or 34.0% of sales as compared to \$5,494,000 or 35.3% of sales for the same period a year ago. The Company's gross profit for the nine months ended March 31, 2008 decreased by \$970,000 to \$15,908,000 or 34.4% of sales as compared to \$16,878,000 or 37.0% of sales for the same period a year ago. The decrease in gross profit for the nine months resulted primarily from a lower overhead absorption rate and an increase in the inventory reserve of \$150,000 in the nine months ended March 31, 2008 as well as a decrease in the Company's inventory reserve in the nine months ended March 31, 2007. The absorption rate in the first nine months of fiscal 2008 decreased as a result of the Company's high forecast and production rates in the first nine months of fiscal 2007 as compared to those in the first nine months of fiscal 2008.

Selling, general and administrative expenses for the three months ended March 31, 2008 decreased by \$271,000 to \$3,955,000, or 24.4% of sales, as compared to \$4,226,000, or 27.1% of sales a year ago. Selling, general and administrative expenses for the nine months ended March 31, 2008 remained relatively constant at \$12,252,000, or 26.5% of sales, as compared to \$12,205,000, or 26.7% of sales a year ago. The decrease in dollars and as a percentage of sales for the three months ended March 31, 2008 was due primarily to the timing of a major tradeshow (\$264,000). In the prior year this tradeshow occurred in March of 2007 but it did not occur until April of 2008 in the current fiscal year.

Interest expense, net for the three months ended March 31, 2008 increased by \$48,000 to \$216,000 as compared to \$168,000 for the same period a year ago. Interest expense, net for the nine months ended March 31, 2008 increased by \$258,000 to \$635,000 as compared to \$377,000 for the same period a year ago. The

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increase in interest expense for the three and nine months resulted primarily from the increase in the Company's average outstanding debt which was due primarily to the Company's increase in inventory and its Treasury stock repurchases as discussed below.

The Company's provision for income taxes for the three months ended March 31, 2008 decreased by \$1,909,000 to a benefit of \$1,904,000 as compared to a provision of \$5,000 for the same period a year ago. The Company's provision for income taxes for the nine months ended March 31, 2008 decreased by \$2,891,000 to a benefit of \$1,741,000 as compared to a provision of \$1,150,000 for the same period a year ago. The decrease in provision for income taxes for the three and nine months resulted primarily from the Company recognizing a net tax benefit to income tax expense of \$2,131,000 as described on page 16. In addition, during the quarter ended December 31, 2007 Napco completed a corporate restructuring for which new offshore companies were formed. As a result, the Company's effective rate for the three and nine months ended December 31, 2007, prior to the effect of the \$2,131,000 benefit described above, was 17% and 13%, respectively, which reflected this restructuring as well as an additional provision of \$66,000 resulting from the Company's adoption of FIN48, both as

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described in Note 8 of the accompanying condensed consolidated financial statements.

Net income increased by \$2,145,000 to \$3,277,000 or \$0.17 per diluted share for the three months ended March 31, 2008 as compared to \$1,132,000 or \$0.06 per diluted share for the same period a year ago. Net income increased by \$1,596,000 to \$4,824,000 or \$0.24 per diluted share for the nine months ended March 31, 2008 as compared to \$3,228,000 or \$0.16 per diluted share for the same period a year ago. The increase for the three and nine months ended March 31, 2008 was primarily due to the tax benefit relating to the Company's Dominican Republic operation described above.

Liquidity and Capital Resources

During the nine months ended March 31, 2008 the Company utilized all of its cash from operations and additional borrowings to purchase inventory (\$6,457,000), property, plant and equipment (\$668,000) and treasury stock (\$3,225,000). The Company's management believes that current working capital, cash flows from operations and its revolving credit agreement will be sufficient to fund the Company's operations through at least the next twelve months.

Accounts Receivable at March 31, 2008 decreased \$3,771,000 to \$21,808,000 as compared to \$25,579,000 at June 30, 2007. This decrease is primarily the result of the higher sales volume during the quarter ended June 30, 2007 as compared to the quarter ended March 31, 2008.

Inventories at March 31, 2008 increased by \$6,457,000 to \$34,680,000 as compared to \$28,223,000 at June 30, 2007. This increase was primarily the result of the Company level-loading its production schedule in anticipation of its historical sales cycle where a larger portion of the Company's sales occur in the latter fiscal quarters as compared to the earlier quarters as well as to support a projection of higher sales in fiscal 2008. The Company has initiated several steps in order to reduce inventory levels and it is our expectation that we will begin seeing noticeable reductions during the fourth quarter of fiscal 2008 and continuing in fiscal 2009.

Treasury stock at March 31, 2008 increased by \$3,225,000 to \$5,615,000 from \$2,390,000 at June 30, 2007. The treasury stock was repurchased pursuant to the repurchase plan authorized by the Company's Board of Directors on March 16, 2007, which authorized the repurchase of up to one million (1,000,000) shares of its common stock. In January of 2008, the Company completed the repurchase of these 1,000,000 shares.

Accrued income taxes decreased by \$2,057,000 from \$1,932,000 at June 30, 2007 to a net receivable of \$125,000 at March 31, 2008. This decrease resulted primarily from the Company recognizing a net tax benefit to income tax expense of \$2,131,000 as described on page 16.

Long-term debt consists of a revolving credit and term loan facility with outstanding borrowings of \$13,900,000 at March 31, 2008 and \$10,900,000 at June 30, 2007. In September 2007, the Company amended its secured revolving credit agreement with its primary bank. The Company's borrowing capacity under the amended agreement was increased to \$25,000,000 from \$18,000,000. The amended revolving credit agreement is secured by all the accounts receivable, inventory, the Company's headquarters in Amityville, New York and certain other assets of Napco Security Systems, Inc. and the common stock of three of the Company's subsidiaries. The revolving credit agreement bears interest at either the Prime Rate less 1/4% or an alternate rate based on LIBOR as described in the agreement. As of March 31, 2008 the interest rate on the outstanding portion of this facility was 5.3%. The September 2007 amendment also extended the revolving credit agreement to September 2011. Any outstanding borrowings are to be repaid

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or refinanced on or before that time. The agreement contains various restrictions and covenants including, among others, restrictions on payment of dividends, restrictions on borrowings, restrictions on capital expenditures, the maintenance of minimum amounts of tangible net worth, and compliance with other certain financial ratios, as defined in the agreement.

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As of March 31, 2008 the Company had no material commitments for capital expenditures or inventory purchases other than purchase orders issued in the normal course of business.

ITEM 3: Quantitative and Qualitative Disclosures About Market Risk

The Company's principal financial instrument is long-term debt (consisting of a revolving credit facility) that provides for interest at a spread below the prime rate. The Company is affected by market risk exposure primarily through the effect of changes in interest rates on amounts payable by the Company under this credit facility. At March 31, 2008, an aggregate principal amount of approximately \$13,900,000 was outstanding under the Company's credit facility with a weighted average interest rate of approximately 5.3%. If principal amounts outstanding under the Company's credit facility remained at this year-end level for an entire year and the prime rate increased or decreased, respectively, by 1% the Company would pay or save, respectively, an additional \$139,000 in interest that year.

A significant number of foreign sales transactions by the Company are denominated in U.S. dollars. As such, the Company has shifted foreign currency exposure onto many of its foreign customers. As a result, if exchange rates move against foreign customers, the Company could experience difficulty collecting unsecured accounts receivable, the cancellation of existing orders or the loss of future orders. The foregoing could materially adversely affect the Company's business, financial condition and results of operations. In addition, the Company transacts certain sales in Europe in British Pounds Sterling, therefore exposing itself to a certain amount of foreign currency risk. Management believes that the amount of this exposure is immaterial. We are also exposed to foreign currency risk relative to expenses incurred in Dominican Pesos ("RD\$"), the local currency of the Company's production facility in the Dominican Republic. The result of a 10% strengthening in the U.S. dollar to our RD\$ expenses would result in an annual decrease in income from operations of approximately \$415,000.

ITEM 4: Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management to allow timely decisions regarding required disclosure. Management necessarily applied its judgment in assessing the costs and benefits of such controls and procedures, which, by their nature, can provide only reasonable assurance regarding management's control objectives.

At the conclusion of the period ended March 31, 2008, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the

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effectiveness of the design and operation of our disclosure controls and procedures. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective in alerting them in a timely manner to information relating to the Company required to be disclosed in this report except as follows:

Management's review over it's internal controls at the conclusion of fiscal 2007 identified conditions which they deemed to be material weaknesses, (as defined by standards established by the SEC and the Public Company Accounting Oversight Board) with respect to certain of our inventory valuation estimation methods and the classification of inventory in accordance with Accounting Research Bulletin 43 ("ARB No. 43"). Management has informed it's independent auditors and the Audit Committee that it has corrected its method of classifying its inventory so as to be in compliance with ARB No. 43, has initiated a review of the ways in which we can accumulate information to provide better substantiation of our overhead estimates, including implementation of an additional time-tracking system, and established an additional review of our obsolescence estimates. We will also conduct a review of our inventory turnover and utilize this review to support classification on the balance sheet to prevent reoccurrences of these material weaknesses and will continue to monitor the effectiveness of these actions and will make any other changes or take such additional actions as management determines to be appropriate. Management expects to complete these actions during fiscal 2008.

During the third quarter of fiscal 2008, there were no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting except for the procedure described above which has corrected the weakness relating to inventory classification on the balance sheet.

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PART II: OTHER INFORMATION

Item 1A. Risk Factors

Information regarding the Company's Risk Factors are set forth in the Company's Annual Report on Form 10-K for the year ended June 30, 2007. There have been no material changes in the risk factors previously disclosed in the Company's Form 10-K for the year ended June 30, 2007 during the three months ended March 31, 2008.

Item 2. Unregistered Sales of Equity Securities and Uses of Proceeds

Issuer Purchases of Equity Securities:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Num Shares Purc Part of Pu Announced Progrn |
|--------|--|------------------------------------|---|
|--------|--|------------------------------------|---|

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| | | | |
|--|--------|--------|-------|
| January 1, 2008 - January 31, 2008 | 17,671 | \$5.98 | 17,6 |
| February 1, 2008 - February 29, 2008 | - | - | - |
| March 1, 2008 - March 31, 2008 | - | - | - |
| ----- | | | |
| Total for the quarter ended March 31, 2008 | 17,671 | \$5.98 | 17,6 |
| | ===== | | ===== |

On March 16, 2007, the Company announced that its Board of Directors authorized the repurchase of up to one million (1,000,000) shares of its common stock. In January of 2008, the Company completed the repurchase of these 1,000,000 shares.

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 6. Exhibits

- 31.1 Certification Pursuant to Rule 13a-14(a)/15d-14(a) of Richard L. Soloway, Chairman of the Board and President
- 31.2 Certification Pursuant to Rule 13a-14(a)/15d-14(a) of Kevin S. Buchel, Senior Vice President of Operations and Finance
- 32.1 Section 1350 Certifications

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

May 9, 2008

NAPCO SECURITY SYSTEMS, INC
(Registrant)

By: /S/ RICHARD L. SOLOWAY

Richard L. Soloway
Chairman of the Board of Directors, President and Secretary
(Chief Executive Officer)

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By: /S/ KEVIN S. BUCHEL

Kevin S. Buchel
Senior Vice President of Operations and Finance and Treasurer
(Principal Financial and Accounting Officer)

21

\$3,292 \$3,604

Income per share from continuing operations available to common stockholders:

Basic

\$0.05 \$0.10 \$0.12 \$0.18

Diluted

\$0.05 \$0.10 \$0.12 \$0.18

Loss per share from discontinued operations:

Basic

\$ \$ \$(0.01) \$(0.01)

Diluted

\$ \$ \$(0.01) \$(0.01)

Net income per share available to common stockholders:

Basic

\$0.05 \$0.10 \$0.11 \$0.17

Diluted

\$0.05 \$0.10 \$0.11 \$0.17

Weighted average common shares outstanding:

Basic

33,372,240 21,421,300 30,453,957 21,421,300

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Diluted

33,872,344 21,584,913 30,944,327 21,559,958

See accompanying notes to the condensed consolidated financial statements.

Table of Contents**DIGITAL REALTY TRUST, INC.****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(unaudited in thousands)**

| | Three months ended June 30, | | Six months ended June 30, | |
|--|--|-------------|--------------------------------------|-------------|
| | 2006 | 2005 | 2006 | 2005 |
| Net income | \$ 5,095 | \$ 4,335 | \$ 10,182 | \$ 7,074 |
| Other comprehensive income: | | | | |
| Foreign currency translation adjustments | 2,703 | 2 | 3,276 | 1,166 |
| Minority interests in foreign currency translation adjustments | (1,211) | (1) | (1,517) | (694) |
| Increase (decrease) in fair value of interest rate swaps | 1,061 | (1,412) | 2,265 | (2) |
| Minority interests in change in fair value of interest rate swaps | (474) | 840 | (1,117) | 1 |
| Reclassification of other comprehensive income to interest expense | (644) | 236 | (1,065) | 545 |
| Minority interests in reclassification of other comprehensive income to interest expense | 287 | (140) | 512 | (324) |
| Comprehensive income | \$ 6,817 | \$ 3,860 | \$ 12,536 | \$ 7,766 |

See accompanying notes to the condensed consolidated financial statements.

Table of Contents**DIGITAL REALTY TRUST, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(unaudited in thousands)

| | Six Months Ended | |
|--|------------------|------------------|
| | June 30, 2006 | June 30, 2005 |
| Cash flows from operating activities (including discontinued operations): | | |
| Net income | \$ 10,182 | \$ 7,074 |
| Adjustments to reconcile net income to net cash provided by operating activities | | |
| Minority interests in operating partnership and discontinued operations | 3,171 | 5,295 |
| Write-off of net assets due to early lease terminations | 80 | (58) |
| Depreciation and amortization of buildings and improvements, tenant improvements and acquired ground leases, including amounts for discontinued operations | 21,294 | 14,331 |
| Amortization over the vesting period of the fair value of equity compensation | 866 | 96 |
| Allowance for doubtful accounts | 524 | (81) |
| Amortization of deferred financing costs | 1,702 | 1,382 |
| Write-off of deferred financing costs, included in net loss on early extinguishment of debt | 106 | 125 |
| Amortization of debt premium | (114) | (39) |
| Amortization of acquired in place lease value and deferred leasing costs | 16,764 | 12,140 |
| Amortization of acquired above market leases and acquired below market leases, net | (2,216) | (818) |
| Changes in assets and liabilities: | | |
| Accounts and other receivables | (2,213) | (1,689) |
| Deferred rent | (7,992) | (4,991) |
| Deferred leasing costs | (3,720) | (721) |
| Other assets | (1,439) | 610 |
| Accounts payable and other accrued liabilities | 4,194 | (241) |
| Security deposits and prepaid rents | 3,267 | 1,903 |
| Net cash provided by operating activities (including discontinued operations) | 44,456 | 34,318 |
| Cash flows from investing activities: | | |
| Acquisitions of properties (including \$16.5 million paid to GI Partners in 2005) | (146,497) | (311,034) |
| Deposits paid for acquisitions of properties | (500) | |
| Receipt of value added tax refund | 3,121 | |
| Refundable value added tax in conjunction with acquisition | (805) | |
| Change in restricted cash | (787) | (10,754) |
| Improvements to investments in real estate | (23,769) | (4,790) |
| Other deposits | (911) | |
| Tenant improvement advances to tenants | (7,362) | |
| Net cash used in investing activities | (177,510) | (326,578) |

Table of Contents**DIGITAL REALTY TRUST, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**

(unaudited in thousands)

| | Six Months Ended | |
|---|------------------|-----------------|
| | June 30, 2006 | June 30, 2005 |
| Cash flows from financing activities: | | |
| Borrowings on line of credit | \$ 225,554 | \$ 212,000 |
| Repayments on line of credit | (195,000) | (68,000) |
| Proceeds from mortgage loans | 107,865 | 100,000 |
| Principal payments on mortgage loans | (42,230) | (11,769) |
| Settlement of foreign currency forward sale contract | 694 | (2,519) |
| Reimbursement by GI Partners of settlement cost of foreign currency forward sale contract | | 1,911 |
| Payment of loan fees and costs | (1,965) | (1,085) |
| Refund of rate-lock deposit | 1,200 | |
| Gross proceeds from the sale of common stock | 97,600 | |
| Gross proceeds from the sale of preferred stock | | 103,500 |
| Common stock offering costs paid | (3,097) | (594) |
| Preferred stock offering costs paid | | (4,203) |
| Proceeds from exercise of employee stock options | 452 | |
| Payment of dividends to preferred stockholders | (6,890) | (3,470) |
| Payment of dividends to common stockholders and distributions to limited partners of operating partnership | (47,990) | (34,086) |
| Net cash provided by financing activities | 136,193 | 291,685 |
| Net increase (decrease) in cash and cash equivalents | 3,139 | (575) |
| Cash and cash equivalents classified within assets held for sale | (661) | |
| Cash and cash equivalents at beginning of period | 10,930 | 4,557 |
| Cash and cash equivalents at end of period | \$ 13,408 | \$ 3,982 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for interest, including amounts capitalized | \$ 23,540 | \$ 15,502 |
| Supplementary disclosure of noncash investing and financing activities: | | |
| Change in net assets related to foreign currency translation adjustments | \$ 3,276 | \$ 473 |
| Increase in other assets related to increase in fair value of interest rate swaps | 2,265 | |
| Reclassification of owner's equity to minority interest in the Operating Partnership | (42,123) | |
| Operating Partnership units converted to common stock | 53,842 | |
| Accrual for additions to investments in real estate and tenant improvement advances included in accounts payable and accrued expenses | 3,261 | 435 |
| Allocation of purchase of properties to: | | |
| Investments in real estate | 146,703 | 271,810 |
| Accounts and other receivables | | 200 |
| Acquired above market leases | | 12,380 |
| Acquired below market leases | (22,846) | (19,198) |
| Acquired in place lease value and deferred leasing costs | 23,699 | 66,520 |
| Other Assets | | 500 |
| Mortgage loans assumed | | (9,746) |
| Loan premium | | (944) |

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| | | |
|---|---------|----------|
| Accounts payable and other accrued liabilities | (1,059) | (11,333) |
| Reverse minority interest in consolidated joint venture | | 845 |
| Cash paid for acquisition of properties | 146,497 | 311,034 |
| Increase to components of net investment foreign currency hedge upon settlement: | | |
| Investment in real estate | | 5,304 |
| Mortgage loans | | (3,307) |
| Other accrued liabilities | | (1,997) |
| Accrual of common and preferred stock offering costs | | 250 |
| Reallocation of limited partners' interests in Operating Partnership to the general partner | | 257 |

See accompanying notes to the condensed consolidated financial statements.

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DIGITAL REALTY TRUST, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2006 and 2005

(unaudited)

1. Organization and Description of Business

Digital Realty Trust, Inc. through its controlling interest in Digital Realty Trust, L.P. (the Operating Partnership) and the subsidiaries of the Operating Partnership (collectively, we or the Company) is engaged in the business of owning, acquiring, repositioning and managing technology-related real estate. As of June 30, 2006 our portfolio consists of 50 properties; 45 are located throughout the United States, four are located in Europe, and one property is located in Canada. Our properties are diversified in major markets where corporate data center and technology tenants are concentrated, including the Boston, Chicago, Dallas, Los Angeles, New York, Philadelphia, San Francisco and Silicon Valley metropolitan areas. The portfolio consists of Internet gateway properties, data center properties, technology manufacturing properties and regional or national headquarters of technology companies.

We completed our initial public offering (IPO) on November 3, 2004 and commenced operations on that date. The Operating Partnership was formed on July 21, 2004 in anticipation of our IPO. As of June 30, 2006, we own a 57.3% common interest and a 100% preferred interest in the Operating Partnership. We have control over the Operating Partnership. The limited partners of the Operating Partnership do not have rights to replace the general partner nor do they have participating rights, although they do have certain protective rights.

2. Summary of Significant Accounting Policies

(a) Principles of Consolidation and Basis of Presentation

The accompanying condensed consolidated financial statements include all of the accounts of Digital Realty Trust, Inc., the Operating Partnership, the subsidiaries of the Operating Partnership and its consolidated joint venture. Intercompany balances and transactions have been eliminated. The interests of the joint venture partner, a third party, is reflected in minority interests in the accompanying condensed consolidated financial statements.

Property interests contributed to the Operating Partnership by Global Innovation Partners, LLC (GI Partners) in exchange for Units in anticipation of completion of our IPO have been accounted for as a reorganization of entities under common control in a manner similar to a pooling of interests. Accordingly, the contributed assets and assumed liabilities were recorded at the historical cost basis. Property interests acquired from third parties for cash or Units are accounted for using purchase accounting.

The accompanying condensed interim financial statements are unaudited, but have been prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP) for interim financial information and in compliance with the rules and regulations of the United States Securities and Exchange Commission. Accordingly, they do not include all of the disclosures required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments are of a normal recurring nature and necessary for a fair presentation of the consolidated financial statements for these interim periods have been included. The results of operations for the interim periods are not necessarily indicative of the results to be obtained for the full fiscal year. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto included in our annual report on Form 10-K for the year ended December 31, 2005.

(b) Cash Equivalents

For purpose of the condensed consolidated statements of cash flows, we consider short-term investments with original maturities of 90 days or less when purchased to be cash equivalents. As of June 30, 2006 and December 31, 2005, cash equivalents consist of investments in a money market fund.

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(c) Share Based Compensation

We account for share based compensation, including stock options and fully vested long-term incentive units granted in connection with the IPO, using the fair value method of accounting. The estimated fair value of each of the long-term incentive units granted in connection with our IPO was equal to the IPO price of our stock and such amount was recorded as an expense upon closing of the IPO since those long-term incentive units were fully vested as of the grant date. The estimated fair value of the stock options granted by us is being amortized over the vesting period of the stock options. The estimated fair value of the Class C Partnership units (discussed in note 8) is being amortized over the expected service period of five years.

(d) Income Taxes

We have elected to be treated and believe that we have operated in a manner that has enabled us to qualify as a Real Estate Investment Trust (REIT) under Sections 856 through 860 of the Internal Revenue Code of 1986, (the Code) as amended. As a REIT, we generally are not required to pay federal corporate income taxes on our taxable income to the extent it is currently distributed to our stockholders.

However, qualification and taxation as a REIT depends upon our ability to meet the various qualification tests imposed under the Code including tests related to annual operating results, asset composition, distribution levels and diversity of stock ownership. Accordingly, no assurance can be given that we will be organized or be able to operate in a manner so as to qualify or remain qualified as a REIT. If we fail to qualify as a REIT in any taxable year, we will be subject to federal income tax (including any applicable alternative minimum tax) on our taxable income at regular corporate tax rates.

We have elected to treat three of the Operating Partnership's subsidiaries as taxable REIT subsidiaries (each, a TRS). In general, a TRS may perform non-customary services for tenants, hold assets that we cannot hold directly and generally may engage in any real estate or non-real estate related business (except for the operation or management of health care facilities or lodging facilities or the provision to any person, under a franchise, license or otherwise, rights to any brand name under which any lodging facility or health care facility is operated). Our TRS's are subject to corporate federal and state income taxes based on their taxable income. These rates are generally those rates which are charged for regular corporate entities. Income taxes are recorded using the asset and liability method. Under the asset and liability method, deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. A valuation allowance is recorded against the combined federal and state net deferred taxes reducing the deferred tax asset to a net amount. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

As of June 30, 2006 one of our TRS's is estimated to have a net operating loss carryforward for federal and state income tax purposes. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Due to the uncertainty of future realizability, management has fully offset the net deferred tax assets with a valuation allowance.

To the extent that any foreign taxes are incurred by the subsidiaries invested in real estate located outside of the United States, a provision is made for such taxes.

(e) Asset Retirement Obligations

We record accruals for estimated retirement obligations, as required by SFAS No. 143, *Accounting for Asset Retirement Obligations* and FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (FIN 47). The amount of asset retirement obligations relates primarily to estimated asbestos removal costs at the end of the economic life of properties that were built before 1984. As of both June 30, 2006 and December 31, 2005 the amount included in accounts payable and other accrued liabilities on our condensed consolidated balance sheets was approximately \$0.8 million and the equivalent asset is recorded at \$0.7 million, net of amortization.

Table of Contents**(f) Reclassifications**

Certain reclassifications have been made to the 2005 consolidated financial statements to conform to the 2006 presentation. These include the reclassification of 7979 East Tufts Avenue revenues and expenses to discontinued operations in the accompanying condensed consolidated statements of operations, as further described in note 5.

(g) Management's Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates made.

3. Minority Interests in the Operating Partnership

Minority interests in the Operating Partnership relate to the interests that are not owned by us. The following table shows the ownership interest in the Operating Partnership at June 30, 2006 and December 31, 2005.

| | June 30, 2006 | | December 31, 2005 | |
|---|--|---------------------|--|---------------------|
| | Common units and long term incentive units | Percentage of total | Common units and long term incentive units | Percentage of total |
| The Company | 36,104,961 | 57.3% | 27,363,408 | 46.4% |
| Minority interest consisting of: | | | | |
| GI Partners | 19,669,175 | 31.2 | 23,699,359 | 40.2 |
| Third Parties | 5,655,846 | 8.9 | 6,331,511 | 10.7 |
| Employees (long term incentive units, see note 8) | 1,622,671 | 2.6 | 1,622,671 | 2.7 |
| | 63,052,653 | 100.0% | 59,016,949 | 100.0% |

In conjunction with our formation, GI Partners received common units (founder units), in exchange for contributing ownership interests in properties to the Operating Partnership. Also in connection with acquiring real estate interests owned by third parties, the Operating Partnership issued common units to those sellers. Limited partners who acquired common units in the formation transactions have the right to require the Operating Partnership to redeem part or all of their common units for cash based upon the fair market value of an equivalent number of shares of our common stock at the time of the redemption. Alternatively, we may elect to acquire those common units in exchange for shares of our common stock on a one-for-one basis, subject to adjustment in the event of stock splits, stock dividends, issuance of stock rights, specified extraordinary distributions and similar events. Pursuant to registration rights agreements we entered into with GI Partners and the other third party contributors, we filed a shelf registration statement covering the issuance of the shares of our common stock issuable upon redemption of the common units, and the resale of those shares of common stock by the holders. GI Partners distributed 4,030,184 Operating Partnership common units to its owners and these units were converted into shares of our common stock on March 29, 2006 and sold to third parties on April 3, 2006. Richard Magnuson, the Executive Chairman of our board of directors, Michael Foust, our Chief Executive Officer and a member of our board of directors, and Scott Peterson, our Senior Vice President, Acquisitions, are minority indirect investors in GI Partners. The conversion of the GI Partners' founder units of the Operating Partnership to shares of our common stock was recorded as a reduction to minority interest and an increase to common stock and additional paid in capital based on the book value per unit in the accompanying condensed consolidated balance sheet.

During the three months ended June 30, 2006, third parties converted 675,665 Operating Partnership units into shares of our common stock. These conversions were recorded as a reduction to minority interest and an increase to common stock and additional paid in capital based on the book value per unit in the accompanying condensed consolidated balance sheet. We did not receive any cash proceeds upon conversion of these Operating Partnership units.

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Under the terms of certain third parties (the eXchange parties) contribution agreement signed in the third quarter of 2004, we have agreed to indemnify each eXchange party against adverse tax consequences in the event the Operating Partnership directly or indirectly, sells, exchanges or otherwise disposes of (whether by way of merger, sale of assets or otherwise) in a taxable transaction any interest in 200 Paul Avenue 1-4 or 1100 Space Park Drive until the earlier of November 3, 2013 and the date on which these contributors hold less than 25% of the Units issued to them in the formation transactions consummated concurrently with the IPO. Under the eXchange parties' contribution agreement, we have agreed to make \$20.0 million of indebtedness available for guaranty by these parties until the earlier of November 3, 2013 and the date on which these contributors or certain transferees hold less than 25% of the Units issued to them in the formation transactions consummated concurrently with the IPO.

4. Investments in Real Estate Acquired During the Three Months Ended June 30, 2006

We made the following acquisitions of real estate assets during the three months ended June 30, 2006:

| Property | Metropolitan Area | Date acquired | Purchase Price (in millions) |
|----------------------|-------------------|----------------|------------------------------|
| 6800 Millcreek Drive | Toronto, Canada | April 13, 2006 | \$ 16.0 |
| 101 Aquila Way | Atlanta | April 20, 2006 | 25.3 |
| 12001 North Freeway | Houston | April 26, 2006 | 30.5 |
| 14901 FAA Boulevard | Dallas | June 30, 2006 | 50.6 |
| | | | \$ 122.4 |

The purchase prices of these acquisitions have been allocated on a preliminary basis to the assets acquired and the liabilities assumed. We expect to finalize our purchase price allocation no later than twelve months from the date of each acquisition.

5. Discontinued Operations

In June 2006, we classified 7979 East Tufts Avenue as held for sale upon committing to sell this property and we also ceased recording depreciation expense at that time.

The results of operations of 7979 East Tufts Avenue are reported as discontinued operations for all periods presented in the accompanying consolidated condensed financial statements. The following table summarizes the income and expense components that comprise loss from discontinued operations for the three and six months ended June 30, 2006 and 2005 (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|----------|------------------------------|----------|
| | 2006 | 2005 | 2006 | 2005 |
| Operating revenues | \$ 1,660 | \$ 1,490 | \$ 3,151 | \$ 3,034 |
| Operating expenses | (1,476) | (1,360) | (2,949) | (2,683) |
| Interest and other income | 4 | 4 | 7 | 7 |
| Interest expense | (351) | (351) | (700) | (702) |
| Loss from discontinued operations before minority interests | (163) | (217) | (491) | (344) |
| Minority interests attributable to discontinued operations | 73 | 133 | 264 | 212 |
| Loss from discontinued operations | \$ (90) | \$ (84) | \$ (227) | \$ (132) |

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The major classes of assets and liabilities associated with assets held for sale as of June 30, 2006 consist of the following (in thousands):

| | June 30, 2006 |
|--|--------------------------|
| Investments in real estate | \$ 37,389 |
| Accumulated depreciation and amortization | (5,360) |
| Net investments in real estate | 32,029 |
| Other assets | 5,868 |
| Assets held for sale | \$ 37,897 |
| Mortgage loans | 26,000 |
| Other liabilities | 2,081 |
| Liabilities related to assets held for sale | \$ 28,081 |
| Minority interests in consolidated joint venture related to assets and liabilities held for sale | \$ 191 |

Table of Contents**6. Debt**

A summary of outstanding indebtedness as of June 30, 2006 and December 31, 2005, respectively, is as follows (in thousands):

| Properties | Interest Rate at June 30, 2006 | Maturity Date | Principal Outstanding June 30, 2006 | Principal Outstanding December 31, 2005 |
|---|---------------------------------------|----------------------|--|--|
| Mortgage loans: | | | | |
| Secured Term Debt (1) | 5.65% | Nov. 11, 2014 | \$ 151,905 | \$ 152,918 |
| 350 East Cermak Road | 1-month LIBOR + 2.20%(2)(3) | Jun. 9, 2008(4) | 100,000 | 100,000 |
| 200 Paul Avenue 1-4 | 5.74% | Oct. 8, 2015 | 81,000 | 81,000 |
| 2323 Bryan Street (5) | 6.04% | Nov. 6, 2009 | 56,931 | 57,282 |
| 34551 Ardenwood Boulevard 1-4, 2334 Lundy Place, 2440 Marsh Lane | 1-month LIBOR + 1.59%(2) | Aug. 9, 2006(6) | 43,000 | 43,000 |
| 7979 East Tufts Avenue | 5.14% | | | 26,000(7) |
| 6 Braham Street | 6.85% | | | 22,490(8) |
| 6 Braham Street | 3-month GBP LIBOR + 0.90%(2) | Apr. 10, 2011 | 24,399(8) | |
| 4055 Valley View Lane | 3-month LIBOR + 1.20%(2) | Jan. 1, 2009 | 20,880 | 21,150 |
| 100 Technology Center Drive | 3-month LIBOR + 1.70%(2) | Apr. 1, 2009 | 20,000 | 20,000 |
| Paul van Vlissingenstraat 16 | 3-month EURIBOR + 1.60%(2) | Jul. 18, 2013 | 14,325(9) | |
| Chemin de l' Epinglier 2 | 3-month EURIBOR + 1.50%(2) | Jul. 18, 2013 | 10,334(9) | |
| 47700 Kato Road & 1055 Page Avenue | 1-month LIBOR + 2.25% | | | 17,540 |
| 1125 Energy Park Drive | 7.62%(10) | Mar. 1, 2032 | 9,622 | 9,675 |
| 375 Riverside Parkway | 3-month LIBOR + 1.85%(2) | Nov. 25, 2006(4) | 8,775 | 8,775 |
| 600 West Seventh Street | 5.80% | Mar. 15, 2016 | 59,731 | |
| 731 East Trade Street | 8.22% | Jul. 1, 2020 | 5,964 | 6,042 |
| | | | 606,866 | 565,872 |
| Unsecured line of credit | 1-month LIBOR + 1.50%(11) | Oct. 31, 2008(12) | 211,554 | 181,000 |
| Total principal outstanding | | | 818,420 | 746,872 |
| Loan premium 1125 Energy Park Drive and 731 East Trade Street mortgages | | | 2,081 | 2,195 |
| Total indebtedness | | | \$ 820,501 | \$ 749,067 |

(1) This amount represents six mortgage loans secured by our interests in 36 NE 2nd Street, 3300 East Birch Street, 100 & 200 Quannapowitt Parkway, 300 Boulevard East, 4849 Alpha Road, and 11830 Webb Chapel Road. Each of these loans is cross-collateralized by the six properties.

(2) We have entered into interest rate swap agreements as a cash flow hedge for interest generated by these LIBOR, EURIBOR and GBP LIBOR based loans. The total notional amount of the swap agreements was \$241.7 million as of June 30, 2006 and \$192.9 million as of December 31, 2005. See note 10 for further information.

(3) This is the weighted average interest rate as of June 30, 2006. The first note, in a principal amount of \$80.0 million, bears interest at a rate of 1-month LIBOR + 1.375% per annum and the second note, in a principal amount of \$20.0 million, bears interest at a rate of 1-month LIBOR + 5.5% per annum.

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- (4) Two one-year extensions are available, which we may exercise if certain conditions are met.
- (5) This loan is also secured by a \$5.0 million letter of credit.
- (6) The 13-month extension option has been exercised and a one-year extension is available.
- (7) As of June 30, 2006 the outstanding principal for this loan is \$26.0 million and is included in liabilities related to assets held for sale in our condensed consolidated balance sheet.
- (8) Based on exchange rate of \$1.85 to £1.00 as of June 30, 2006 and \$1.72 to £1.00 as of December 31, 2005.
- (9) Based on exchange rate of \$1.28 to 1.00 as of June 30, 2006.
- (10) If the loan is not repaid by March 1, 2012, the interest rate increases to the greater of 9.62% or the then treasury rate plus 2%.
- (11) The interest rate under our unsecured line of credit equals either (i) LIBOR (ranging from 1- to 6-month LIBOR) plus a margin of between 1.250% and 1.625% or (ii) the greater of (x) the base rate announced by the lender and (y) the federal funds rate, plus a margin of between 0.375% - 0.750%. In each case, the margin is based on our leverage ratio. We incur a fee ranging from 0.15% to 0.25% for the unused portion of our unsecured line of credit.
- (12) A one-year extension option is available.

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At June 30, 2006, our Operating Partnership has an unsecured revolving line of credit facility (credit facility) for \$350.0 million (with the option to further increase to \$500 million subject to receipt of lender commitments and satisfaction of other conditions). As of June 30, 2006 borrowings under the credit facility bear interest at a rate of 6.83%, which is based on 1-month LIBOR plus a margin ranging from 1.250% to 1.625%, depending on our Operating Partnership's overall leverage and this margin was 1.50% as of June 30, 2006. The credit facility matures in October 2008, subject to a one-year extension option and has a \$150.0 million sub-facility for foreign exchange advances in Euros and British Sterling. As of June 30, 2006, approximately \$211.6 million was drawn under this facility. The credit facility contains various restrictive covenants, including limitations on our ability to incur additional indebtedness, make certain investments or merge with another company, and requirements to maintain financial coverage ratios and maintain a pool of unencumbered assets. In addition, except to enable us to maintain our status as a REIT for federal income tax purposes, we will not during any four consecutive fiscal quarters make distributions with respect to common stock or other equity interests in an aggregate amount in excess of 95% of Funds From Operations, as defined, for such period, subject to certain other adjustments. As of June 30, 2006, we were in compliance with all the covenants. On July 24, 2006 we increased the size of our credit facility to \$500 million.

Some of the loans impose penalties upon prepayment. The terms of the following mortgage loans do not permit prepayment of the loan prior to the dates listed below:

| Loan | Date |
|------------------------|----------------|
| 2323 Bryan Street | August 2009 |
| 200 Paul Avenue 1-4 | November 2010 |
| 1125 Energy Park Drive | December 2011 |
| Secured Term Debt | September 2014 |

During the three and six months ended June 30, 2006 we capitalized interest of approximately \$1.1 million and \$1.8 million, respectively. We did not capitalize any interest in the same periods in 2005.

Table of Contents**7. Income per Share**

The following is a summary of basic and diluted income per share (in thousands, except share and per share amounts):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------|------------|---------------------------|------------|
| | 2006 | 2005 | 2006 | 2005 |
| Income from continuing operations | \$ 5,185 | \$ 4,419 | \$ 10,409 | \$ 7,206 |
| Preferred stock dividends | (3,445) | (2,199) | (6,890) | (3,470) |
| Income from continuing operations available to common stockholders | 1,740 | 2,220 | 3,519 | 3,736 |
| Loss from discontinued operations | (90) | (84) | (227) | (132) |
| Net income available to common stockholders | \$ 1,650 | \$ 2,136 | \$ 3,292 | \$ 3,604 |
| Weighted average shares outstanding - basic | 33,372,240 | 21,421,300 | 30,453,957 | 21,421,300 |
| Potentially dilutive common shares: | | | | |
| Stock options | 398,235 | 163,613 | 393,566 | 138,658 |
| Class C Units | 101,869 | | 96,804 | |
| Weighted average shares outstanding - diluted | 33,872,344 | 21,584,913 | 30,944,327 | 21,559,958 |
| Income (loss) per share - basic: | | | | |
| Income per share available to common stockholders | \$ 0.05 | \$ 0.10 | \$ 0.12 | \$ 0.18 |
| Loss per share from discontinued operations | | | (0.01) | (0.01) |
| Net income per share from continuing operations available to common stockholders | \$ 0.05 | \$ 0.10 | \$ 0.11 | \$ 0.17 |
| Income (loss) per share - diluted: | | | | |
| Income per share from continuing operations available to common stockholders | \$ 0.05 | \$ 0.10 | \$ 0.12 | \$ 0.18 |
| Loss per share from discontinued operations | | | (0.01) | (0.01) |
| Net income per share available to common stockholders | \$ 0.05 | \$ 0.10 | \$ 0.11 | \$ 0.17 |

We have excluded common Operating Partnership units not owned by us from the computation of diluted earnings per share as their effect would not be dilutive. The weighted average number of common Operating Partnership units excluded was 27,087,007 and 31,521,431 units during the three months ended June 30, 2006 and 2005, respectively, and 29,290,860 and 31,521,431 units during the six months ended June 30, 2006 and 2005, respectively. In addition for the three and six months ended June 30, 2006, the effect of the assumed exercise of 52,500 potentially dilutive outstanding stock options was not included in the net income per share calculation as this effect is antidilutive.

8. Stockholders' Equity**(a) Redeemable Preferred Stock**

Underwriting discounts and commissions and other offering costs totaling approximately \$7.0 million are reflected as a reduction to preferred stock in the accompanying condensed consolidated balance sheets.

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8.50% Series A Cumulative Redeemable Preferred Stock

We currently have outstanding 4,140,000 shares of our 8.50% series A cumulative redeemable preferred stock, or series A preferred stock. Dividends are cumulative on our series A preferred stock from the date of original issuance in the amount of \$2.125 per share each year, which is equivalent to 8.50% of the \$25.00 liquidation preference per share. Dividends on our series A preferred stock are payable quarterly in arrears. Our series A preferred stock does not have a stated maturity date and is not subject to any sinking fund or mandatory redemption provisions. Upon liquidation, dissolution or winding up, our series A preferred stock will rank senior to our common stock with respect to the payment of distributions and other amounts and rank on parity with our Series B Preferred Stock. We are not allowed to redeem our series A preferred stock before February 9, 2010, except in limited circumstances to preserve our status as a REIT. On or after February 9, 2010, we may, at our option, redeem our series A preferred stock, in whole or in part, at any time or from time to time, for cash at a redemption price of \$25.00 per share, plus all accrued and unpaid dividends on such series A preferred stock up to but excluding the redemption date. Holders of our series A preferred stock generally have no voting rights except for limited voting rights if we fail to pay dividends for six or more quarterly periods (whether or not consecutive) and in certain other circumstances. Our series A preferred stock is not convertible into or exchangeable for any other property or securities of our company.

7.875% Series B Cumulative Redeemable Preferred Stock

We currently have outstanding 2,530,000 shares of our 7.875% series B cumulative redeemable preferred stock, or series B preferred stock. Dividends are cumulative on our series B preferred stock from the date of original issuance in the amount of \$1.96875 per share each year, which is equivalent to 7.875% of the \$25.00 liquidation preference per share. Dividends on our series B preferred stock are payable quarterly in arrears. Our series B preferred stock does not have a stated maturity date and is not subject to any sinking fund or mandatory redemption provisions. Upon liquidation, dissolution or winding up, our series B preferred stock will rank senior to our common stock with respect to the payment of distributions and other amounts and rank on parity with our Series A Preferred Stock. We are not allowed to redeem our series B preferred stock before July 26, 2010, except in limited circumstances to preserve our status as a REIT. On or after July 26, 2010, we may, at our option, redeem our series B preferred stock, in whole or in part, at any time or from time to time, for cash at a redemption price of \$25.00 per share, plus all accrued and unpaid dividends on such series B preferred stock up to but excluding the redemption date. Holders of our series B preferred stock generally have no voting rights except for limited voting rights if we fail to pay dividends for six or more quarterly periods (whether or not consecutive) and in certain other circumstances. Our series B preferred stock is not convertible into or exchangeable for any other property or securities of our company.

(b) Shares and Units

A common unit and a share of our common stock have essentially the same economic characteristics as they share equally in the total net income or loss and distributions of the Operating Partnership. The common units are further discussed in note 3 and the long term incentive units are discussed in note 9, including the conversion of Operating Partnership common units into our common stock during the three and six months ended June 30, 2006.

In May 2006, we issued 4.0 million shares of common stock at a price of \$24.40, which resulted in net proceeds of approximately \$94.5 million after offering costs.

Table of Contents**(c) Dividends and Distributions**

In 2006, we have declared the following dividends and equivalent distributions on common units in our Operating Partnership:

| Date dividend and distribution declared | Share class | Dividend and distribution amount per share | Period covered | Dividend and distribution payable date | Annual equivalent rate of dividend and distribution per share | Dividend and distribution amount (in thousands) |
|--|--|--|-----------------------------------|---|---|---|
| February 27, 2006 | Series A Preferred Stock | \$ 0.53125 | January 1, 2006 to March 31, 2006 | March 31, 2006 to shareholders on record on March 15, 2006. | \$ 2.125 | \$ 2,199 |
| February 27, 2006 | Series B Preferred Stock | \$ 0.49219 | January 1, 2006 to March 31, 2006 | March 31, 2006 to shareholders on record on March 15, 2006. | \$ 1.969 | 1,246 |
| February 27, 2006 | Common stock and operating partnership common units and long term incentive units. | \$ 0.26500 | January 1, 2006 to March 31, 2006 | March 31, 2006 to shareholders on record on March 15, 2006. | \$ 1.060 | 15,642 |
| May 1, 2006 | Series A Preferred Stock | \$ 0.53125 | April 1, 2006 to June 30, 2006 | June 30, 2006 to shareholders on record on June 15, 2006. | \$ 2.125 | 2,199 |
| May 1, 2006 | Series B Preferred Stock | \$ 0.49219 | April 1, 2006 to June 30, 2006 | June 30, 2006 to shareholders on record on June 15, 2006. | \$ 1.969 | 1,246 |
| May 1, 2006 | Common stock and operating partnership common units and long term incentive units. | \$ 0.26500 | April 1, 2006 to June 30, 2006 | June 30, 2006 to shareholders on record on June 15, 2006. | \$ 1.060 | 16,709 |
| Total 2006 dividends and distributions declared through June 30, 2006: | | | | | | |
| Series A Preferred Stock | | | | | | 4,398 |
| Series B Preferred Stock | | | | | | 2,492 |
| Common stock and operating partnership common units and long term incentive units. | | | | | | 32,351 |
| | | | | | | \$ 39,241 |

(d) Stock Options

The fair value of each option granted under the 2004 Incentive Award Plan is estimated on the date of the grant using the Black-Scholes option-pricing model with the weighted-average assumptions listed below for grants in 2006 and 2005. The fair values are being expensed on a straight-line basis over the vesting period of the options, which ranges from four to five years. The expense recorded for the three months ended June 30, 2006 and 2005 was approximately \$76,000 and \$44,000, respectively, and was \$150,000 and \$96,000 during the six months ended June 30, 2006 and 2005, respectively. Unearned compensation representing the unvested portion of the stock options totaled \$1.1 million and \$1.0 million as of June 30, 2006 and December 31, 2005, respectively. We expect to recognize this unearned compensation over the next 3.4 years on a weighted average basis.

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The following table sets forth the weighted-average assumptions used to calculate the fair value of the stock options granted during the three and six months ended June 30, 2006 and 2005:

| | Three and Six Months Ended June 30, | |
|---------------------------------|--|------------|
| | 2006 | 2005 |
| Dividend yield | 3.79% | 6.88% |
| Expected life of option | 120 months | 120 months |
| Risk-free interest rate | 4.59% | 4.13% |
| Expected stock price volatility | 25.02% | 20.00% |

The following table summarizes the 2004 Incentive Award Plan's stock option activity for the six months ended June 30, 2006:

| | Six months ended June 30, 2006 | |
|--|-----------------------------------|---------------------------------------|
| | Shares | Weighted average exercise price |
| Options outstanding, January 1, 2006 | 939,841 | \$ 13.27 |
| Granted | 52,500 | 28.09 |
| Exercised | (35,704) | 12.67 |
| Forfeited | (25,954) | 12.34 |
| Options outstanding, June 30, 2006 | 930,683 | \$ 14.16 |
| Exercisable, end of period | 147,422 | \$ 12.14 |
| Weighted-average fair value of options granted during the period | | \$ 6.42 |

We issued newly created common shares for the common stock options exercised during the six months ended June 30, 2006. The intrinsic value of options exercised in the six months ended June 30, 2006 was approximately \$0.5 million.

The following table summarizes information about stock options outstanding and exercisable at June 30, 2006:

| Exercise price | Options outstanding | | | Options exercisable | | | |
|----------------|-----------------------|--|---------------------------------------|---------------------------------|-----------------------|---------------------------------------|---------------------------------|
| | Number outstanding | Weighted average remaining contractual life | Weighted average exercise price | Aggregate Intrinsic Value | Number exercisable | Weighted average exercise price | Aggregate Intrinsic Value |
| \$12.00-13.02 | 704,933 | 8.34 | \$ 12.06 | \$ 8,902,505 | 140,672 | \$ 12.04 | \$ 1,779,709 |
| \$13.47-14.50 | 53,250 | 8.59 | 14.19 | 559,355 | 6,750 | 14.31 | 70,070 |
| \$20.37 | 120,000 | 9.36 | 20.37 | 518,400 | | 20.37 | |
| \$28.09 | 52,500 | 9.66 | 28.09 | | | | |
| | 930,683 | 8.56 | \$ 14.16 | \$ 9,980,260 | 147,422 | \$ 12.14 | \$ 1,849,779 |

9. Incentive Plan**(a) Incentive Award Plan**

Our 2004 Incentive Award Plan provides for the grant of incentive awards to employees, directors and consultants. Awards issuable under the 2004 Incentive Award Plan include stock options, restricted stock, dividend equivalents, stock appreciation rights, long-term incentive units, cash performance bonuses and other incentive awards. Only employees are eligible to receive incentive stock options under the 2004 Incentive Award Plan. We have reserved a total of 4,474,102 shares of common stock for issuance pursuant to the 2004 Incentive Award Plan, subject to certain adjustments set forth in the 2004 Incentive Award Plan. As of June 30, 2006, 560,493 shares of common stock or awards convertible into

or

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exchangeable for common stock remained available for future issuance under the 2004 Incentive Award Plan. Each long-term incentive and Class C unit issued under the 2004 Incentive Award Plan will count as one share of common stock for purposes of calculating the limit on shares that may be issued under the 2004 Incentive Award Plan and the individual award limit discussed below.

(b) Long Term Incentive Units

Long-term incentive units may be issued to eligible participants for the performance of services to or for the benefit of the Operating Partnership. Long-term incentive units, whether vested or not, will receive the same quarterly per unit distributions as common units in the Operating Partnership, which equal per share distributions on our common stock. Initially, long-term incentive units do not have full parity with common units with respect to liquidating distributions. Upon the occurrence of specified events, long-term incentive units may over time achieve full parity with common units in the Operating Partnership for all purposes, and therefore accrete to an economic value for participants equivalent to our common stock on a one-for-one basis. If such parity is reached, vested long-term incentive units may be converted into an equal number of common units of the Operating Partnership at any time, and thereafter enjoy all the rights of common units of the Operating Partnership.

In connection with the IPO, an aggregate of 1,490,561 of fully vested long-term incentive units were issued and compensation expense totaling \$17.9 million was recorded at the completion of the IPO. Parity was reached for these units on February 9, 2005 upon completion of our series A preferred stock offering.

(c) Class C Profits Interests Units

During the fourth quarter of 2005, we granted to each of our named executive officers and certain other employees an award of Class C Profits Interest Units (Class C Units) of the Operating Partnership under our 2004 Incentive Award Plan. If the performance condition and the other vesting conditions are satisfied with respect to a Class C Unit, as described below, the Class C Unit will be treated in the same manner as the existing long-term incentive units issued by the Operating Partnership.

The Class C Units subject to each award will vest based on the achievement of a 10% or greater compound annual total shareholder return, as defined, for the period from the grant date through earlier of September 30, 2008 and the date of a change of control of our Company (the Performance Condition) combined with the employee's continued service with our company or the Operating Partnership through September 30, 2010. Upon achievement of the Performance Condition, the Class C units will receive the same quarterly per unit distribution as common units in the Operating Partnership.

The aggregate amount of the performance award pool will be equal to 7% of the excess shareholder value, as defined, created during the applicable performance period, but in no event will the amount of the pool exceed the lesser of \$40,000,000 or the value of 2.5% of the total number of shares of our common stock and limited partnership units of the Operating Partnership at the end of the performance period.

Except in the event of a change in control of our company, 60% of the Class C Units that satisfy the Performance Condition will vest at the end of the three year performance period and an additional 1/60th of such Class C Units will vest on the date of each monthly anniversary thereafter, provided that the employee's service has not terminated prior to the applicable vesting date.

To the extent that any Class C Units fail to satisfy the Performance Condition, such Class C Units will automatically be cancelled and forfeited by the employee. In addition, any Class C Units which are not eligible for pro rata vesting in the event of a termination of the employee's employment due to death or disability or without cause (or for good reason, if applicable) will automatically be cancelled and forfeited upon a termination of the employee's employment.

In the event that the value of the employee's allocated portion of the award pool that satisfies the performance condition equates to a number of Class C Units that is greater than the number of Class C Units awarded to the executive, we will make an additional payment to the executive in the form of a number of shares of our restricted stock equal to the difference subject to the same vesting requirements as the Class C Units.

A portion of the award pool remains unallocated and available for grants to other future senior executives or to the then

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current grantees (including the named executive officers) if the Compensation Committee determines that the award pool percentage allocated to one or more of such executives should be increased.

On October 26, 2005, the Operating Partnership amended and restated its agreement of limited partnership in order to create the Class C Units. As of June 30, 2006, and December 31, 2005, 1,180,000 Class C units had been awarded to our executive officers and other employees, and 80,000 Class C units are currently available for future awards. The fair value of these awards of approximately \$4.0 million will be recognized as compensation expense on a straight line basis over the expected service period of five years. The unearned compensation as of June 30, 2006 and December 31, 2005 was \$3.4 million and \$3.8 million respectively, respectively. As of June 30, 2006 and December 31, 2005, none of the above awards had vested. We recognized compensation expense related to these Class C units of \$0.2 million and \$0.4 million in the three and six months ended June 30, 2006, respectively. If the Performance Condition is not met, the unamortized amount will be recognized as an expense at that time.

10. Derivative Instruments**(a) Interest rate swap agreements**

As of June 30, 2006, we were a party to interest rate swap agreements which hedge variability in cash flows related to LIBOR and EURIBOR based mortgage loans. The fair value of these derivatives was \$4.7 million and \$3.3 million at June 30, 2006 and December 31, 2005, respectively.

As of June 30, 2006, we estimate that \$2.3 million of accumulated other comprehensive income will be reclassified to earnings as a reduction to interest expense during the twelve months ending June 30, 2007 as the hedged forecasted transactions impact earnings.

The table below summarizes the terms of these interest rate swaps and their fair values as of June 30, 2006 (in thousands):

| Current Notional Amount | Strike Rate | Effective Date | Expiration Date | Fair Value |
|-------------------------|-------------|----------------|-----------------|-----------------|
| \$ 43,000 | 3.250% | Nov. 26, 2004 | Sept. 15, 2006 | \$ 189 |
| 20,835 | 3.754 | Nov. 26, 2004 | Jan. 2, 2009 | 812 |
| 20,000 | 3.824 | Nov. 26, 2004 | Apr. 1, 2009 | 856 |
| 8,775 | 3.331 | Nov. 26, 2004 | Dec. 1, 2006 | 77 |
| 100,000 | 4.025 | May 26, 2005 | Jun. 15, 2008 | 2,662 |
| 24,399 | 4.944 | Jul. 10, 2006 | Apr. 10, 2011 | 158 |
| 14,325 | 3.981 | May 17, 2006 | Jul. 18, 2013 | 28 |
| 10,334 | 4.070 | Jun. 23, 2006 | Jul. 18, 2013 | (33) |
| \$241,668 | | | | \$ 4,749 |

We have two LIBOR interest rate caps that are not designated as hedges. The fair values of the caps were immaterial as of June 30, 2006 and December 31, 2005.

(b) Foreign currency contract

On January 4, 2006, we received net proceeds of \$0.7 million when we terminated a foreign currency forward sale contract entered into on January 24, 2005 which was used to hedge our equity investment in 6 Braham Street, located in London, England. This forward contract was designated as a net investment hedge. The cumulative translation adjustment amounts related to the net investment hedge (including the \$0.7 million received upon termination in January 2006) are included in other accumulated comprehensive income and will be reclassified to earnings when the hedged investment is sold or liquidated.

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11. Related Party Transactions

We paid CB Richard Ellis, an affiliate of GI Partners, building management fees and leasing commissions. Fees incurred were \$1.1 million and \$0.2 million for the three months ended June 30, 2006 and 2005, respectively and \$1.5 million and \$0.6 million for the six months ended June 30, 2006 and 2005, respectively.

In April 2005, we entered into two agreements with Linc Facility Services, LLC, or LFS primarily for personnel providing for operations and maintenance repairs of the mechanical, electrical, plumbing and general building service systems of five of our properties. LFS belongs to The Linc Group, which GI Partners has owned since late 2003. Our consolidated statement of operations includes amounts related to these fees of \$0.5 million and \$0.2 million for the three months ended June 30, 2006 and 2005, respectively, and \$0.7 million and \$0.2 million for the six months ended June 30, 2006 and 2005, respectively.

GI Partners distributed 4,030,184 Operating Partnership common units to its owners and these units were converted into shares of our common stock on March 29, 2006 and sold to third parties on April 3, 2006. Our condensed consolidated statement of operations included general and administrative expenses representing legal and other costs directly related to facilitating this conversion of \$0.3 million during the three months ended March 31, 2006. During the three months ended June 30, 2006 GI Partners agreed to reimburse us for these costs which we recognized as a reduction in general and administrative expenses in the accompanying condensed consolidated statement of operations for the three months ended June 30, 2006.

12. Commitments and Contingencies

The seller of 350 East Cermak Road can earn an additional \$20.0 million by obtaining a change in the real estate tax classification prior to December 31, 2006. We have also agreed with the seller to share a portion, not to exceed \$135,000 per month, of rental revenue, adjusted for our costs to lease the premises, from the lease of the 260,000 square feet of space held for redevelopment. This revenue sharing agreement will terminate in May 2013. We have recorded no liability for these contingent liabilities on our condensed consolidated balance sheet at June 30, 2006, as the events causing this contingency had not occurred at June 30, 2006.

As part of the acquisition of Paul van Vlissingenstraat 16, we entered into an agreement with the seller, whereby, for twelve months from the execution of the purchase and sale agreement, our purchase price may increase depending upon future leasing activity as a result of actions by the seller. The amount of the potential commitment is not currently quantifiable as it is based on a 10% cap rate on the incremental operating income from qualifying new leases that are closed or binding during the participation period. We have recorded no liability for this contingent liability on our consolidated balance sheet at June 30, 2006 as the events causing this contingency had not occurred at June 30, 2006.

As part of the acquisition of Clonshaugh Industrial Estate, we entered into an agreement with the seller whereby the seller is entitled to receive 40% of the net rental income generated by the existing building, after we have received a 9% return on all capital invested in the property. As of February 6, 2006 the date we acquired this property, we have estimated the present value of these expected payments over the 10 year lease term to be approximately \$1.1 million and this value has been capitalized with a corresponding amount recorded in accounts payable and other liabilities. No amounts have been paid to the seller as at June 30, 2006.

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As of June 30, 2006 we had signed purchase agreements to acquire the following properties:

| Location | Purchase price (\$ millions) | Purchase completed on: |
|---|---------------------------------|------------------------|
| Properties acquired between June 30, 2006 and August 4, 2006: | | |
| Gyroscopweg 2E-2F in Amsterdam, Netherlands (1) | \$ 11.3 | 27-Jul-06 |
| Properties not acquired as of August 4, 2006: | | |
| Miami | 5.6(2) | |
| Boston | 8.7(2) | |
| Tempe, Arizona | 9.8(2) | |
| | 24.1 | |
| Total | \$ 35.4 | |

(1) The purchase price was approximately 8.9 million and is translated at the rate of exchange on the date we acquired the property.

(2) As we are completing due diligence for these potential acquisitions we can give no assurance that we will complete their purchase.

Our properties require periodic investments of capital for tenant-related capital expenditures and for general capital improvements. As of June 30, 2006, we had commitments under leases in effect for approximately \$38.3 million of tenant improvement costs and leasing commissions all of which we expect to incur in 2006.

13. Tenant leases

Revenues recognized from Savvis Communications comprised approximately 12.2% and 8.8% of total operating revenues, for the three months ended June 30, 2006 and 2005, respectively, and comprised approximately 12.6% and 9.9% of total revenues, for the six months ended June 30, 2006 and 2005, respectively. Revenues recognized from Qwest Communications International, Inc., comprised approximately 11.5% and 9.8% of total operating revenues, for the three months ended June 30, 2006 and 2005, respectively, and comprised approximately 11.9% and 9.0% of total operating revenues, for the six months ended June 30, 2006 and 2005, respectively. Other than noted here, for the three and six months ended June 30, 2006 and 2005 no single tenant comprised more than 10% of total operating revenues.

14. Subsequent Events

On July 12, 2006, we completed the sale of 7979 East Tufts Avenue for \$60.4 million, realizing a gain of approximately \$17 million, after the deduction of minority interests.

On July 14, 2006 we signed a purchase agreement to acquire a property in Atlanta for approximately \$6.1 million.

On July 24, 2006 we increased the amount of our credit facility from \$350 million to \$500 million.

On July 25, 2006 we acquired 120 East Van Buren Street, a property located in Phoenix for approximately \$175.0 million. This property is the leading internet gateway in Phoenix and a premier datacenter facility for companies with operations in the Southwestern United States.

On July 27, 2006 we acquired a property in Amsterdam, Netherlands for approximately 8.9 million (approximately \$11.3 million based on the rate of exchange on July 27, 2006). Simultaneous with this property purchase we closed a 7.1 million 7-year loan with 1.5% amortization per annum at a fixed rate of 5.49% based on the swap rate.

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On July 31, 2006, we declared the following dividends per share and the Operating Partnership declared an equivalent distribution per unit.

| Share Class | Series A Preferred Stock | Series B Preferred Stock | Common stock |
|---|-----------------------------|-----------------------------|--------------------|
| Dividend and distribution amount | \$ 0.53125 | \$ 0.49219 | \$ 0.265 |
| Dividend and distribution payable date | October 2, 2006 | October 2, 2006 | October 2, 2006 |
| Dividend payable to shareholders of record on: | September 15, 2006 | September 15, 2006 | September 15, 2006 |
| Annual equivalent rate of dividend and distribution | \$ 2.125 | \$ 1.969 | \$ 1.060 |

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

The following discussion should be read in conjunction with the condensed consolidated financial statements and notes thereto appearing elsewhere in this report. This report contains forward-looking statements within the meaning of the federal securities laws. We caution investors that any forward-looking statements presented in this report, or which management may make orally or in writing from time to time, are based on management's beliefs and assumptions made by, and information currently available to, management. When used, the words "anticipate," "believe," "expect," "intend," "may," "might," "plan," "estimate," "project," "should," "will," "result" and similar expressions, which do not relate to historical matters, are intended to identify forward-looking statements. Such statements are subject to risks, uncertainties and assumptions and are not guarantees of future performance, which may be affected by known and unknown risks, trends, uncertainties and factors that are beyond our control. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated or projected. We expressly disclaim any responsibility to update forward-looking statements, whether as a result of new information, future events or otherwise.

Some of the risks and uncertainties that may cause our actual results, performance or achievements to differ materially from those expressed or implied by forward-looking statements include, among others, the following: adverse economic or real estate developments in our markets or technology related real estate; general and local economic conditions; defaults on or non-renewal of leases by tenants; increased interest rates and operating costs; our inability to manage growth effectively; our failure to obtain necessary outside financing; decreased rental rates or increased vacancy rates; difficulties in identifying properties to acquire and completing acquisitions; our failure to successfully operate acquired properties and operations; our failure to successfully redevelop properties acquired for that purpose; our failure to maintain our status as a REIT; possible adverse changes to tax laws; environmental uncertainties and risks related to natural disasters; financial market fluctuations; changes in foreign currency exchange rates; and changes in real estate and zoning laws and increases in real property tax rates.

The risks included here are not exhaustive, and additional factors could adversely affect our business and financial performance, including factors and risks included in other sections of this report. In addition, we discussed a number of material risks in our annual report on Form 10-K for the year ended December 31, 2005. Those risks continue to be relevant to our performance and financial condition. Moreover, we operate in a very competitive and rapidly changing environment. New risk factors emerge from time to time and it is not possible for management to predict all such risk factors, nor can it assess the impact of all such risk factors on the business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Given these risks and uncertainties, investors should not place undue reliance on forward-looking statements as a prediction of actual results.

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Overview

Our Company. We completed our initial public offering, (IPO) of common stock on November 3, 2004. We believe that we have operated in a manner that has enabled us to qualify, and have elected to be treated, as a Real Estate Investment Trust (REIT) under Sections 856 through 860 of the Internal Revenue Code of 1986 as amended (the Code). Our company was formed on March 9, 2004. During the period from our formation until we commenced operations in connection with the completion of our IPO we did not have any corporate activity other than the issuance of shares of common stock in connection with the initial capitalization of the company. Any reference to our , we and us in this filing includes our company and our predecessor. The predecessor is comprised of the real estate activities and holdings of Global Innovation Partners LLC (GI Partners) related to the properties in our portfolio.

Business and strategy. Our primary business objectives are to maximize sustainable long-term growth in earnings, funds from operations and cash flow per share and to maximize returns to our stockholders. We expect to achieve our objectives by focusing on our core business of investing in technology-related real estate. We target high quality, strategically located properties containing applications and operations critical to the day-to-day operations of corporate enterprise data center and technology industry tenants. Most of our properties contain fully redundant electrical supply systems, multiple power feeds, above-standard precision cooling systems, raised floor areas, extensive in-building communications cabling and high-level security systems. We focus solely on technology-related real estate because we believe that the growth in corporate data center adoption and the technology-related real estate industry generally will be superior to that of the overall economy.

Since the acquisition of our first property in 2002 and through June 30, 2006, we acquired an aggregate of 50 technology-related real estate properties with 10.3 million net rentable square feet including approximately 1.2 million square feet of space held for redevelopment. We have developed detailed, standardized procedures for evaluating acquisitions to ensure that they meet our financial and other criteria. We expect to continue to acquire additional assets as a key part of our growth strategy. We intend to aggressively manage and lease our assets to increase their cash flow.

We may acquire properties subject to existing mortgage financing and other indebtedness or new indebtedness may be incurred in connection with acquiring or refinancing these properties. Debt service on such indebtedness will have a priority over any dividends with respect to our common stock and our preferred stock. We currently intend to limit our indebtedness to 60% of our total market capitalization and, based on the closing price of our common stock on June 30, 2006 of \$24.69, our ratio of debt to total market capitalization was approximately 32% as of June 30, 2006. Our total market capitalization is defined as the sum of the market value of our outstanding common stock (which may decrease, thereby increasing our debt to total market capitalization ratio), excluding options issued under our incentive award plan, plus the liquidation value of our preferred stock, plus the aggregate value of the units not held by us (with each unit value equal to the market value of one share of our common stock), plus the book value of our total consolidated indebtedness excluding a \$26.0 million loan related to 7979 East Tufts Avenue, a property classified as held for sale as of June 30, 2006 and which we sold on July 12, 2006.

Revenue Base. As of June 30, 2006, we owned 50 properties through our Operating Partnership. These properties are mainly located throughout the U.S., with four properties located in Europe and one property in Canada. We acquired our first portfolio property in January 2002 and have added properties as follows:

| Year Ended December 31: | Properties acquired | Net rentable square feet acquired | Space held for redevelopment square feet at June 30, 2006 (1) |
|-----------------------------------|----------------------------|--|--|
| 2002 | 5 | 1,125,292 | 19,890 |
| 2003 | 8 | 1,540,806 | 123,891 |
| 2004 | 11 | 2,796,275 | 88,238 |
| 2005 | 20 | 2,657,572 | 855,139 |
| Six months ended June 30, 2006 | 6 | 1,012,412 | 69,279 |
| Properties owned at June 30, 2006 | 50 | 9,132,357 | 1,156,437 |

(1) Redevelopment space is unoccupied space that requires significant capital investment in order to develop data center

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facilities that are ready for use. Most often this is shell space. However, in certain circumstances this may include partially built data center space that was not completed by previous ownership and requires a large capital investment in order to build out the space. As of June 30, 2006, the properties in our portfolio were approximately 94.7% leased excluding 1.2 million square feet held for redevelopment. Due to the capital intensive and long term nature of the operations being supported, our lease terms are generally longer than standard commercial leases. At June 30, 2006, our average lease term was approximately 12 years, with an average of approximately 7 years remaining. For current and future colocation facilities, the typical lease is shorter. Our lease expirations through 2008 are 7.1% of net rentable square feet excluding space held for redevelopment as of June 30, 2006. Operating revenues from properties outside the United States were \$5.5 million and \$2.2 million for the six months ended June 30, 2006 and 2005, respectively.

Operating expense. Our operating expenses generally consist of utilities, property and ad valorem taxes, insurance and site maintenance costs, as well as rental expenses on our ground leases. Since the consummation of our IPO, our asset management function has been internalized and we are incurring our general and administrative expenses directly. Prior to April 2005, we had a transition services agreement with CB Richard Ellis Investors with respect to transitional accounting and other services. In addition, as a public company, we are incurring significant legal, accounting and other expenses related to corporate governance, Securities and Exchange Commission reporting and compliance with the various provisions of Sarbanes-Oxley Act of 2002. In addition, we engage third-party property managers to manage most of our properties. As of June 30, 2006, 34 of our properties were managed by CB Richard Ellis, an affiliate of GI Partners.

Formation Transactions. In connection with the completion of our IPO, our Operating Partnership received contributions of direct and indirect interests in 23 of the properties in our portfolio in exchange for consideration that included cash, assumption of debt, and an aggregate of 38,262,206 units in our Operating Partnership (with the cash, assumed debt and units having an aggregate value of \$1,097.7 million based on the IPO price per share of \$12.00).

We accounted for the ownership interests contributed to us by GI Partners in exchange for a partnership interest in our Operating Partnership as a reorganization of entities under common control in a manner similar to a pooling of interests. Accordingly, the assets and liabilities contributed by GI Partners are accounted for by our Operating Partnership at GI Partners' historical cost. We utilized purchase accounting to account for the acquisition of (i) ownership interests in 200 Paul Avenue 1-4 and 1100 Space Park Drive, which were contributed to us by third parties in exchange for interests in our Operating Partnership, cash and the assumption of debt and (ii) the 10% minority ownership interest in 2323 Bryan Street, which was contributed to us by our joint venture partner in exchange for an interest in our Operating Partnership and the repayment of debt. Accordingly, the purchase price for these interests, which are equal to the value of the Operating Partnership units that we issued in exchange for these interests plus cash paid and debt assumed, were allocated to the assets acquired and liabilities assumed based on the fair value of the assets and liabilities.

Factors Which May Influence Future Results of Operations

Rental income. The amount of net rental income generated by the properties in our portfolio depends principally on our ability to maintain the occupancy rates of currently leased space and to lease currently available space and space available from lease terminations. Excluding 1.2 million square feet held for redevelopment, as of June 30, 2006, the occupancy rate in the properties in our portfolio was approximately 94.7% of our net rentable square feet.

The amount of rental income generated by us also depends on our ability to maintain or increase rental rates at our properties. Included in our approximately 9.1 million square feet of net rentable square feet at June 30, 2006 is approximately 97,000 net rentable square feet of space with extensive data center improvements that is currently, or will shortly be, available for lease. We had leased approximately 281,000 square feet of similar space at June 30, 2006. Rather than leasing all of this space to large single tenants, we are subdividing some of it for multi-tenant turn-key data center use, with tenants averaging between 100 and 15,000 square feet of net rentable space. Multi-tenant turn-key data centers are effective solutions for tenants who lack the expertise or capital budget to provide their own extensive data center infrastructure and security. As experts in data center construction and operations we are able to lease space to these tenants at a significant premium over other uses. Negative trends in one or more of these factors could adversely affect our rental income in future periods.

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In addition, as of June 30, 2006, we had approximately 1.2 million square feet of redevelopment space, or approximately 11% of the total space in our portfolio, including three vacant properties comprising approximately 424,800 square feet. Redevelopment space requires significant capital investment in order to develop data center facilities that are ready for use, and in addition, we may require additional time or encounter delays in securing tenants for redevelopment space. We intend to purchase additional vacant properties and properties with vacant redevelopment space in the future.

Future economic downturns or regional downturns affecting our submarkets or downturns in the technology-related real estate industry that impair our ability to renew or re-lease space and the ability of our tenants to fulfill their lease commitments, as in the case of tenant bankruptcies, could adversely affect our ability to maintain or increase rental rates at our properties. At June 30, 2006 one tenant, VarTec Telecom, Inc. (VarTec) was in bankruptcy and leased approximately 149,000 square feet of net rentable space across two separate properties as follows:

VarTec's lease of approximately 135,300 square feet at 2440 Marsh Lane, was modified in June 2006, with a new lease expiration date of September 30, 2006. We are currently in discussions with Comtel Telcom (the purchaser of essentially all of VarTec's operating assets) to remain in the current data center space at 2440 Marsh Lane.

Var Tec also leases approximately 13,600 square feet at 350 East Cermak Road. On April 27, 2006 we were notified that VarTec intends to petition the court to accept this lease. As of June 30, 2006, the carrying values of lease related net assets relating to this lease was approximately \$2.3 million. We will continue to monitor events to determine if a write off of these assets is appropriate. In January 2006, VarTec notified us of its intention to file a motion to reject its lease of approximately 8,600 square feet at 2323 Bryan Street. The motion was granted by the bankruptcy court on February 21, 2006 and as such, this lease was rejected effective February 28, 2006.

Scheduled lease expirations. Our ability to re-lease expiring space will impact our results of operations. In addition to approximately 0.5 million square feet of available space in our portfolio excluding approximately 1.2 million square feet available for redevelopment as of June 30, 2006, leases representing approximately 2.7% and 1.2% of the square footage of our portfolio, excluding redevelopment space, are scheduled to expire during the periods ending December 31, 2006 and 2007, respectively.

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Conditions in significant markets. As of June 30, 2006 our portfolio was geographically concentrated in the following metropolitan markets:

| Metropolitan Market | Percentage of total gross annualized rent (1) |
|---------------------|---|
| Silicon Valley | 21.3% |
| Dallas | 16.4% |
| Chicago | 12.6% |
| Los Angeles | 7.9% |
| San Francisco | 7.5% |
| Boston | 5.5% |
| Philadelphia | 4.5% |
| New York | 4.5% |
| Other | 19.8% |
| | 100.0% |

(1) Gross annualized rent is monthly contractual rent under existing leases as of the stated date multiplied by 12.

Operating expenses. Our operating expenses generally consist of utilities, property and ad valorem taxes, insurance and site maintenance costs, as well as rental expenses on our ground leases. We are also incurring general and administrative expenses, including expenses relating to the internalization of our asset management function, as well as significant legal, accounting and other expenses related to corporate governance, Securities and Exchange Commission reporting and compliance with the various provisions of the Sarbanes-Oxley Act. Increases or decreases in such operating expenses will impact our overall performance. As a relatively new public company, we expect to incur additional operating expenses as we expand our various business functions.

Interest Rates. At June 30, 2006, we had approximately \$453.3 million of variable rate debt, of which approximately \$241.7 million is subject to interest rate swap agreements. Since 2002, the United States Federal Reserve has been increasing short term interest rates, which has recently had a significant upward impact on shorter-term interest rates, including the interest rates that our variable rate debt is based upon. Continued increases in interest rates may increase our interest expense and therefore negatively affect our financial condition and results of operations. Increased interest rates may also increase the risk that the counterparties to our swap agreements will default on their obligations, which would further increase our interest expense.

Critical Accounting Policies

Our discussion and analysis of financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles (GAAP). The preparation of these financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses in the reporting period. Our actual results may differ from these estimates. We have provided a summary of our significant accounting policies in Note 2 to our consolidated financial statements included elsewhere in this report. We describe below those accounting policies that require material subjective or complex judgments and that have the most significant impact on our financial condition and consolidated results of operations. Our management evaluates these estimates on an ongoing basis, based upon information currently available and on various assumptions management believes are reasonable as of the date on the front cover of this report.

Investments in Real Estate

Acquisition of real estate. The price that we pay to acquire a property is impacted by many factors including the condition of the property and improvements, the occupancy of the building, the existence of above and below market tenant leases, the creditworthiness of the tenants, favorable or unfavorable financing, above or below market ground leases and numerous other factors. Accordingly, we are required to make subjective assessments to allocate the purchase price paid to acquire investments in real estate among the assets acquired and liabilities assumed based on our estimate of the fair values of such assets and liabilities. This includes determining the value of the property and improvements, land, any ground leases,

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tenant improvements, in-place tenant leases, tenant relationships, the value (or negative value) of above (or below) market leases and any debt assumed from the seller or loans made by the seller to us. Each of these estimates requires a great deal of judgment and some of the estimates involve complex calculations. Our allocation methodology is summarized in Note 2 to our consolidated financial statements. These allocation assessments have a direct impact on our results of operations. For example, if we were to allocate more value to land, there would be no depreciation with respect to such amount. If we were to allocate more value to the property as opposed to allocating to the value of tenant leases, this amount would be recognized as an expense over a much longer period of time. This potential effect occurs because the amounts allocated to property are depreciated over the estimated lives of the property whereas amounts allocated to tenant leases are amortized over the terms of the leases. Additionally, the amortization of value (or negative value) assigned to above (or below) market rate leases is recorded as an adjustment to rental revenue as compared to amortization of the value of in-place leases and tenant relationships, which is included in depreciation and amortization in our consolidated statements of operations.

Useful lives of assets. We are required to make subjective assessments as to the useful lives of our properties for purposes of determining the amount of depreciation to record on an annual basis with respect to our investments in real estate. These assessments have a direct impact on our net income because if we were to shorten the expected useful lives of our investments in real estate we would depreciate such investments over fewer years, resulting in more depreciation expense and lower net income on an annual basis.

Asset impairment evaluation. We review the carrying value of our properties when circumstances, such as adverse market conditions, indicate potential impairment may exist. We base our review on an estimate of the future cash flows (excluding interest charges) expected to result from the real estate investment's use and eventual disposition. We consider factors such as future operating income, trends and prospects, as well as the effects of leasing demand, competition and other factors. If our evaluation indicates that we may be unable to recover the carrying value of a real estate investment, an impairment loss is recorded to the extent that the carrying value exceeds the estimated fair value of the property. These losses have a direct impact on our net income because recording an impairment loss results in an immediate negative adjustment to net income. The evaluation of anticipated cash flows is highly subjective and is based in part on assumptions regarding future occupancy, rental rates and capital requirements that could differ materially from actual results in future periods. Since cash flows on properties considered to be long-lived assets to be held and used are considered on an undiscounted basis to determine whether an asset has been impaired, our strategy of holding properties over the long-term directly decreases the likelihood of recording an impairment loss. If our strategy changes or market conditions otherwise dictate an earlier sale date, an impairment loss may be recognized and such loss could be material. If we determine that impairment has occurred, the affected assets must be reduced to their fair value. No such impairment losses have been recognized to date.

We estimate the fair value of rental properties utilizing a discounted cash flow analysis that includes projections of future revenues, expenses and capital improvement costs, similar to the income approach that is commonly utilized by appraisers.

Capitalization of costs.

We capitalize pre-acquisition costs related to probable property acquisitions. We also capitalize direct and indirect costs related to construction and development, including property taxes, insurance and financing costs relating to space under development. Costs previously capitalized related to any property acquisitions no longer considered probable are written off. The selection of costs to capitalize and which acquisitions are probable is subjective and depends on many assumptions including the timing of potential acquisitions and the probability that future acquisitions occur. If we made different assumptions in this respect we would have a different amount of capitalized costs in the periods presented leading to different net income.

Revenue Recognition

Rental income is recognized using the straight-line method over the terms of the tenant leases. Deferred rents included in our balance sheets represent the aggregate excess of rental revenue recognized on a straight-line basis over the contractual rental payments that would be recognized under the remaining terms of the leases. Our leases generally contain provisions under which the tenants reimburse us for a portion of property operating expenses and real estate taxes incurred by us. Such reimbursements are recognized in the period that the expenses are incurred. Lease termination fees are recognized over the remaining term of the lease, effective as of the date the lease modification is finalized, assuming collection is not considered doubtful. As discussed above, we recognize amortization of the value of acquired above or below market tenant

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leases as a reduction of rental income in the case of above market leases or an increase to rental revenue in the case of below market leases.

We must make subjective estimates as to when our revenue is earned and the collectibility of our accounts receivable related to minimum rent, deferred rent, expense reimbursements, lease termination fees and other income. We specifically analyze accounts receivable and historical bad debts, tenant concentrations, tenant creditworthiness and current economic trends when evaluating the adequacy of the allowance for bad debts. These estimates have a direct impact on our net income because a higher bad debt allowance would result in lower net income, and recognizing rental revenue as earned in one period versus another would result in higher or lower net income for a particular period.

Share-based awards

We recognize compensation expense related to share-based awards. We generally amortize this compensation expense over the vesting period of the award. The calculation of the fair value of share-based awards is subjective and requires several assumptions over such items as expected stock volatility, dividend payments and future company results. These assumptions have a direct impact on our net income because a higher share-based awards amount would result in lower net income for a particular period.

Results of Operations

The discussion below relates to our financial condition and results of operations for the three and six months ended June 30, 2006 and 2005. A summary of our results for the three and six months ended June 30, 2006 and 2005 is as follows (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|------------------------------------|-------------|----------------------------------|-------------|
| | 2006 | 2005 | 2006 | 2005 |
| Statement of Operations Data: | | | | |
| Total operating revenues | \$ 64,708 | \$ 48,059 | \$ 124,200 | \$ 86,026 |
| Total operating expenses | (46,117) | (31,540) | (87,496) | (56,719) |
| Operating income | 18,591 | 16,519 | 36,704 | 29,307 |
| Other Income (expenses) | (11,993) | (8,828) | (22,860) | (16,594) |
| Income from continuing operations before minority interests | \$ 6,598 | \$ 7,691 | \$ 13,844 | \$ 12,713 |

Our property portfolio has experienced consistent and significant growth since the first property acquisition in January 2002. As a result of such growth, a period-to-period comparison of our financial performance focuses primarily on the impact on our revenues and expenses resulting from the new property additions to our portfolio. On a same space property basis, our revenues and expenses have remained substantially stable as a result of the generally consistent occupancy rates at our properties. The following table identifies each of the properties in our portfolio acquired from December 31, 2003 through June 30, 2006:

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| | Acquisition Date | Redevelopment Space (1) | Net Rentable Square Feet Excluding Redevelopment Space | Square Feet including Redevelopment Space | Occupancy Rate June 30, 2006 (2) |
|---|------------------|-------------------------|--|---|----------------------------------|
| Acquired Properties | | | | | |
| <i>At December 31, 2003 (13 properties)</i> | | 143,781 | 2,666,098 | 2,809,879 | 95.5% |
| Year Ended December 31, 2004 | | | | | |
| 100 Technology Center Drive | Feb-04 | | 197,000 | 197,000 | 100.0 |
| 4849 Alpha Road | Apr-04 | | 125,538 | 125,538 | 100.0 |
| 600 West Seventh Street | May-04 | 59,319 | 430,403 | 489,722 | 97.3 |
| 2045 & 2055 LaFayette Street | May-04 | | 300,000 | 300,000 | 100.0 |
| 100 & 200 Quannapowitt Parkway | Jun-04 | | 388,000 | 388,000 | 94.9 |
| 11830 Webb Chapel Road | Aug-04 | | 365,647 | 365,647 | 95.0 |
| 150 South First Street | Sep-04 | | 179,761 | 179,761 | 100.0 |
| 3065 Gold Camp Drive | Oct-04 | | 62,957 | 62,957 | 100.0 |
| 200 Paul Avenue 1-4 | Nov-04 | 28,919 | 498,761 | 527,680 | 95.1 |
| 1100 Space Park Drive | Nov-04 | | 165,297 | 165,297 | 100.0 |
| 3015 Winona Avenue | Dec-04 | | 82,911 | 82,911 | 100.0 |
| Subtotal | | 88,238 | 2,796,275 | 2,884,513 | 97.3 |
| Year Ended December 31, 2005 | | | | | |
| 833 Chestnut Street | Mar-05 | 119,660 | 535,098 | 654,758 | 75.5 |
| 1125 Energy Park Drive | Mar-05 | | 112,827 | 112,827 | 100.0 |
| 350 East Cermak Road | May-05 | 263,208 | 870,183 | 1,133,391 | 93.3 |
| 8534 Concord Center Drive | Jun-05 | | 82,229 | 82,229 | 100.0 |
| 2401 Walsh Street | Jun-05 | | 167,932 | 167,932 | 100.0 |
| 200 North Nash Street | Jun-05 | | 113,606 | 113,606 | 100.0 |
| 2403 Walsh Street | Jun-05 | | 103,940 | 103,940 | 100.0 |
| 4700 Old Ironsides Drive | Jun-05 | | 90,139 | 90,139 | 100.0 |
| 4650 Old Ironsides Drive | Jun-05 | | 84,383 | 84,383 | 100.0 |
| 731 East Trade Street | Aug-05 | | 40,879 | 40,879 | 100.0 |
| 113 North Myers | Aug-05 | 9,707 | 19,511 | 29,218 | 100.0 |
| 125 North Myers | Aug-05 | 13,242 | 12,160 | 25,402 | 100.0 |
| Paul van Vlissingenstraat 16 | Aug-05 | 35,000 | 77,472 | 112,472 | 58.8 |
| 600-780 S. Federal | Sep-05 | | 161,547 | 161,547 | 83.6 |
| 115 Second Avenue | Oct-05 | 56,236 | 10,494 | 66,730 | |
| Chemin de l Epinglier 2 | Nov-05 | | 59,190 | 59,190 | 100.0 |
| 251 Exchange Place | Nov-05 | | 70,982 | 70,982 | 100.0 |
| 7500 Metro Center Drive | Dec-05 | 74,962 | | 74,962 | |
| 7520 Metro Center Drive | Dec-05 | | 45,000 | 45,000 | 100.0 |
| 3 Corporate Place | Dec-05 | 283,124 | | 283,124 | |
| Subtotal | | 855,139 | 2,657,572 | 3,512,711 | 90.3 |
| Six Months Ended June 30, 2006 | | | | | |
| 4025 Midway Road | Jan-06 | 50,000 | 49,947 | 99,947 | 40.5 |
| Clonshaugh Industrial Estate | Feb-06 | | 20,000 | 20,000 | 100.0 |
| 6800 Millcreek Drive | Apr-06 | | 83,758 | 83,758 | 100.0 |
| 101 Aquila Way | Apr-06 | | 313,581 | 313,581 | 100.0 |
| 12001 North Freeway | Apr-06 | 19,279 | 281,426 | 300,705 | 98.8 |
| 14901 FAA Boulevard | Jun-06 | | 263,700 | 263,700 | 100.0 |
| Subtotal | | 69,279 | 1,012,412 | 1,081,691 | 96.7 |
| Total | | 1,156,437 | 9,132,357 | 10,288,794 | 94.7% |

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- (1) Redevelopment space requires significant capital investment in order to develop data center facilities that are ready for use. Most often this is shell space. However, in certain circumstances this may include partially built data center space that was not completed by previous ownership and requires a large capital investment in order to build out the space.
- (2) Occupancy rates exclude redevelopment space.

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Comparison of the Three Months Ended June 30, 2006 to the Three Months Ended June 30, 2005 and the Six Months Ended June 30, 2006 to the Six Months Ended June 30, 2005

Portfolio

As of June 30, 2006, our portfolio consisted of 50 properties, including one property disclosed as held for sale, with an aggregate of 10.3 million net rentable square feet including 1.2 million square feet held for redevelopment compared to a portfolio consisting of 33 properties with an aggregate of 8.2 million net rentable square feet including 0.6 million square feet held for redevelopment as of June 30, 2005. The increase in our portfolio reflects the acquisition of 17 properties in the twelve months ended June 30, 2006.

Operating revenues

Operating revenues during the three and six months ended June 30, 2006 and 2005 were as follows (in thousands):

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|--------------------------|------------------------------------|-------------|---------------|----------------------------------|-------------|---------------|
| | 2006 | 2005 | Change | 2006 | 2005 | Change |
| Rental | \$ 52,033 | \$ 36,148 | \$ 15,885 | \$ 99,857 | \$ 67,337 | \$ 32,520 |
| Tenant reimbursements | 12,675 | 8,079 | 4,596 | 24,175 | 14,557 | 9,618 |
| Other | | 3,832 | (3,832) | 168 | 4,132 | (3,964) |
| Total operating revenues | \$ 64,708 | \$ 48,059 | \$ 16,649 | \$ 124,200 | \$ 86,026 | \$ 38,174 |

As shown by the same space and new properties table shown below, the increases in rental revenues and tenant reimbursement revenues in the periods ended June 30, 2006 compared to the same periods in 2005 were primarily due to our acquisitions of properties. Other revenues changes in the periods presented were primarily due to varying tenant termination revenues. We acquired 17 properties during the twelve months ended June 30, 2006.

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The following tables show operating revenues for new properties (properties that were not owned for each of the full six months ended June 30, 2006 and 2005) and same space properties (all other properties) (in thousands):

| | Same space | | | New properties | | |
|--------------------------|----------------------------------|-----------|----------|----------------------------------|----------|-----------|
| | Three Months Ended June 30, 2006 | 2005 | Change | Three Months Ended June 30, 2006 | 2005 | Change |
| Rental | \$ 33,324 | \$ 31,246 | \$ 2,078 | \$ 18,709 | \$ 4,902 | \$ 13,807 |
| Tenant reimbursements | 8,593 | 6,565 | 2,028 | 4,082 | 1,514 | 2,568 |
| Other | | 3,780 | (3,780) | | 52 | (52) |
| Total operating revenues | \$ 41,917 | \$ 41,591 | \$ 326 | \$ 22,791 | \$ 6,468 | \$ 16,323 |

| | Same space | | | New properties | | |
|--------------------------|--------------------------------|-----------|----------|--------------------------------|----------|-----------|
| | Six Months Ended June 30, 2006 | 2005 | Change | Six Months Ended June 30, 2006 | 2005 | Change |
| Rental | \$ 64,870 | \$ 61,461 | \$ 3,409 | \$ 34,987 | \$ 5,876 | \$ 29,111 |
| Tenant reimbursements | 15,929 | 12,722 | 3,207 | 8,246 | 1,835 | 6,411 |
| Other | | 4,080 | (4,080) | 168 | 52 | 116 |
| Total operating revenues | \$ 80,799 | \$ 78,263 | \$ 2,536 | \$ 43,401 | \$ 7,763 | \$ 35,638 |

Same space rental revenues increased in both the three and six months ended June 30, 2006 compared to the same periods in 2005 primarily as a result of new leases at our properties during the twelve months ended June 30, 2006, the largest of which was for space in 200 Paul Avenue 1-4 and 300 Boulevard East. Same space tenant reimbursement revenues increased in both the three and six months ended June 30, 2006 compared to the same periods in 2005 primarily as a result of higher utility and operating expenses being billed to our tenants, the largest occurrences of which were at 600 West Seventh Street and 200 Paul Avenue 1-4. The decrease in other revenues was due to termination fee revenues recognized in the three and six months ended June 30, 2005. No such fees were recognized in the same periods in 2006.

Expenses

Expenses during the three and six months ended June 30, 2006 and 2005 were as follows (in thousands):

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|-----------------------------|-----------|-----------|---------------------------|-----------|-----------|
| | 2006 | 2005 | Change | 2006 | 2005 | Change |
| Rental property operating and maintenance | \$ 13,618 | \$ 9,166 | \$ 4,452 | \$ 25,328 | \$ 15,810 | \$ 9,518 |
| Property taxes | 7,096 | 4,721 | 2,375 | 13,935 | 8,203 | 5,732 |
| Insurance | 1,068 | 511 | 557 | 1,958 | 1,091 | 867 |
| Depreciation and amortization | 19,511 | 13,728 | 5,783 | 37,024 | 25,267 | 11,757 |
| General and administrative | 4,674 | 2,453 | 2,221 | 8,920 | 4,866 | 4,054 |
| Other | 150 | 961 | (811) | 331 | 1,482 | (1,151) |
| Total operating expenses | 46,117 | 31,540 | 14,577 | 87,496 | 56,719 | 30,777 |
| Interest expense | 11,830 | 8,938 | 2,892 | 22,869 | 16,708 | 6,161 |
| Loss from early extinguishment of debt | 425 | | 425 | 482 | 125 | 357 |
| Total expenses | \$ 58,372 | \$ 40,478 | \$ 17,894 | \$ 110,847 | \$ 73,552 | \$ 37,295 |

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As shown in the same space expense and new properties table below, total expenses in the three and six months ended June 30, 2006 increased compared to the same periods in 2005 primarily as a result of acquisition of properties. The following table shows expenses for new properties (properties that were not owned for each of the full six months ended June 30, 2006 and 2005) and same space properties (all other properties) (in thousands):

| | Same space | | | New properties | | |
|---|----------------------------------|------------------|-----------------|----------------------------------|-----------------|------------------|
| | Three Months Ended June 30, 2006 | 2005 | Change | Three Months Ended June 30, 2006 | 2005 | Change |
| Rental property operating and maintenance | \$ 9,318 | \$ 7,350 | \$ 1,968 | \$ 4,300 | \$ 1,816 | \$ 2,484 |
| Property taxes | 3,379 | 3,370 | 9 | 3,717 | 1,351 | 2,366 |
| Insurance | 632 | 459 | 173 | 436 | 52 | 384 |
| Depreciation and amortization | 11,971 | 11,000 | 971 | 7,540 | 2,728 | 4,812 |
| General and administrative (1) | 4,674 | 2,453 | 2,221 | | | |
| Other | 63 | 961 | (898) | 87 | | 87 |
| Total operating expenses | 30,037 | 25,593 | 4,444 | 16,080 | 5,947 | 10,133 |
| Interest expense | 7,034 | 7,120 | (86) | 4,796 | 1,818 | 2,978 |
| Loss from early extinguishment of debt | 425 | | 425 | | | |
| Total expenses | \$ 37,496 | \$ 32,713 | \$ 4,783 | \$ 20,876 | \$ 7,765 | \$ 13,111 |

| | Same space | | | New properties | | |
|---|--------------------------------|------------------|-----------------|--------------------------------|-----------------|------------------|
| | Six Months Ended June 30, 2006 | 2005 | Change | Six Months Ended June 30, 2006 | 2005 | Change |
| Rental property operating and maintenance | \$ 17,915 | \$ 13,497 | \$ 4,418 | \$ 7,413 | \$ 2,313 | \$ 5,100 |
| Property taxes | 6,714 | 6,799 | (85) | 7,221 | 1,404 | 5,817 |
| Insurance | 1,168 | 1,031 | 137 | 790 | 60 | 730 |
| Depreciation and amortization | 23,257 | 21,990 | 1,267 | 13,767 | 3,277 | 10,490 |
| General and administrative (1) | 8,920 | 4,866 | 4,054 | | | |
| Other | 205 | 1,482 | (1,277) | 126 | | 126 |
| Total operating expenses | 58,179 | 49,665 | 8,514 | 29,317 | 7,054 | 22,263 |
| Interest expense | 13,528 | 14,215 | (687) | 9,341 | 2,493 | 6,848 |
| Loss from early extinguishment of debt | 482 | 125 | 357 | | | |
| Total expenses | \$ 72,189 | \$ 64,005 | \$ 8,184 | \$ 38,658 | \$ 9,547 | \$ 29,111 |

(1) General and administrative expenses are included in same space as they are not allocable to specific properties.

Same space rental property and maintenance expenses increased in the three and six months ended June 30, 2006 compared to the same periods in 2005 primarily as a result of higher utility rates in several of our properties leading to higher utility expense in 2006. Rental property operating and maintenance expenses included amounts paid to related parties, CB Richard Ellis Investors and The Linc Group, for property management and other fees of \$1.4 million and \$0.8 million in the six months ended June 30, 2006 and 2005, respectively. We capitalized amounts relating to compensation expense of employees directly engaged in construction and leasing activities of \$0.6 million and \$1.1 million, respectively, in the three and six months ended June 30, 2006. We did not capitalize any similar costs in the three or six months ended June 30, 2005.

Same space interest expense decreased in the three and six months ended June 30, 2006 compared to the same period in 2005 primarily as a result of lower outstanding debt following the repayment of the 34551 Ardenwood Boulevard 1-4, 2334 Lundy Place, 2440 Marsh Lane mezzanine debt in the fourth quarter of 2005 and repayment of the 47700 Kato Road & 1055 Page Avenue mortgage loan in the first quarter of 2006. Interest incurred on our line of credit is allocated entirely to new properties in the table above.

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Other expenses are primarily comprised of write-offs of the carrying amounts for deferred tenant improvements, acquired in place lease value and acquired above market lease values as a result of the early termination of tenant leases. Other expenses decreased in the three and six months ended June 30, 2006 compared to the same periods in 2005 primarily due to the write off of assets following the termination of a tenant in the three months ended June 30, 2005.

General and administrative expenses in the three and six months ended June 30, 2006 increased compared to the same period in 2005 primarily due to higher employee compensation, insurance, legal and consulting costs.

Table of Contents*Discontinued Operations*

In June 2006, we classified 7979 East Tufts Avenue as held for sale upon committing to sell this property and we also ceased recording depreciation expense at that time. We completed the sale of the property on July 12, 2006 and recognized a gain upon closing. The results of operations of 7979 East Tufts Avenue are reported as discontinued operations for all periods presented.

Liquidity and Capital Resources*Analysis of Liquidity and Capital Resources*

As of June 30, 2006, we had \$13.4 million of cash and cash equivalents, excluding \$22.7 million of restricted cash. Restricted cash primarily consists of interest bearing cash deposits required by the terms of several of our mortgage loans for a variety of purposes, including real estate taxes, insurance, anticipated or contractually obligated tenant improvements and leasing deposits.

Our short term liquidity requirements primarily consist of operating expenses and other expenditures associated with our properties, dividend payments on our preferred stock, dividend payments to our stockholders and distributions to our unitholders in the Operating Partnership required to maintain our REIT status, capital expenditures, debt service on our loans and, potentially, acquisitions. We expect to meet our short-term liquidity requirements through net cash provided by operations, restricted cash accounts established for certain future payments and by drawing upon our unsecured credit facility.

As of June 30, 2006 our Operating Partnership had a \$350 million unsecured revolving line of credit facility (we further increased the unsecured revolving credit facility to \$500 million on July 24, 2006). Borrowings under this credit facility currently bear interest at a rate based on 1-month LIBOR plus a margin ranging from 1.250% to 1.625%, depending on our Operating Partnership's overall leverage, which margin was 1.50% as of June 30, 2006. The unsecured revolving line of credit facility matures in October 2008, subject to a one-year extension option that we may exercise if certain conditions are met. The amended unsecured revolving line of credit facility has a \$150.0 million sub-facility for foreign exchange advances in Euros and British Sterling. We intend to use available borrowings under the amended unsecured revolving credit facility to, among other things, finance the acquisition of additional properties, to fund tenant improvements and capital expenditures, and to provide for working capital and other corporate purposes. As of June 30, 2006, we had outstanding \$211.6 million under the credit facility and \$91.5 million was available for use.

Properties acquired in 2006

During the six months ended June 30, 2006 we acquired the following properties:

| Property | Metropolitan Area | Date acquired | Purchase Price (in millions) |
|------------------------------|--------------------------|----------------------|---|
| 4025 Midway Road | Dallas | January 6, 2006 | \$ 16.2 |
| Clonshaugh Industrial Estate | Dublin, Ireland | February 6, 2006 | 6.3 |
| 6800 Millcreek Drive | Toronto, Canada | April 13, 2006 | 16.0 |
| 101 Aquila Way | Atlanta | April 20, 2006 | 25.3 |
| 12001 North Freeway | Houston | April 26, 2006 | 30.5 |
| 14901 FAA Boulevard | Dallas | June 30, 2006 | 50.6 |
| | | | \$ 144.9 |

Future uses of cash

Our properties require periodic investments of capital for tenant-related capital expenditures and for general capital improvements. As of June 30, 2006, we had commitments under leases in effect for \$38.3 million of tenant improvement costs and leasing commissions all of which we expect to incur in 2006.

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As of June 30, 2006, we have identified from our existing properties approximately 1.2 million square feet of redevelopment space and we also owned approximately 97,000 net rentable square feet of data center space with extensive installed tenant improvements that we may subdivide for multi-tenant turn-key data center use during the next two years rather than lease such space to large single tenants. Turn-Key Data Center space is move-in-ready space for the placement of computer and network equipment required to provide a data center environment. Depending on demand for additional turn-key data space, we may incur significant tenant improvement costs to build out and redevelop these spaces.

Subsequent to June 30, 2006 we acquired the following properties:

120 East Van Buren Street, a property located in Phoenix for \$175.0 million on July 25, 2006.

Gyroscoopweg 2E-2F, a property located in Amsterdam, Netherlands for 8.9 million (approximately \$11.3 million at the rate of exchange on the date of purchase) on July 27, 2006.

As of August 4, 2006 we also had agreements to acquire the following properties. As we are completing due diligence for these potential acquisitions we can give no assurance that we will complete their purchase:

| Location | Purchase amount (\$ millions) |
|-----------------|--|
| Miami | \$ 5.6 |
| Boston | 8.7 |
| Atlanta | 6.1 |
| Tempe, Arizona | 9.8 |
| | \$ 30.2 |

On December 3, 2005, we terminated share purchase agreements to acquire 100% of the shares of two German entities which together own IBM Technology Park, an approximately 80 acre technical campus located near Mainz, Germany containing 11 buildings with a total of approximately 1.5 million net rentable square feet. The terminated share purchase agreements provided for an aggregate purchase price, excluding expenses, for 100% of the shares in the two entities of approximately 77.4 million (approximately \$99.1 million based on the rate of exchange on August 3, 2006). We are still in purchase discussions with the owner of this property but there can be no assurance that we will acquire this property in the future, or if we do so that the price will be similar to the terminated agreements.

We are also subject to the commitments discussed below under **Commitments and Contingencies** and **Off-Balance Sheet Arrangements, and Distributions** as described below.

We expect to meet our long-term liquidity requirements to pay for scheduled debt maturities and to fund property acquisitions and non-recurring capital improvements with net cash from operations, future long-term secured and unsecured indebtedness and the issuance of equity and debt securities. We also may fund future property acquisitions and non-recurring capital improvements using our unsecured credit facility pending permanent financing.

Distributions

We are required to distribute 90% of our REIT taxable income (excluding capital gains) on an annual basis in order to continue to qualify as a REIT for federal income tax purposes. Accordingly, we intend to make, but are not contractually bound to make, regular quarterly distributions to preferred stockholders, common stockholders and unit holders from cash flow from operating activities. All such distributions are at the discretion of our board of directors. We may be required to use borrowings under the credit facility, if necessary, to meet REIT distribution requirements and maintain our REIT status. We consider market factors and our performance in addition to REIT requirements in determining distribution

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levels. Amounts accumulated for distribution to stockholders are invested primarily in interest-bearing accounts and short-term interest-bearing securities, which are consistent with our intention to maintain our status as a REIT.

Commitments and Contingencies

The following table summarizes our contractual obligations as of June 30, 2006, including the maturities and scheduled principal on our secured debt and unsecured credit facility debt, and provides information about the commitments due in connection with our ground leases, tenant improvement and leasing commissions (in thousands):

| Obligation | Total | 2006 | 2007-2008 | 2009-2010 | Thereafter |
|---|--------------|------------|------------|------------|------------|
| Long-term debt principal payments (1) | \$ 818,420 | \$ 54,661 | \$ 323,556 | \$ 108,103 | \$ 332,100 |
| Interest payable (2) | 237,185 | 24,027 | 88,061 | 42,901 | 82,196 |
| Ground leases (3) | 19,484 | 200 | 724 | 724 | 17,836 |
| Operating lease | 3,682 | 290 | 1,176 | 1,290 | 926 |
| Tenant improvements and leasing commissions | 38,285 | 38,285 | | | |
| | \$ 1,117,056 | \$ 117,463 | \$ 413,517 | \$ 153,018 | \$ 433,058 |

(1) Includes \$211.6 million of borrowings under our unsecured credit facility, which is due to mature in October 2008 and excludes \$2.1 million of loan premiums and a \$26.0 million loan related to 7979 East Tufts Avenue, a property classified as held for sale as of June 30, 2006 and which we sold on July 12, 2006.

(2) Interest payable is based on the interest rate in effect on June 30, 2006 including the effect of interest rate swaps and excludes interest payable on a \$26.0 million loan related to 7979 East Tufts Avenue, a property classified as held for sale as of June 30, 2006, and which we sold on July 12, 2006. Interest payable excluding the effect of interest rate swaps is as follows (in thousands):

| | Total |
|------------|------------|
| 2006 | \$ 25,384 |
| 2007-2008 | 92,113 |
| 2009-2010 | 42,728 |
| Thereafter | 81,660 |
| | \$ 241,885 |

(3) This is comprised of ground lease payments on 2010 East Centennial Circle, Chemin de l'Épinglier 2, Clonshaugh Industrial Estate and Paul van Vlissingenstraat 16. After February 2036, rent for the remaining term of the 2010 East Centennial Circle ground lease will be determined based on a fair market value appraisal of the asset and, as a result, is excluded from the above information. The Chemin de l'Épinglier 2 ground lease which expires in July 2074 contains potential inflation increases which are not reflected in the table above. The Paul van Vlissingenstraat and Clonshaugh Industrial Estate amounts are translated at the June 30, 2006 exchange rate of \$1.25 per 1.00. The 16 Chemin de l'Épinglier 2 amounts are translated at the June 30, 2006 exchange rate of \$0.80 per Swiss Franc.

We are obligated to pay the seller of the 350 East Cermak Road a contingent fee of up to \$20.0 million in the event a new real estate tax classification for the property is obtained prior to December 31, 2006. We have also agreed with the seller to share a portion, not to exceed \$135,000 per month, of rental revenue, adjusted for our costs to lease the premises, from the lease of the 263,000 square feet of space held for redevelopment. This revenue sharing agreement will terminate in May 2013. As part of the acquisition of Paul van Vlissingenstraat 16, we entered into an agreement with the seller, whereby, for twelve months from the execution of the purchase and sale agreement, our purchase price may increase dependant upon future leasing activity as a result of actions by the seller. The amount of the potential commitment is not currently quantifiable as it is based on a 10% cap rate on the incremental operating income from qualifying new leases that are closed or binding during the participation period. We have no liability for these contingent liabilities on our consolidated balance sheets as of June 30, 2006 and December 31, 2005.

We have entered into interest rate swap agreements to hedge variability in cash flows related to LIBOR based mortgage

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loans for approximately \$241.7 million of our variable rate debt as of June 30, 2006. Under these swaps, we receive variable-rate amounts in exchange for fixed-rate payments over the life of the agreements without exchange of the underlying principal amounts. See Item 3 Quantitative and Qualitative Disclosures about Market Risk.

Outstanding Consolidated Indebtedness

The table below summarizes our debt, at June 30, 2006. These amounts exclude a \$26.0 million loan related to 7979 East Tufts Avenue, a property classified as held for sale as of June 30, 2006 and which we sold on July 12, 2006 (in millions):

| | |
|--|------------|
| Debt Summary: | |
| Fixed rate | \$ 367.2 |
| Variable rate hedged by interest rate swaps | 217.3 |
| Total fixed rate | 584.5 |
| Variable rate unhedged | 236.0 |
| Total | 820.5 |
| Percent of Total Debt: | |
| Fixed rate (including swapped debt) | 71.2% |
| Variable rate | 28.8% |
| Total | 100.0% |
| Effective Interest Rate at June 30, 2006: | |
| Fixed rate (including swapped debt) | 5.77% |
| Variable rate unhedged | 6.70% |
| Effective interest rate | 6.04% |

At June 30, 2006, we had approximately \$820.5 million of outstanding consolidated long-term debt as set forth in the table above. Our ratio of debt to total market capitalization was approximately 32% (based on the closing price of our common stock on June 30, 2006 of \$24.69). The variable rate debt shown above bears interest at interest rates based on various LIBOR rates ranging from one to twelve months, depending on the agreement governing the debt. The debt secured by our properties at June 30, 2006 had a weighted average term to initial maturity of approximately 5.2 years (approximately 5.9 years assuming exercise of extension options).

Unsecured Credit Facility. At June 30, 2006, we had an unsecured revolving line of credit facility (credit facility) under which we can borrow up to \$350.0 million (we further increased the line to \$500.0 million on July 24, 2006). Borrowings under the credit facility currently bear interest at a rate of based on LIBOR plus a margin ranging from 1.250% to 1.625%, depending on our Operating Partnership's overall leverage. This margin was 1.50% as of June 30, 2006, resulting in an interest rate at this date of 6.43%. The credit facility matures in October 2008, subject to a one-year extension option, which we may exercise if certain conditions are met. The credit facility has a \$150.0 million sub-facility for foreign exchange advances in Euros and British Sterling. At June 30, 2006 we had outstanding \$211.6 million under the credit facility and \$91.5 million was available for use.

Off-Balance Sheet Arrangements

As of June 30, 2006 we were a party to interest rate cap agreements in connection with debt and interest rate swap agreements related to \$241.7 million of outstanding principal on our variable rate debt. See Item 3 Quantitative and Qualitative Disclosures about Market Risk.

Table of Contents**Cash Flows**

The following summary discussion of our cash flows is based on the consolidated statements of cash flows and is not meant to be an all-inclusive discussion of the changes in our cash flows for the periods presented below.

Comparison of Six Months Ended June 30, 2006 to Six Months Ended June 30, 2005

The following table shows cash flows and ending cash and cash equivalent balances for the six months ended June 30, 2006 and 2005, respectively (in thousands):

| | Six Months Ended June 30, | | Change |
|---|--------------------------------------|-------------|---------------|
| | 2006 | 2005 | |
| Net cash provided by operating activities (including discontinued operations) | \$ 44,456 | \$ 34,318 | \$ 10,138 |
| Net cash used in investing activities | (177,510) | (326,578) | 149,068 |
| Net cash provided by financing activities | 136,193 | 291,685 | (155,492) |
| Net increase (decrease) in cash and cash equivalents | \$ 3,139 | \$ (575) | \$ 3,714 |

The increase in net cash provided by operating activities was primarily due to revenues from the properties added to our portfolio which was partially offset by increased operating and interest expenses. We acquired 17 properties during the twelve months ended June 30, 2006.

Net cash used in investing activities primarily relates to new properties acquired during the six months ended June 30, 2006 and 2005. The decrease in net cash used in investing activities was primarily due to lower expenditures to acquire properties in the six months ended June 30, 2006 compared to the same period in 2005.

Net cash flows from financing activities consisted of the following amounts (in thousands):

| | Six Months Ended June 30, | | Change |
|---|--------------------------------------|-------------|---------------|
| | 2006 | 2005 | |
| Net proceeds from borrowings | \$ 96,189 | \$ 232,231 | \$ (136,042) |
| Net proceeds from issuance of stock | 94,955 | 98,703 | (3,748) |
| Dividend and distribution payments | (54,880) | (37,556) | (17,324) |
| Other | (71) | (1,693) | 1,622 |
| Net cash provided by financing activities | \$ 136,193 | \$ 291,685 | \$ (155,492) |

Proceeds from issuance of stock were primarily related to our common stock sale in May 2006 and preferred stock offering in February 2005. Dividend and distribution payments increased primarily as a result of our July 2005 offering of common and preferred stock. We obtained a mortgage loan on our 600 West Seventh Street property for \$60.0 million in the first quarter of 2006, and a \$100.0 million loan when we acquired our East Cermark property in May 2005.

Minority interest

Minority interests relate to the interests in the Operating Partnership that are not owned by us, which, at June 30, 2006, amounted to 42.7% of the Operating Partnership common units. In conjunction with our formation, GI Partners received common units, in exchange for contributing ownership interests in properties to the Operating Partnership. Also in connection with acquiring real estate interests owned by third parties, the Operating Partnership issued common units to those sellers.

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Limited partners who acquired common units in the formation transactions have the right to require the Operating Partnership to redeem part or all of their common units for cash based upon the fair market value of an equivalent number

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of shares of our common stock at the time of the redemption. Alternatively, we may elect to acquire those common units in exchange for shares of our common stock on a one-for-one basis, subject to adjustment in the event of stock splits, stock dividends, issuance of stock rights, specified extraordinary distributions and similar events. Pursuant to registration rights agreements we entered into with GI Partners and the other third party contributors, we filed a shelf registration statement covering the issuance of the shares of our common stock issuable upon redemption of the common units, and the resale of those shares of common stock by the holders. GI Partners distributed 4,030,184 Operating Partnership common units to its owners and these units were converted into shares of our common stock on March 29, 2006 and sold to third parties on April 3, 2006.

During the three months ended June 30, 2006, third parties converted 675,665 Operating Partnership units into shares of our common stock. These conversions were recorded as a reduction to minority interest and an increase to common stock and additional paid in capital based on the book value per unit in the accompanying condensed consolidated balance sheet. We did not receive any cash proceeds upon conversion of these Operating Partnership units.

Inflation

Substantially all of our leases provide for separate real estate tax and operating expense escalations. In addition, many of the leases provide for fixed base rent increases. We believe that inflationary increases may be at least partially offset by the contractual rent increases and expense escalations described above.

New Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This Interpretation is effective for fiscal years beginning after December 15, 2006. We do not expect the impact of the adopting this Interpretation will have a material impact on our consolidated balance sheet or statement of operations.

Table of Contents**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our future income, cash flows and fair values relevant to financial instruments depend upon prevalent market interest rates. Market risk refers to the risk of loss from adverse changes in market prices and interest rates. We do not use derivatives for trading or speculative purposes and only enter into contracts with major financial institutions based on their credit rating and other factors.

Analysis of debt between fixed and variable rate.

We use interest rate swap agreements and fixed rate debt to reduce our exposure to interest rate movements. As of June 30, 2006, our consolidated debt (excluding a \$26.0 million loan related to 7979 East Tufts Avenue, a property classified as held for sale as of June 30, 2006 and which we sold on July 12, 2006) was as follows (in millions):

| | |
|--|----------|
| Fixed rate debt: | |
| Fair value of fixed rate debt | \$ 364.2 |
| Carrying value of fixed rate debt | 367.2 |
| | |
| Excess of fair value over carrying value | \$ (3.0) |
| | |
| Total outstanding debt: | |
| Principal on mortgage loans | 606.8 |
| Debt premium on two mortgage loans | 2.1 |
| Notes payable under line of credit | 211.6 |
| | |
| Total outstanding debt | \$ 820.5 |
| | |
| Variable rate debt ignoring interest rate swaps | \$ 453.3 |
| Variable rate debt after interest rate swaps | \$ 236.0 |
| Variable rate debt after interest rate swaps as percentage of total outstanding debt | 28.8% |

Interest rate swaps included in this table and their fair values as of June 30, 2006 were as follows (in thousands):

Current**Notional**

| Amount | Strike Rate | Effective Date | Expiration Date | Fair Value |
|-----------|-------------|----------------|-----------------|------------|
| \$ 43,000 | 3.250% | Nov. 26, 2004 | Sept. 15, 2006 | \$ 189 |
| 20,835 | 3.754 | Nov. 26, 2004 | Jan. 2, 2009 | 812 |
| 20,000 | 3.824 | Nov. 26, 2004 | Apr. 1, 2009 | 856 |
| 8,775 | 3.331 | Nov. 26, 2004 | Dec. 1, 2006 | 77 |
| 100,000 | 4.025 | May 26, 2005 | Jun. 15, 2008 | 2,662 |
| 24,399 | 4.944 | Jul. 10, 2006 | Apr. 10, 2011 | 158 |
| 14,325 | 3.981 | May 17, 2006 | Jul. 18, 2013 | 28 |
| 10,334 | 4.070 | Jun. 23, 2006 | Jul. 18, 2013 | (33) |
| \$241,668 | | | | \$ 4,749 |

Table of Contents*Sensitivity to changes in interest rates.*

The following table shows the effect if assumed changes in interest rates occurred:

| Assumed event | Interest rate change (basis points) | Change (\$ millions) |
|--|-------------------------------------|----------------------|
| Increase in fair value of interest rate swaps following an assumed 10% increase in interest rates | 53 | \$ 2.6 |
| Decrease in fair value of interest rate swaps following an assumed 10% decrease in interest rates | (53) | (2.7) |
| Increase in annual interest expense on our debt that is variable rate and not subject to swapped interest following a 10% increase in interest rates | 53 | 0.1 |
| Decrease in annual interest expense on our debt that is variable rate and not subject to swapped interest following a 10% increase in interest rates | 53 | (0.1) |
| Increase in fair value of fixed rate debt following a 10% decrease in interest rates | (53) | 10.7 |
| Decrease in fair value of fixed rate debt following a 10% increase in interest rates | 53 | (11.4) |

Interest risk amounts were determined by considering the impact of hypothetical interest rates on our financial instruments. These analyses do not consider the effect of any change in overall economic activity that could occur in that environment. Further, in the event of a change of that magnitude, we may take actions to further mitigate our exposure to the change. However, due to the uncertainty of the specific actions that would be taken and their possible effects, these analyses assume no changes in our financial structure.

Foreign currency forward exchange risk

As of June 30, 2006, we have foreign operations in the United Kingdom, Switzerland, Ireland, Canada and The Netherlands and as such are subject to risk from the effects of exchange rate movements of foreign currencies, which may affect future costs and cash flows. Our foreign operations are conducted in the Euro, Swiss Francs and the British Pound. For these currencies we are a net receiver of the foreign currency (we receive more cash than we pay out) and therefore our foreign investments benefit from a weaker U.S. dollar and are adversely affected by a stronger U.S. dollar relative to the foreign currency. For the six months ended June 30, 2006, operating revenues from properties outside the United States contributed \$5.5 million which represented 4.4% of our operating revenues.

As of June 30, 2006, we have not entered into any foreign currency forward exchange contracts to hedge the effects of adverse fluctuations in foreign currency exchange rates. Prior to January 2006, we were party to a foreign currency forward sale contract with a notional value of approximately £7.9 million. We terminated this contract in January 2006 and received cash of approximately \$0.7 million.

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ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We have adopted and maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Rule 13a-15(b) of the Securities Exchange Act of 1934, we have carried out an evaluation, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the quarter covered by this report. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control Over Financial Reporting

There has been no change in our internal control over financial reporting that has occurred during the fiscal quarter ended June 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1 Legal Proceedings.

None.

ITEM 1A Risk factors.

See our risk factors set forth in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

ITEM 2 Unregistered Sales of Equity Securities and Use of Proceeds.

None.

ITEM 3 Defaults Upon Senior Securities.

None.

Table of Contents**ITEM 4 Submission of Matters to a Vote of Security Holders.**

On May 1, 2006 the company held its Annual Meeting of Stockholders. The following resolutions were passed:

Election of the following six individuals as directors of the company for a one year term which will expire at the 2007 Annual Meeting of Stockholders:

| | Votes for | Votes withheld |
|-----------------------|------------|----------------|
| Richard A. Magnuson | 25,173,565 | 148,407 |
| Michael F. Foust | 25,314,272 | 7,700 |
| Laurence A. Chapman | 25,315,372 | 6,600 |
| Kathleen Earley | 22,283,958 | 3,038,014 |
| Ruann F. Ernst, Ph.D. | 25,313,893 | 8,079 |
| Dennis E. Singleton | 25,315,372 | 6,600 |

Ratification of KPMG LLP as the company's independent registered public accounting firm for the year ending December 31, 2006. This resolution was passed with 25,298,412 votes for, 20,835 votes against and 2,725 abstentions, and there were 0 broker non-votes.

ITEM 5 Other Information.

(a) None.

(b) None.

ITEM 6 Exhibits**Exhibit**

- 10.1 Amendment No. 3 to the Credit Agreement, dated as of May 3, 2006, among Digital Realty Trust, L.P., Citicorp North America, Inc., as administrative agent, the financial institutions named therein, Merrill Lynch, Pierce, Fenner & Smith Incorporated, as syndication agent, Bank of America, N.A., KeyBank National Association and Royal Bank of Canada, as co-documentation agents, and Citigroup Global Markets Inc. and Merrill Lynch, as the arrangers (incorporated by reference to our Quarterly Report on Form 10-Q for the period ended March 31, 2006).
- 10.2 Amendment No. 4 to the Credit Agreement, dated as of July 24, 2006, among Digital Realty Trust, L.P., Citicorp North America, Inc., as administrative agent, the financial institutions named therein, Merrill Lynch, Pierce, Fenner & Smith Incorporated, as syndication agent, Bank of America, N.A., KeyBank National Association and Royal Bank of Canada, as co-documentation agents, and Citigroup Global Markets Inc. and Merrill Lynch, as the arrangers.
- 10.3 Purchase and Sale Agreement, dated as of July 25, 2006, by and between Sterling Network Exchange, LLC and Digital Phoenix Van Buren, LLC.
- 10.4 Securities Purchase Agreement, dated as of July 25, 2006, among Sterling Telecom Holdings, LLC, George D. Slessman, William D. Slessman and Anthony L. Wanger and Digital Phoenix Van Buren, LLC, Digital Services Phoenix, LLC and Fund Management Services, LLC, as the Seller Representative.
- 12.1 Statement of Computation of Ratios
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

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- 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes Oxley Act of 2002.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

DIGITAL REALTY TRUST, INC.

August 4, 2006

/s/ MICHAEL F. FOUST
Michael F. Foust
Chief Executive Officer

August 4, 2006

/s/ A. WILLIAM STEIN
A. William Stein
Chief Financial Officer and Chief Investment Officer
(principal financial officer)

August 4, 2006

/s/ EDWARD F. SHAM
Edward F. Sham
Vice President and Controller
(principal accounting officer)