ASSOCIATED ESTATES REALTY CORP
Form 10-Q
July 31, 2015

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2015

OR

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

For the transition period from _________ to _________

Commission File Number 1-12486
Associated Estates Realty Corporation
(Exact name of registrant as specified in its charter)

OHIO (State or other jurisdiction of incorporation or organization)	34-1747603 (I.R.S. Employer Identification Number)

1 AEC Parkway, Richmond Hts., Ohio 44143-1550
(Address of principal executive offices)
(216) 261-5000
(Registrant's telephone number, including area code)
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

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

The number of Common Shares outstanding as of July 27, 2015 was 58,020,888.

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ASSOCIATED ESTATES REALTY CORPORATION

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PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

ASSOCIATED ESTATES REALTY CORPORATION

CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

(In thousands, except share and per share amounts)	June 30, 2015	December 31, 2014
ASSETS		
Real estate assets		
Land	$279,570	$261,777
Buildings and improvements	1,435,902	1,346,870
Furniture and fixtures	42,367	41,609
Construction in progress	47,886	73,581
Gross real estate	1,805,725	1,723,837
Less: Accumulated depreciation	(398,659)	(397,210)
Net real estate owned	1,407,066	1,326,627
Investment in unconsolidated entities	59,396	54,800
Total net real estate	1,466,462	1,381,427
Cash and cash equivalents	7,411	4,692
Restricted cash	36,186	46,361
Accounts receivable, net		
Rents	1,142	1,093
Other	3,855	2,977
Other assets, net	30,805	29,147
Total assets	$1,545,861	$1,465,697
LIABILITIES AND EQUITY		
Mortgage notes payable	$288,355	$272,613
Unsecured notes	250,000	250,000
Unsecured revolving credit facility	136,000	76,500
Unsecured term loan	150,000	150,000
Total debt	824,355	749,113
Accounts payable and other liabilities	41,745	47,070
Dividends payable	1,027	12,886
Resident security deposits	3,921	3,860
Accrued interest	5,254	5,192
Total liabilities	876,302	818,121
Equity		
Common shares, without par value, $.10 stated value; 91,000,000 authorized; 58,021,078 issued and 58,020,888 outstanding at June 30, 2015 and 57,708,675 issued and 57,649,609 outstanding at December 31, 2014, respectively	5,802	5,771
Paid-in capital	760,274	758,079
Accumulated distributions in excess of accumulated net income	(96,644)	(114,551)
Accumulated other comprehensive loss	(218)	(1,093)
Less: Treasury shares, at cost, 190 and 56,066 shares at June 30, 2015 and December 31, 2014, respectively	(5)	(980)
Total shareholders' equity attributable to AERC	669,209	647,226
Noncontrolling interest	350	350

Total equity	669,559	647,576
Total liabilities and equity	$1,545,861	$1,465,697

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

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ASSOCIATED ESTATES REALTY CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
(UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands, except per share amounts)	2015	2014	2015	2014
REVENUE				
Property revenue	$48,314	$47,268	$95,631	$96,417
Commercial revenue	580	455	1,192	933
Property management and construction services revenue	307	179	621	267
Total revenue	49,201	47,902	97,444	97,617
EXPENSES				
Property operating and maintenance	19,162	18,132	38,073	37,500
Depreciation and amortization	16,741	15,885	32,676	32,180
General and administrative	6,972	4,596	13,491	9,915
Development costs	133	198	332	528
Construction services	248	33	451	90
Costs associated with acquisitions	11	27	73	113
Total expenses	43,267	38,871	85,096	80,326
Operating income	5,934	9,031	12,348	17,291
Interest expense	(6,417)	(6,587)	(12,530)	(13,540)
Gain on change in control	—	—	444	—
Gain on disposition of properties	30,022	59,904	30,022	100,870
Net income	29,539	62,348	30,284	104,621
Allocation to participating securities	(73)	(212)	(75)	(355)
Net income applicable to common shares	$29,466	$62,136	$30,209	$104,266
Earnings per common share - basic:				
Net income applicable to common shares - basic	$0.51	$1.08	$0.52	$1.82
Earnings per common share - diluted:				
Net income applicable to common shares - diluted	$0.51	$1.07	$0.52	$1.80
Comprehensive income:				
Net income	$29,539	$62,348	$30,284	$104,621
Other comprehensive income:				
Change in fair value and reclassification of hedge instruments	1,011	(683)	875	(746)
Total comprehensive income	30,550	61,665	31,159	103,875
Dividends declared per common share	$—	$0.19	$0.21	$0.38
Weighted average shares outstanding - basic	57,744	57,475	57,678	57,419
Weighted average shares outstanding - diluted	58,346	57,919	58,285	57,876

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

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ASSOCIATED ESTATES REALTY CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Six Months Ended June 30,	
(In thousands)	2015	2014
Cash flow from operating activities:		
Net income	$30,284	$104,621
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	32,676	32,180
Gain on change in control	(444)	—
Gain on disposition of properties	(30,022)	(100,870)
Amortization of deferred financing costs and other	597	549
Share-based compensation expense	2,032	2,170
Net change in assets and liabilities:		
Accounts receivable	30	16
Accounts payable and accrued expenses	(61)	(4,180)
Other operating assets and liabilities	786	667
Total adjustments	5,594	(69,468)
Net cash flow provided by operating activities	35,878	35,153
Cash flow from investing activities:		
Recurring fixed asset additions	(5,263)	(4,203)
Revenue enhancing/non-recurring fixed asset additions	(3,335)	(696)
Acquisition fixed asset additions	(82,330)	(46,385)
Development fixed asset additions	(28,972)	(27,609)
Acquisition of unconsolidated entity	(8,316)	—
Net proceeds from disposition of operating properties	47,994	168,756
Contributions to joint ventures	(13,384)	(5,636)
Deposits on potential future acquisitions	(1,903)	3,193
Cash proceeds from sale of equity interest in development property	—	24,075
Escrow deposits related to property sales	(32,100)	(72,292)
Escrow disbursements related to property acquisitions	43,295	52,414
Costs paid on behalf of joint venture	—	(5,639)
Reimbursements of costs paid on behalf of joint venture	—	4,420
Other investing activity	(397)	(589)
Net cash flow (used for) provided by investing activities	(84,711)	89,809
Cash flow from financing activities:		
Principal amortization payments on mortgage notes payable	(1,137)	(1,041)
Principal repayments of mortgage notes payable	—	(20,038)
Payment of debt procurement costs	(42)	(130)
Proceeds from secured construction loans	17,257	20,782
Unsecured revolving credit facility borrowings	157,000	117,000
Unsecured revolving credit facility repayments	(97,500)	(214,500)
Common share dividends paid	(24,037)	(22,579)
Exercise of stock options	1,198	714
Purchase of treasury shares	(1,187)	(999)
Other financing activities, net	—	127
Net cash flow provided by (used for) financing activities	51,552	(120,664)

Increase in cash and cash equivalents	2,719	4,298
Cash and cash equivalents, beginning of period	4,692	4,586
Cash and cash equivalents, end of period	$7,411	$8,884
Supplemental disclosure of non-cash transactions:		
Dividends declared but not paid	$1,027	$11,495
Net change in accounts payable related to fixed asset additions	(5,768)	5,028
Increase in consolidated net assets due to change in control	8,400	—
Deconsolidation of net assets	—	26,238

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

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ASSOCIATED ESTATES REALTY CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. BUSINESS

Except as the context otherwise requires, all references to "we," "our," "us," "AERC," "AEC" and the "Company" in this report collectively refer to Associated Estates Realty Corporation and its consolidated subsidiaries.

We are a fully-integrated, self-administered and self-managed equity real estate investment trust ("REIT") specializing in multifamily ownership, operation, acquisition, development, disposition and property management activities. Our primary source of income is rental payments from the leasing of apartment units. Additional income is derived from commercial rents, property management fees and construction services fees. As of June 30, 2015, our operating portfolio consisted of 50 apartment communities containing 12,786 units in nine states that are owned, either directly or indirectly, through subsidiaries. In conjunction with our acquisition of land for development of an apartment community, we acquired a commercial building in Los Angeles, California, containing approximately 78,800 total square feet of office and commercial space. Additionally, we provide property management services for two apartment communities that we expect to acquire pursuant to existing contracts.

2. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared by management in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and applicable rules and regulations of the Securities and Exchange Commission ("SEC"). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments consisting only of normal and recurring adjustments considered necessary for a fair statement have been included. The reported results of operations are not necessarily indicative of the results that may be expected for the full year. These financial statements should be read in conjunction with the audited financial statements and accompanying notes in our Annual Report on Form 10-K for the year ended December 31, 2014.

Principles of Consolidation

The Company follows the provisions of Accounting Standards Codification No. 810, Consolidation. This standard requires a company to perform an analysis to determine whether its variable interests give it a controlling financial interest in a Variable Interest Entity (“VIE”). This analysis identifies the primary beneficiary of a VIE as the entity that has the power to direct the activities of the VIE that most significantly affect the VIE’s economic performance and the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. In determining whether it has the power to direct the activities of the VIE that most significantly affect the VIE’s performance, this standard requires a company to assess whether it has an implicit financial responsibility to ensure that a VIE operates as designed. When an entity is not deemed to be a VIE, the Company considers the provisions to determine whether a general partner, or the general partners as a group, controls a limited partnership or similar entity when the limited partners have certain rights. Investments in real estate joint ventures in which the Company has the ability to exercise significant influence, but does not have financial or operating control, are accounted for using the equity method of accounting.

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In February 2015, the FASB issued ASU 2015-02, Consolidation (Topic 810) ("ASU 2015-02"), an amendment to the consolidation accounting guidance. This guidance changes the required analysis to determine whether certain types of legal entities should be consolidated. The amendment modifies the evaluation of whether limited partnerships and similar legal entities are VIEs or voting interest entities, eliminates the presumption that a general partner should consolidate a limited partnership and may affect the consolidation analysis of entities involved in VIEs, particularly those having fee arrangements and related party relationships. ASC 2015-02 will become effective for the Company for fiscal years, and for interim reporting periods within those fiscal years, beginning after December 15, 2015. The Company is currently in the process of evaluating the impact the adoption fo ASU 2015-02 will have on the Company's financial position.

Segment Reporting

Substantially all of our properties are multifamily communities and, while the economic climate of the markets in which they are located may vary from time to time, the communities offer similar products and services and have similar economic characteristics. Management evaluates the performance of our properties and makes acquisition/disposition decisions on an individual basis. During the six months ended June 30, 2015, substantially all of our consolidated revenue was provided by our multifamily properties. We have determined that, as of June 30, 2015, we have one reportable segment which is multifamily properties.

Discontinued Operations

In April 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant and Equipment (Topic 360): Reporting of Discontinued Operations and Disclosures of Components of an Entity ("ASU 2014-08"). ASU 2014-08 states that only those disposals of components of an entity that represent a strategic shift that has (or will have) a major effect on an entity's operations and financial results should be reported as discontinued operations in the financial statements. Prior accounting guidance held that a component of an entity that is a reportable segment, an operating segment, a reporting unit, a subsidiary or an asset group was eligible for discontinued operations presentation. This led to many disposals, many of which were routine in nature and did not change an entity's strategy, to be reported as discontinued operations. The amendments in ASU 2014-08 require expanded disclosure for discontinued operations, which should provide financial statement users with more information about the assets, liabilities, revenues and expenses of discontinued operations. As such, our disposition of individual properties will generally no longer meet the guidance to be classified as discontinued operations. This updated guidance requires prospective application for all disposals of components of an entity that occur within annual periods beginning on or after December 15, 2014 and interim periods within those years, with early adoption permitted. We adopted this guidance effective January 1, 2014.

Debt Issuance Costs

In April 2015, the FASB issued ASU 2015-03, Interest - Imputation of Interest (Subtopic 835-30) ("ASU 2015-03"). In order to simplify presentation of debt issuance costs, ASU 2015-03 requires that debt issuance costs be presented in the balance sheet as a direct deduction from the carrying amount of debt liability, consistent with debt discounts or premiums, rather than as a deferred asset. This updated guidance requires retrospective application for all prior periods disclosed and will be effective for financial statements issued for fiscal years beginning after December 15, 2015. The amendments in ASU 2015-03 require disclosure over the nature of and reason for the change in accounting principle, the transition method, a description of the prior-period information that has been retrospectively adjusted and the effect of the change on the financial statement line items. ASU 2015-03 will become effective for the Company on January 1, 2016. The Company does not expect a material impact on our financial position from the adoption of ASU 2015-03.

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3. ACQUISTION, DEVELOPMENT, AND DISPOSITION ACTIVITY

Acquisition Activity

On September 20, 2013, we entered into an agreement to acquire a portfolio of seven properties for a total purchase price of $323.9 million, including the assumption of $28.0 million of existing mortgage financing. During the year ended December 31, 2013, we closed on three of the seven properties: The Apartments at Blakeney, St. Mary's Square and Lofts at Weston Lakeside. During the year ended December 31, 2014, we closed on an additional two properties: Alpha Mill Phase I and Alpha Mill Phase II, which we operate as one property. During the six months ended June 30, 2015, we closed on one property: 1160 Hammond. We expect to acquire the remaining property based on the closing period set forth in the following table. This remaining closing is contingent upon the completed construction of the property. Our obligation to purchase this property is subject to certain closing conditions specified in the agreement. If we choose not to purchase the remaining property, despite the closing conditions having been satisfied within the time period contemplated by the purchase agreement, we would forfeit the then-remaining balance of our earnest money deposit, which was, as of June 30, 2015, $10.0 million. This remaining balance of our earnest money deposit represents our maximum exposure to loss until the closing of the remaining portfolio property. We consider our deposit allocated to the entity developing the property under construction to be a variable interest and the development entity to be a VIE for which we are not the primary beneficiary as of this reporting date as we do not have control over the entity. Although we intend to acquire the remaining property, and regard our acquisition as probable, there can be no assurance that we will acquire the property.

The table below provides details for the remaining property we plan to acquire:

(Dollar amounts in thousands)

Property	Location	Units	Estimated Closing Period	Purchase Price
Varela Westshore	Tampa, FL	350	Q3 2015	$79,450

During the year ended December 31, 2012, we entered into an agreement to acquire for a purchase price of $80.2 million a 331-unit property in Ft. Lauderdale, Florida. Our purchase obligation is conditioned upon the successful completion of the property in accordance with agreed upon plans and specifications and up to an 18-month period to allow for lease up of the property. Closing will not occur unless the conditions are satisfied, which is currently expected to occur in March 2016. The developer may elect to terminate our agreement to purchase by agreeing to the release of our $4.0 million earnest money deposit from escrow and paying us an $8.0 million termination fee. If we choose not to purchase the property, despite the closing conditions having been satisfied within the time period contemplated by the purchase agreement, we would forfeit our $4.0 million earnest money deposit. This earnest money deposit represents our maximum exposure to loss until the closing of the property. We consider our deposit to be a variable interest and the development entity to be a VIE for which we are not the primary beneficiary as of this reporting date as we do not have control over the entity.

On March 2, 2015, we acquired 1160 Hammond, a 345-unit property located in Atlanta, Georgia, for a total purchase price of $80.4 million. This acquisition was funded by borrowings from our unsecured revolving line of credit and proceeds from property dispositions held for a 1031 exchange.

During the six months ended June 30, 2014, we acquired Alpha Mill Phase I and Phase II, a combined 267 units, located in Charlotte, North Carolina, for a total purchase price of $45.1 million. We paid cash for this acquisition, which was funded from proceeds from the sale of Vista Germantown.

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The following table represents the purchase price allocation for the properties acquired during the six months ended June 30, 2015 and 2014, respectively.

	Six Months Ended June 30,	
(In thousands)	2015	2014
Land	$6,953	$8,140
Buildings and improvements	71,664	36,044
Furniture and fixtures	1,270	468
Existing leases (Other assets)	463	423
Total	$80,350	$45,075

The following table presents actual and pro forma information related to the properties acquired during the three and six months ended June 30, 2015 and 2014, respectively. The pro forma information is presented as if the properties were acquired on January 1, 2014. We recognized acquisition costs during the six months ended June 30, 2015 totaling $54,000 related to the current year acquisition, which are included in "Costs associated with acquisitions" in the Consolidated Statements of Operations and Comprehensive Income. Additionally, we recognized acquisition costs totaling $26,000 and $24,000 related to the current year acquisition during 2014 and 2013, respectively. The pro forma presentation is presented for informational purposes only, and is not necessarily indicative of what our actual results of operations would have been had the acquisition occurred at such time.

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands, except per share amounts)	2015	2014	2015	2014
Actual revenue from acquisitions	$938	$161	$1,177	$161
Actual net loss from acquisitions	(534)	(45)	(786)	(45)
Pro forma revenue	49,201	48,372	97,782	98,678
Pro forma net income applicable to common shares	29,577	62,288	29,989	104,493
Pro forma earnings per common share - basic:				
Pro forma net income applicable to common shares	$0.51	$1.08	$0.52	$1.82
Pro forma earnings per common share - diluted:				
Pro forma net income applicable to common shares	$0.51	$1.08	$0.51	$1.81

Development Activity

During the year ended December 31, 2013, we entered into a partnership agreement with an unrelated third-party for the limited purpose of acquiring a property in Monrovia, California, known as 5th and Huntington, and to produce construction drawings for improvements to the property. The land, upon which the partnership planned to develop a 154-unit multifamily apartment community, was purchased by the partnership on August 9, 2013 for $13.1 million. We held a 50.0% equity interest in the partnership, which was accounted for under the equity method. On February 3, 2015, we purchased our partner's 50.0% interest in 5th and Huntington for an agreed upon price of $8.4 million, increasing our ownership percentage in the development to 100%. We recognized a gain of $444,000 related to this acquisition, which represented the amount by which the $8.4 million fair value of our interest in the partnership exceeded our carrying value at the date of acquisition. The gain is included in "Gain on change in control" in the Consolidated Statements of Operations and Comprehensive Income. As of June 30, 2015, this development project is fully consolidated in our financial statements.

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On May 28, 2013, we acquired a 3.36-acre parcel of land in the SoMa neighborhood of San Francisco, California for $46.6 million. On February 2, 2014, we entered into a 50/50 partnership with AIG to develop and own this site known as 350 8th. The partnership is developing a 410-unit apartment community with 40,000 square feet commercial space and underground parking. See Note 6 for additional information related to this partnership.

The following table identifies our consolidated development activity on which construction has commenced or completed:

(Dollar amounts in thousands)

Under Construction	Location	Ownership %		Total Units	Total Estimated Capital Cost [(1)]	Cost to Date	Total Debt	Actual Construction Start	Actual/ Estimated Construction Completion
Cantabria at Turtle Creek	Dallas, TX	100.0%		249	$55,912	$55,912	$39,120	Q2 2013	Q1 2015
7001 Arlington at Bethesda	Bethesda, MD	98.1%	(2)	140	53,400	52,306	26,816	Q4 2012	Q2 2015
The Desmond on Wilshire	Los Angeles, CA	100.0%		175	77,800	57,540	—	Q2 2013	Q4 2015
Total				564	$187,112	$165,758	$65,936		

(1) Total capital costs are calculated as if owned 100% by AEC and represent estimated costs for projects under development inclusive of all capitalized costs in accordance with GAAP. Based on current projections as of July 31, 2015.

(2) Ownership percentage is based on expected total equity of the joint venture and is subject to change based on changes in total equity. Costs are shown at 100%. Joint venture partner contribution is $350.

The following table identifies our unconsolidated development activity on which construction has commenced:

(Dollar amounts in thousands)

Under Construction	Location	Ownership %	Total Units	Total Estimated Capital Cost [(1)]	Cost to Date	AEC Investment to Date	Total Debt	AEC Share of Debt	Actual Construction Start	Estimated Construction Completion
350 8th	San Francisco,CA	50.01%	410	$245,000	$117,003	$47,735	$6,481	$3,241 (2)	Q2 2014	Q4 2016
950 East Third	Los Angeles, CA	50.0%	472	176,300	42,003	11,661	—	—	Q3 2014	Q4 2017
Total			882	$421,300	$159,006	$59,396	$6,481	$3,241		

(1) Total capital costs are calculated as if owned 100% by AEC and represent estimated costs for projects under development inclusive of all capitalized costs in accordance with GAAP. Based on current projections as of July 31, 2015.

(2) AEC has guaranteed 100% of a $143.6 million construction loan.

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The following table identifies our consolidated development activity that is in the planning phase:

(Dollar amounts in thousands)

Name	Location	Ownership %	Estimated Total Units [1]	Cost to Date		Total Debt
5th and Huntington	Monrovia, CA	100.0%	154	$16,970	(2)	$—
Warner Center	Woodland Hills, CA	100.0%	379	21,351		—
Total			533	$38,321		$—

(1) Based on current projections as of July 31, 2015.

(2) Does not include the $444 gain on change in control related to the acquisition of our partner's interest.

Capitalized Interest and Development Payroll. Total capitalized interest during the three and six months ended June 30, 2015 was $1.4 million and $2.7 million, respectively. Total capitalized interest during the three and six months ended June 30, 2014 was $1.2 million and $2.2 million, respectively. Capitalized payroll costs, including share-based compensation, are allocated to projects based upon time incurred by the applicable personnel. Capitalized costs related to development and construction are transferred to buildings and improvements and/or furniture and fixtures, as applicable, upon substantial completion of the project (i.e., certificate of occupancy has been obtained). Total capitalized payroll costs during the three and six months ended June 30,