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MISSION WEST PROPERTIES INC

Form 10-Q

November 13, 2001

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

Form 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2001

COMMISSION FILE NUMBER 1-8383

Mission West Properties, Inc.
(Exact name of registrant as specified in its charter)

Maryland

95-2635431

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer Identification Number)

10050 Bandley Drive
Cupertino, California 95014-2188
(Address of principal executive offices)

Registrant's telephone number, including area code is (408) 725-0700

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

YES NO

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date:

17,120,279 shares outstanding as of November 12, 2001

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Mission West Properties, Inc.

FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2001

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PART I - FINANCIAL INFORMATION
 ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS

MISSION WEST PROPERTIES, INC.
 CONSOLIDATED BALANCE SHEETS
 (Dollars in thousands, except share amounts)

| | September 30, 2001 |
|-------------------------------|----------------------|
| | ----- (Unaudited) |
| ASSETS | |
| Real estate assets, at cost | |
| Land | \$214,620 |
| Buildings | 688,634 |
| | ----- |
| Less accumulated depreciation | 903,254 (46,182) |
| | ----- |
| Net real estate assets | 857,072 |
| Cash and cash equivalents | 5,435 |
| Restricted cash | 15,359 |

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| | |
|---------------|-----------|
| Deferred rent | 16,222 |
| Other assets | 12,564 |
| | ----- |
| Total assets | \$906,652 |
| | ===== |

LIABILITIES AND STOCKHOLDERS' EQUITY

| | | |
|---|-----------|-----------|
| Liabilities: | | |
| Line of credit (related parties) | \$ 81,466 | |
| Mortgage notes payable | 127,904 | |
| Mortgage notes payable (related parties) | 11,441 | |
| Interest payable | 345 | |
| Security deposits | 7,739 | |
| Prepaid rental income | 10,283 | |
| Dividends/distributions payable | 24,654 | |
| Refundable option payment | 19,335 | |
| Accounts payable and accrued expenses | 6,399 | |
| | ----- | |
| Total liabilities | 289,566 | |
| Commitments and contingencies (Note 9) | | |
| Minority interest | | 511,296 |
| Stockholders' equity: | | |
| Preferred stock, \$.001 par value, 20,000,000 shares authorized, none issued and outstanding | | - |
| Common stock, \$.001 par value, 200,000,000 shares authorized, 17,120,279 and 17,025,365 shares issued and outstanding at September 30, 2001 and December 31, 2000, respectively | | 17 |
| Paid-in-capital | 124,036 | |
| Accumulated deficit | (18,263) | |
| | ----- | |
| Total stockholders' equity | | 105,790 |
| | ----- | |
| Total liabilities and stockholders' equity | | \$906,652 |
| | ===== | |

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

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MISSION WEST PROPERTIES, INC
CONSOLIDATED STATEMENTS OF OPERATIONS
(Dollars in thousands, except share and per share amounts)
(Unaudited)

| | Three months ended September 30, | | Nine mo |
|--------------------------------|----------------------------------|-----------|---------|
| | 2001 | 2000 | 2001 |
| | ----- | | ----- |
| Revenues: | | | |
| Rental income from real estate | \$ 33,227 | \$ 26,822 | \$ 94, |
| Tenant reimbursements | 5,309 | 3,746 | 12, |

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| | | | |
|--|------------|------------|---------|
| Other income, including interest and gain on sales of assets | 9,111 | 234 | 13, |
| Total revenues | 47,647 | 30,802 | \$120, |
| Expenses: | | | |
| Operating expenses | 2,470 | 1,449 | 5, |
| Real estate taxes | 2,494 | 2,123 | 7, |
| Depreciation of real estate | 4,326 | 3,950 | 12, |
| General and administrative | 150 | 363 | |
| Interest | 2,144 | 2,227 | 6, |
| Interest (related parties) | 1,272 | 1,328 | 3, |
| Total expenses | 12,856 | 11,440 | 36, |
| Income before minority interest | 34,791 | 19,362 | 84, |
| Minority interest | 29,061 | 16,005 | 70, |
| Net income to common stockholders | \$ 5,730 | \$ 3,357 | \$ 13, |
| Basic net income per share | \$ 0.33 | \$ 0.20 | \$ 0 |
| Diluted net income per share | \$ 0.33 | \$ 0.20 | \$ 0 |
| Weighted average number of common shares outstanding (basic) | 17,120,278 | 17,025,365 | 17,084, |
| Weighted average number of common shares outstanding (diluted) | 17,320,462 | 17,191,306 | 17,302, |

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

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MISSION WEST PROPERTIES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands)
(Unaudited)

| | | | |
|---------------------------------------|--|--|--------|
| | | | Nine m |
| | | | 20 |
| Cash flows from operating activities: | | | |
| Net income | | | \$ 13, |

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| | |
|---|--------|
| Adjustments to reconcile net income to net cash provided by operating activities: | |
| Minority interest | 70, |
| Depreciation | 12, |
| Gain on sales of real estate | (11, |
| Other | |
| Changes in assets and liabilities: | |
| Deferred rent | (5, |
| Other assets | (|
| Interest payable | |
| Security deposits | 1, |
| Prepaid rental income | (1, |
| Accounts payable and accrued expenses | 2, |
| | ----- |
| Net cash provided by operating activities | 81, |
| | ----- |
| Cash flows from investing activities: | |
| Additions to property | |
| Improvements to real estate assets | (|
| Refundable option payment | (1, |
| Proceeds from sales of real estate | 38, |
| Restricted cash | (38, |
| | ----- |
| Net cash used in investing activities | (1, |
| | ----- |
| Cash flows from financing activities: | |
| Principal payments on mortgage notes payable | (4, |
| Principal payments on mortgage notes payable (related parties) | (|
| Net payments under line of credit (related parties) | (62, |
| Proceeds from stock options exercised | |
| Minority interest distributions | (2, |
| Dividends paid | (10, |
| | ----- |
| Net cash used in financing activities | (78, |
| | ----- |
| Net increase/(decrease) in cash and cash equivalents | 4, |
| Cash and cash equivalents, beginning | ----- |
| Cash and cash equivalents, ending | \$ 5, |
| | ===== |
| Supplemental information: | |
| Cash paid for interest | \$ 10, |
| | ===== |
| Supplemental schedule of non-cash investing and financing activities: | |
| Advances under line of credit from O.P. units distributions (related parties) | \$ 47, |
| | ===== |
| Debt incurred in connection with property acquisitions | \$ 43, |
| | ===== |
| Assumption of other liabilities in connection with property acquisitions | \$ 2, |
| | ===== |
| Issuance of operating partnership units in connection with property acquisitions | \$ 28, |
| | ===== |

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

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MISSION WEST PROPERTIES, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except share, per share, square footage and
operating partnership unit amounts)

(Unaudited)

1. PRINCIPLES OF CONSOLIDATION AND BASIS OF PRESENTATION

The accompanying consolidated financial statements include the accounts of Mission West Properties, Inc. and its controlled subsidiaries including the operating partnerships (the "Company"). All significant intercompany balances have been eliminated in consolidation.

Minority interest represents the separate private ownership of the operating partnerships by the Berg Group (defined as Carl E. Berg, his brother Clyde J. Berg, members of their respective immediate families, and certain entities they control) and other non-affiliate interests. In total, these interests account for approximately 83% of the ownership interests in the real estate operations of the Company as of September 30, 2001. Minority interest in earnings has been calculated by taking the net income of the operating partnerships (on a stand-alone basis) multiplied by the respective minority interest ownership percentage.

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") applicable to interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. However, in the opinion of management, all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation have been included. The Company presumes that users of the interim financial information have read or have access to the audited financial statements for the preceding fiscal year and that the adequacy of additional disclosure needed for a fair presentation may be determined in that context. The results of operations for the three and nine months ended September 30, 2001 are not necessarily indicative of the results to be expected for the entire year.

The Company has elected to be taxed as a real estate investment trust under the Internal Revenue Code of 1986, as amended. Accordingly, no provision has been made for income taxes for the three and nine months ended September 30, 2001.

2. REAL ESTATE

BERG LAND HOLDINGS OPTION AGREEMENT

Under the terms of the Berg land holdings option agreement, the Company, through the operating partnerships, has the option to acquire any future Research & Development ("R&D"), office and industrial buildings developed by the Berg Group on land currently owned, optioned, or acquired for these purposes in the future, directly or indirectly by certain members of the Berg Group. At present, there are approximately 297 acres of Silicon Valley land, including land under development, owned directly or under 50% joint venture by certain members of the Berg Group that are subject to the terms

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of the Berg land holdings option agreement. The owners of the future R&D property developments may obtain cash or, at their option, operating partnership ("O.P.") units valued at the average closing price of shares of common stock over the 30-trading-day period preceding the acquisition date. As of September 30, 2001, the Company had completed fifteen acquisitions under the Berg land holdings option agreement representing approximately 1,475,000 rentable square feet. Upon the Company's exercise of an option to purchase any of the future R&D property developments under the terms of the Berg land holdings option agreement, the acquisition price will equal the sum of (a) the full construction cost of the building; (b) 10% of the full construction cost of the building; (c) the acquisition value of the parcel as defined in the agreement upon which the improvements are constructed (currently ranging from \$8.50 to \$20.00 per square foot); (d) 10% per annum of the acquisition value of the parcel for the period from January 1, 1998 to the close of escrow; and (e) interest at LIBOR (London Interbank Offer Rate) plus 1.65% per annum on the full construction costs of the building for the period from the date funds were disbursed by the developer to the close of escrow; less (f) any debt encumbering the property, or a lesser amount as approved by the independent directors committee.

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No estimate can be given at this time as to the total cost to the Company to acquire projects under the Berg land holdings option agreement, or the timing of the Company's acquisition of any of such projects. However, the Berg Group currently has six properties under development with a total of approximately 699,000 rentable square feet of R&D properties that the Company has the right to acquire under this agreement. Of the six properties, two are joint ventures in which the Berg Group holds an approximately 50% interest. The joint venture properties represent a total of approximately 311,000 rentable square feet. As of September 30, 2001, the estimated acquisition price to the operating partnerships for these six projects would be approximately \$82,100. The final acquisition price of these six properties could differ significantly from this estimate. In addition to projects currently under development, the Company has the right to acquire future developments by the Berg Group on up to 250 additional acres of land currently controlled by the Berg Group, which could support approximately 3.9 million square feet of new developments. Under the Berg land holdings option agreement, as long as the Berg Group's percentage ownership interest in the Company and the operating partnerships taken as a whole is at least 65%, the Company also has an option to purchase all land acquired, directly or indirectly, by Carl E. Berg or Clyde J. Berg in the future which has not been improved with completed buildings and which is zoned for, intended for or appropriate for research and development, office and/or industrial development or use in the states of California, Oregon and Washington.

PROPERTY ACQUISITIONS

Effective January 1, 2001, the Company acquired an approximately 131,500 rentable square foot newly constructed R&D building located at 5325 Hellyer Avenue in San Jose, California from the Berg Group under the Berg land holdings option agreement. The total acquisition price for this property was \$15,472. The Company acquired this property by borrowing \$9,000 under the Berg Group line of credit and issuing 464,452 O.P. units to various members of the Berg Group.

Effective February 1, 2001, the Company acquired an approximately 117,740 rentable square foot newly constructed R&D building located at 5500 Hellyer Avenue in San Jose, California from the Berg Group under the Berg land holdings option agreement. The total acquisition price for this property was \$17,809. The Company acquired this property by borrowing \$11,000 under

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the Berg Group line of credit and issuing 506,599 O.P. units to various members of the Berg Group.

Effective April 1, 2001, the Company acquired an approximately 59,400 rentable square foot property located at 245 Caspian Drive in Sunnyvale, California from the Berg Group in a tax-deferred exchange transaction involving the Company's former R&D property at 4949 Hellyer Avenue, San Jose, California. The total acquisition price for this property was \$13,388. The amount of the selling price of the property surrendered in the exchange disposition was classified as restricted cash at March 31, 2001, although the Company had no right to retain the cash under the terms of the contract of exchange. No debt or O.P. units were issued for this acquisition. This property is subject to a 15-year lease. The lessee is currently paying rent to the Company under the lease, although the building constructed on the site has not been completed. The Berg Group is obligated to complete construction at no cost to the Company upon receipt of the lessee's request.

Effective May 1, 2001, the Company acquired an approximately 67,912 rentable square foot newly constructed R&D building located at 855 Branham Lane East in San Jose, California from the Berg Group in a tax-deferred exchange transaction involving the Company's former R&D property at 4949 Hellyer Avenue, San Jose, California. The total acquisition price for this property was \$9,809. The amount of the selling price of the property surrendered in the exchange disposition was classified as restricted cash at March 31, 2001, although the Company had no right to retain the cash under the terms of the contract of exchange. No debt or O.P. units were issued for this acquisition.

Effective June 1, 2001, the Company acquired an approximately 78,794 rentable square foot newly constructed R&D building located at 5550 Hellyer Avenue in San Jose, California from the Berg Group under the Berg land holdings option agreement. The total acquisition price for this property was \$7,134. The Company acquired this property by borrowing \$2,973 under the Berg Group line of credit and issuing 314,156 O.P. units to various members of the Berg Group.

Effective July 1, 2001, the Company acquired three newly constructed R&D buildings totaling approximately 247,500 rentable square feet located at 5905-5965 Silver Creek Valley Road in San Jose, California from the Berg Group under the Berg land holdings option agreement. The total acquisition price for this property was \$26,991. The Company acquired this property by borrowing \$16,431 under the Berg Group line of credit, issuing 647,279 O.P. units to various members of the Berg Group and assuming other liabilities of \$1,602.

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Effective August 1, 2001, the Company acquired an approximately 73,312 rentable square foot newly constructed R&D building located at 5750 Hellyer Avenue in San Jose, California from the Berg Group under the Berg land holdings option agreement. The total acquisition price for this property was \$6,620. The Company acquired this property by borrowing \$4,480 under the Berg Group line of credit, issuing 127,438 O.P. units to various members of the Berg Group and assuming other liabilities of \$422.

PROPERTY DISPOSITIONS

In January 2001, the Company completed the sale of a 200,484 square foot R&D property located at 4949 Hellyer Avenue, San Jose, California to Cisco Systems, Inc., which exercised its purchase option in November 2000. The Company realized a gain of \$3,102, which is included in other income, on

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the total sale price of \$23,130.

In September 2001, the Company completed the sale of a 77,700 square foot R&D property located at 5713-5729 Fontanoso Way, San Jose, California to Cisco Systems, Inc., which exercised its purchase option in November 2000. The Company realized a gain of \$8,452, which is included in other income, on the total sale price of \$15,445.

3. RESTRICTED CASH

At March 31, 2001, restricted cash represents proceeds from a property sale and interest income being held in a separate cash account at a trust company in order to preserve the Company's option of reinvesting the proceeds on a tax-deferred basis. On June 25, 2001, the proceeds were used in an exchange for two properties as discussed above in Note 2, "Property Acquisitions."

At September 30, 2001, the balance represents proceeds from a property sale and interest income being held in a separate cash account at a trust company in order to preserve the Company's option of reinvesting the proceeds on a tax-deferred basis.

4. STOCK TRANSACTIONS

During the nine months ended September 30, 2001, stock options to purchase 14,588 shares of common stock were exercised at \$4.50 per share, stock options to purchase 38,000 shares of common stock were exercised at \$8.25 per share, and stock options to purchase 6,000 shares of common stock were exercised at \$13.00 per share. Total proceeds to the Company were \$457. One limited partner in an operating partnership exchanged 36,323 O.P. units for 36,323 shares of the Company's common stock under the terms of the exchange rights agreement.

5. OTHER INCOME

See Note 2 "Property Dispositions." The Company realized a gain of \$11,554 on the sale of two properties in the first nine months of 2001. Interest income generated from the sale proceeds was approximately \$487 for the nine months ended September 30, 2001.

6. NET INCOME PER SHARE

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted net income per share is computed by dividing net income by the sum of the weighted-average number of common shares outstanding for the period plus the assumed exercise of all dilutive securities.

The computation for weighted average shares is detailed below:

| | Three Months Ended September 30, | | Nine |
|---|----------------------------------|------------|------------|
| | 2001 | 2000 | 2001 |
| Weighted average shares outstanding (basic) | 17,120,278 | 17,025,365 | 17,025,365 |
| Incremental shares from assumed option exercise | 200,184 | 165,941 | 200,184 |
| Weighted average shares outstanding (diluted) | 17,320,462 | 17,191,306 | 17,225,549 |

=====
=====
=====
The outstanding O.P. units, which are exchangeable at the unit holder's option, subject to certain conditions, for shares of common stock on a one-for-one basis have been excluded from the diluted net income per share calculation, as there would be no effect on the amounts because the minority interests' share of income would

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also be added back to net income. The total number of O.P. units outstanding at September 30, 2001 and 2000 was 85,599,628 and 81,667,227, respectively.

7. RELATED PARTY TRANSACTIONS

As of September 30, 2001, the Berg Group owned 78,845,976 O.P. units. Along with the Company's common shares owned by the Berg Group, the Berg Group's ownership as of September 30, 2001 represented approximately 77% of the equity interests of the Company, assuming conversion of the 85,599,628 O.P. units outstanding into the common stock of the Company.

As of September 30, 2001, debt in the amount of \$81,466 was due the Berg Group under the line of credit established March 1, 2000. The \$75,000 line of credit from the Berg Group was increased to \$100,000 effective July 1, 2001. The Berg Group line of credit is currently collateralized by eleven properties, bears interest at LIBOR plus 1.30%, and matures in July 2002. The Company believes that the terms of the Berg Group line of credit are more favorable than those available from commercial lenders. As of September 30, 2001, debt in the amount of \$11,441 was due the Berg Group under a mortgage note established May 15, 2000 in connection with the acquisition of a 50% interest in Hellyer Avenue Limited Partnership, the obligor under the mortgage note. The mortgage note bears interest at 7.65%, and is due in 10 years with principal payments amortized over 20 years.

Carl E. Berg has a substantial financial interest in one company that leases space from the operating partnerships. This company occupies 5,862 square feet at \$0.93 per square foot per month. This lease was in effect prior to the Company's acquisition of its general partnership interests in July 1998. The lease expires in May 2003.

The Company currently leases office space owned by Berg & Berg Enterprises, Inc., an affiliate of Carl E. Berg and Clyde J. Berg. Rental amounts and overhead reimbursements paid to Berg & Berg Enterprises, Inc. were \$23 and \$20 for the three months ended September 30, 2001 and 2000, respectively, and \$65 and \$60 for the nine months ended September 30, 2001 and 2000, respectively.

8. SUBSEQUENT EVENTS

On October 11, 2001, the Company paid dividends of \$0.24 per share of common stock to all common stockholders of record as of September 28, 2001. On the same date, the operating partnerships paid a distribution of \$0.24 per O.P. unit.

9. COMMITMENTS AND CONTINGENCIES

The Company and the operating partnerships are or may become, from time to time, parties to litigation arising out of the normal course of business. Management does not expect that such matters would have a material adverse

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effect on the consolidated financial position, results of operations or cash flows of the Company.

Insurance policies currently maintained by the Company do not cover seismic activity, although they do cover losses from fires after an earthquake.

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ITEM 2

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the accompanying consolidated financial statements and notes thereto contained herein and the Company's consolidated financial statements and notes thereto contained in the Company's Annual Report on Form 10-K as of and for the year ended December 31, 2000. The results for the three and nine months ended September 30, 2001 are not necessarily indicative of the results to be expected for the entire fiscal year ending December 31, 2001. The following discussion includes forward-looking statements, including but not limited to, statements with respect to the Company's future financial performance, operating results, plans and objectives. Actual results may differ materially from those currently anticipated depending upon a variety of factors, including those described below under the sub-heading, "Forward-Looking Information."

OVERVIEW

Mission West Properties, Inc. (the "Company") acquires, markets, leases, and manages R&D and office properties, primarily located in the Silicon Valley portion of the San Francisco Bay Area. As of September 30, 2001, the Company owned and managed 96 properties totaling approximately 6.7 million rentable square feet through four limited partnerships, or operating partnerships, for which it is the sole general partner. This class of property is designed for research and development and office uses and, in some cases, includes space for light manufacturing operations with loading docks. The Company believes that it has one of the largest portfolios of R&D properties in the Silicon Valley. The four tenants who lease the most square footage from the Company are Microsoft Corporation, JDS Uniphase Corporation, Amdahl Corporation (a subsidiary of Fujitsu Limited), and Apple Computer, Inc. For federal income tax purposes the Company operates as a self-managed, self-administered and fully integrated real estate investment trust ("REIT") since 1999.

Our acquisition and growth strategy incorporates the following elements:

- working with the Berg Group to take advantage of their abilities and resources to pursue development opportunities which we have an option to acquire, on pre-negotiated terms, upon completion and leasing;
- capitalizing on opportunistic acquisitions from third parties of high-quality R&D and office properties that provide attractive initial yields and significant potential for growth in cash-flow;
- focusing on general purpose, single-tenant Silicon Valley R&D and office properties for information technology companies in order to maintain low operating costs, reduce tenant turnover and capitalize on our relationships with these companies and our extensive knowledge of their real estate needs; and
- maintaining prudent financial management principles that emphasize current

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cash flow while building long-term value, the acquisition of pre-leased properties to reduce development and leasing risks and the maintenance of sufficient liquidity to acquire and finance properties on desirable terms.

The Company has two wholly owned subsidiaries, MIT Realty, Inc. and Mission West Executive Aircraft Center. Both corporations are inactive.

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RESULTS OF OPERATIONS

COMPARISON OF THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2001 TO THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2000.

As of September 30, 2001, the Company, through its controlling interests in the operating partnerships, owned 96 properties totaling approximately 6.7 million square feet compared to 87 properties totaling approximately 6.0 million square feet owned by the Company as of September 30, 2000. This represents a net increase of approximately 12% in total rentable square footage from one year ago. Since September 30, 2000 the Company has acquired the following properties and disposed of 200,484 rentable square feet at 4949 Hellyer Avenue and 77,700 rentable square feet at 5713-5729 Fontanos Way.

| Date of Acquisition | Address | Rentable Square Footage |
|------------------------|---------------------------------|----------------------------|
| ----- | ----- | ----- |
| 10/00 | 45365 Northport Loop | 64,218 |
| 12/00 | 1768 Automation Parkway | 110,592 |
| 01/01 | 5325 Hellyer Avenue | 131,500 |
| 02/01 | 5500 Hellyer Avenue | 117,740 |
| 04/01 | 245 Caspian Drive (1) | 59,400 |
| 05/01 | 855 Branham Lane East | 67,912 |
| 06/01 | 5550 Hellyer Avenue | 78,794 |
| 07/01 | 5906-65 Silver Creek Valley Rd. | 247,500 |
| 08/01 | 5750 Hellyer Avenue | 73,312 |
| | | ----- |
| | | 950,968 |
| | | ===== |

(1) A lessee currently pays rent for this site under a 15-year lease, although the building has not been completed for occupancy by this lessee.

The following tables reflect the increase in the Company's rental revenues for the three and nine months ended September 30, 2001 over rental revenues for the comparable three and nine months in 2000:

| | Three months ended September 30, | | | |
|-------------------|----------------------------------|----------|-----------|----------|
| | 2001 | 2000 | \$ Change | Percenta |
| | ----- | ----- | ----- | ----- |
| | (\$ in thousands) | | | |
| Same Property (1) | \$16,270 | \$15,789 | \$ 481 | |

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| | | | | |
|-----------------------|----------|----------|----------|----|
| 1998 Acquisitions | 582 | 582 | - | |
| 1999 Acquisitions | 6,512 | 6,295 | 217 | |
| 2000 Acquisitions (2) | 5,153 | 4,156 | 997 | 2 |
| 2001 Acquisitions | 4,710 | - | 4,710 | 10 |
| | ----- | ----- | ----- | |
| | \$33,227 | \$26,822 | \$ 6,405 | 2 |
| | ===== | ===== | ===== | |

Nine months ended September 30,

| | 2001 | 2000 | \$ Change | Percenta |
|-----------------------|-------------------|----------|-----------|----------|
| | ----- | ----- | ----- | ----- |
| | (\$ in thousands) | | | |
| Same Property (1) | \$49,610 | \$43,762 | \$ 5,848 | 1 |
| 1998 Acquisitions | 1,748 | 1,748 | - | |
| 1999 Acquisitions | 19,549 | 18,685 | 864 | |
| 2000 Acquisitions (2) | 15,331 | 7,762 | 7,569 | 9 |
| 2001 Acquisitions | 8,323 | - | 8,323 | 10 |
| | ----- | ----- | ----- | |
| | \$94,561 | \$71,957 | \$22,604 | 3 |
| | ===== | ===== | ===== | |

- (1) "Same Property" is defined as properties owned as of July 1, 1998 and still owned as of September 30, 2001.
- (2) The figures for "2000 Acquisitions" in year 2000 for some properties do not reflect a full three- and nine-months of rent due to the timing of the acquisition of the properties during the year 2000.

For the quarter ended September 30, 2001, rental revenues increased by \$6.41 million from \$26.82 million for the three months ended September 30, 2000 to \$33.23 million for the same period of 2001. Approximately 73.5% of the increased rental revenue came from properties acquired in 2001, 15.6% came from properties acquired in the second half of 2000 and the remaining balance came from rent increases or new leases on existing properties at higher rental rates. Rental revenues increased by \$22.60 million from \$71.96 million for the nine months ended September 30, 2000 to \$94.56 million for the same period of 2001. Approximately 36.8% of the increased rental revenue for the first nine months of 2001 was generated by R&D properties acquired by the Company this year, 33.5% was generated from properties acquired in the second half of 2000, and 25.9% was attributable to rental rate increases and new leases at market rental

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rates on properties originally owned by the Berg Group acquired when the Company became the sole general partner of the operating partnerships in July 1998.

Tenant reimbursements increased by \$1.56 million, or 42%, from \$3.75 million for the three months ended September 30, 2000 to \$5.31 million for the three months ended September 30, 2001. Operating expenses and real estate taxes, on a combined basis, increased by \$1.39 million, or 39%, from \$3.57 million to \$4.96 million for the three months ended September 30, 2000 and 2001, respectively. Tenant reimbursements increased by \$2.36 million, or 23%, from \$10.19 million for the nine months ended September 30, 2000 to \$12.55 million for the nine months ended September 30, 2001. Operating expenses and real estate taxes, on a combined basis, increased by \$2.30 million, or 22%, from \$10.50 million to \$12.80 million for the nine months ended September 30, 2000 and 2001, respectively. The increases in all categories resulted primarily from the

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increase in the total rentable square footage during the periods presented.

Depreciation expense increased by \$0.38 million and \$1.15 million for the three and nine-month period ended September 30, 2001, respectively, over the same period a year ago. The increase was attributable to the acquisition of eleven R&D properties since September 30, 2000.

Interest expense decreased by \$0.09 million, or 4%, from \$2.23 million for the three months ended September 30, 2000 to \$2.14 million for the three months ended September 30, 2001 due to a reduction in scheduled principal debt repayments. Interest expense (related parties) decreased by \$0.06 million, or 4%, from \$1.33 million for the three months ended September 30, 2000 to \$1.27 million for the three months ended September 30, 2001 due to lower interest rates and repayments on the Berg Group line of credit. As a result, overall interest expense (including amounts to related parties) for the quarter ended September 30, 2001 decreased by \$0.15 million compared to the third quarter a year ago. Interest expense decreased by \$0.16 million, or 2%, from \$6.73 million for the nine months ended September 30, 2000 to \$6.57 million for the nine months ended September 30, 2001. Interest expense (related parties) increased by \$0.52 million, or 16%, from \$3.21 million for the nine months ended September 30, 2000 to \$3.73 million for the nine months ended September 30, 2001. Overall interest expense for the nine months ended September 30, 2001 increased by \$0.36 million compared to the nine months ended September 30, 2000. The eleven R&D property acquisitions increased total debt outstanding, including amounts due related parties, by \$33.91 million, or 18%, from \$186.90 million as of September 30, 2000 to \$220.81 million as of September 30, 2001. Management expects interest expense to increase as new debt is incurred in connection with property acquisitions, as the Company draws on the Berg Group line of credit, and as it seeks alternative sources of credit.

The minority interest portion of income was \$29.06 million, resulting in net income to stockholders of \$5.73 million for the three months ended September 30, 2001. For the nine months ended September 30, 2001, the minority interest portion of income was \$70.08 million, resulting in net income to stockholders of \$13.93 million. Minority interest represents the ownership interest of all limited partners in the operating partnerships taken as a whole, which was approximately 83% as of September 30, 2001 and 2000.

RECENT RENTAL MARKET DEVELOPMENTS

All of the Company's properties are located in the Northern California area known as Silicon Valley, which generally consists of portions of Santa Clara County, Southwestern Alameda County, Southeastern San Mateo County and Eastern Santa Cruz County. The Silicon Valley economy and business activity have slowed markedly during the first nine months of 2001 after fast-paced growth in 1999 and 2000. In the past several years, the Silicon Valley R&D property market has fluctuated with the local economy. According to a recent report by BT Commercial Real Estate, vacancy rates for Silicon Valley R&D property increased from approximately 3.4% in late 2000 to 12.6% at the end of the third quarter of 2001. Total vacant R&D square footage in Silicon Valley at the end of the third quarter of 2001 amounted to 19.1 million square feet, of which 49%, or 9.3 million square feet, was sublease space. Total net absorption in 2000 amounted to approximately 12.8 million square feet. During the first nine months of 2001, there was a total negative net absorption of approximately (12.2) million square feet. The impact of this decline has not been uniform throughout the area, however. The Silicon Valley R&D property market has been characterized by a substantial number of submarkets, with rent and vacancy rates varying considerably by submarket and location within each submarket. The Company's average occupancy rate for the three- and nine-month periods ended September 30, 2001 was 98% and 99%, respectively. The Company does not currently anticipate a material decline in occupancy or rental rates for its existing R&D properties. Nonetheless, the Company's operating results and ability to pay dividends at

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current levels remain subject to a number of material risks, as indicated under the caption "Forward-Looking Information" below and in the section entitled "Risk Factors" in the Company's most recent annual report on Form 10-K.

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LEASE EXPIRATIONS

The following table sets forth a schedule of the lease expirations for the properties beginning with 2001, assuming that none of the tenants exercise existing renewal options or termination rights, as of September 30, 2001.

| Year of Lease Expiration | Number of Leases Expiring | Rentable Square Footage Subject to Expiring Leases | 2001 Annual Base Rent Under Expiring Leases (1) | Percentage Base Rent Expiri |
|-----------------------------|---------------------------------|---|--|-----------------------------------|
| 2001 | 6 | 236,208 | \$ 3,485,064 | |
| 2002 | 14 | 541,046 | 8,641,395 | |
| 2003 | 14 | 487,332 | 8,407,922 | |
| 2004 | 21 | 1,049,926 | 13,518,995 | |
| 2005 | 20 | 884,059 | 15,303,832 | |
| 2006 | 16 | 1,211,185 | 34,209,949 | |
| 2007 | 14 | 986,729 | 19,865,130 | |
| 2008 | 3 | 264,750 | 2,797,625 | |
| 2009 | 2 | 58,783 | 632,920 | |
| Thereafter | 6 | 976,309 | 18,855,327 | |
| | ----- 116 | ----- 6,696,327 | ----- \$125,718,159 | |
| | | ===== | ===== | |

(1) The base rent for leases expiring is based on January 2001 monthly rents multiplied by 12.

(2) Based upon 2001 annual rents as discussed in Note (1).

CHANGES IN FINANCIAL CONDITION

In January 2001, the Company completed the sale in a tax-free exchange of a 200,484 square foot R&D property located at 4949 Hellyer Avenue, San Jose, California to Cisco Systems, Inc., which exercised its purchase option in November 2000. The Company realized a gain of \$3.1 million, which is included in other income, on the total sale price of \$23.1 million. In September 2001, the Company also completed the sale in a tax-free exchange of a 77,700 square foot R&D property located at 5713-5729 Fontanos Way, San Jose, California to Cisco Systems, Inc., which exercised its purchase option in November 2000. The Company realized a gain of \$8.5 million, which is included in other income, on the total

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sale price of \$15.4 million. The selling prices of the properties surrendered by the Company were classified as restricted cash to be used in tax-deferred property exchanges.

During the first nine months of 2001, the Company acquired seven additional properties representing approximately 649,000 rentable square feet of R&D properties located in Silicon Valley. These properties were acquired from the Berg Group under the Berg land holdings option agreement. The aggregate acquisition price for these properties was approximately \$74 million. The Company financed these acquisitions by a) borrowing a total of \$43.9 million under the Berg Group line of credit; b) assuming a total of \$2 million in other liabilities and c) issuing 2,059,924 O.P. units. In addition to those seven property purchases, the Company also acquired two R&D properties representing approximately 127,312 rentable square feet for approximately \$23.2 million in a tax-deferred exchange. The selling prices of the properties surrendered by the Company were classified as restricted cash for the use in tax-deferred property exchanges and was included in restricted cash at March 31, 2001. No debt or O.P. units were issued for these acquisitions. At September 30, 2001, real estate assets have increased by approximately \$61.8 million from December 31, 2000 because of seven property acquisitions and some tenant improvements.

At September 30, 2001, total liabilities have increased by approximately \$34.1 million from December 31, 2000 due to mainly debt incurred in connection with seven property acquisitions, increase in security deposits and higher dividend payable.

At September 30, 2001, total stockholders' equity increased by approximately \$3.7 million from December 31, 2000 because of the combination of net earnings, declared dividends, and option exercises and the exchange of O.P. units for common stock. During the nine months ended September 30, 2001, stock options to purchase 14,588 shares of common stock were exercised at \$4.50 per share, stock options to purchase 38,000 shares of common stock were exercised at

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\$8.25 per share, and stock options to purchase 6,000 shares of common stock were exercised at \$13.00 per share. Total proceeds to the Company were approximately \$0.46 million. One limited partner of an operating partnership exchanged 36,323 O.P. units for 36,323 shares of the Company's common stock under the exchange rights agreement among the Company and the limited partners in the operating partnerships.

LIQUIDITY AND CAPITAL RESOURCES

The Company expects its principal sources of liquidity for distributions to stockholders and unitholders, debt service, leasing commissions and recurring capital expenditures to come from Funds From Operations ("FFO") and/or the Berg Group line of credit. The Company expects these sources of liquidity to be adequate to meet projected distributions to stockholders and other presently anticipated liquidity requirements in 2001. The Company expects to meet its long-term liquidity requirements for the funding of property development, property acquisitions and other material non-recurring capital improvements through long-term secured and unsecured indebtedness and the issuance of additional equity securities by the Company. The Company has the ability to meet short-term obligations or other liquidity needs based on the line of credit (related parties).

On July 1, 2001, our \$75 million credit line with the Berg Group was increased to \$100 million with all other terms remaining the same. The Company is continually evaluating alternative sources of credit to replace the Berg Group

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line of credit. There can be no assurance that the Company will be able to obtain a line of credit with terms similar to the Berg Group line of credit, and its cost of borrowing could increase substantially. The Company believes that the terms of the Berg Group line of credit are more favorable than those available from institutional lenders.

On May 17, 2001, the Company obtained a \$5 million variable rate revolving line of credit loan from Cupertino National Bank. The loan, maturing May 17, 2002, bears an initial interest rate of 7% that is subject to change from time to time based on the changes in the Prime Rate. The Company paid a loan fee of \$10,000 and expects to use the loan for general business purposes. At September 30, 2001, the Cupertino National Bank line of credit had a zero outstanding balance.

At September 30, 2001, the Company had total indebtedness of \$220.8 million, including \$127.9 million of fixed rate mortgage debt, \$11.4 million under the Berg Group mortgage note (related parties), and \$81.5 million under the Berg Group line of credit (related parties). In June 2001, the Company paid approximately \$2.7 million to retire a maturing note due Mellon Mortgage Company.

As of September 30, 2001, the Company's Debt to Total Market Capitalization ratio was approximately 15.2%, based upon a Total Market Capitalization of approximately \$1.5 billion. The Company computed this ratio by dividing the Company's total debt outstanding by the sum of this debt plus the market value of common stock (based upon the closing price of \$12.00 per share on September 28, 2001) on a fully diluted basis, taking into account the conversion of all O.P. units into common stock.

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Mortgage Debt

The following table sets forth information regarding debt outstanding as of September 30, 2001:

| Debt Description | Collateral Properties | Ba |
|---|--|----|
| Line of Credit: | | |
| Berg Group (related parties) | 2033-2043 Samaritan Drive, San Jose, CA 2133 Samaritan Drive, San Jose, CA 2233-2243 Samaritan Drive, San Jose, CA 1310-1450 McCandless Drive, Milpitas, CA 1315-1375 McCandless Drive, Milpitas, CA 1650-1690 McCandless Drive, Milpitas, CA 1795-1845 McCandless Drive, Milpitas, CA 5325 Hellyer Avenue, San Jose, CA 5345 Hellyer Avenue, San Jose, CA 2610 N. First Street, San Jose, CA 75 E. Trimble Road, San Jose, CA | \$ |
| Mortgage Notes Payable (related parties): | 5300 & 5350 Hellyer Avenue, San Jose, CA | |

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| | |
|---|--|
| Mortgage Notes Payable: | |
| Prudential Capital Group | 20400 Mariani Avenue, Cupertino, CA |
| New York Life Insurance Company | 10440 Bubb Road, Cupertino, CA |
| Home Savings & Loan Association | 10460 Bubb Road, Cupertino, CA |
| Prudential Insurance Company of America | 10300 Bubb Road, Cupertino, CA |
| | 10500 N. DeAnza Blvd, Cupertino, CA |
| | 4050 Starboard Drive, Fremont, CA |
| | 45700 Northport Loop, Fremont, CA |
| | 45738 Northport Loop, Fremont, CA |
| | 450-460 National Avenue, Mountain View, CA |
| | 6311 San Ignacio Avenue, San Jose, CA |
| | 6321 San Ignacio Avenue, San Jose, CA |
| | 6325 San Ignacio Avenue, San Jose, CA |
| | 6331 San Ignacio Avenue, San Jose, CA |
| | 6341 San Ignacio Avenue, San Jose, CA |
| | 6351 San Ignacio Avenue, San Jose, CA |
| | 3236 Scott Blvd, Santa Clara, CA |
| | 3560 Bassett Street, Santa Clara, CA |
| | 3570 Bassett Street, Santa Clara, CA |
| | 3580 Bassett Street, Santa Clara, CA |
| | 1135 Kern Avenue, Sunnyvale, CA |
| | 1212 Bordeaux Lane, Sunnyvale, CA |
| | 1230 E. Arques, Sunnyvale, CA |
| | 1250 E. Arques, Sunnyvale, CA |
| | 1170 Morse Avenue, Sunnyvale, CA |
| | 1600 Memorex Drive, Santa Clara, CA |
| | 1688 Richard Avenue, Santa Clara, CA |
| | 1700 Richard Avenue, Santa Clara, CA |
| | 3540 Bassett Street, Santa Clara, CA |
| | 3542 Bassett Street, Santa Clara, CA |
| | 3544 Bassett Street, Santa Clara, CA |
| | 3550 Bassett Street, Santa Clara, CA |

Mortgage Notes Payable Subtotal

Total

1

\$2
=====

- (1) The debt owed to the Berg Group under the line of credit carries a variable interest rate equal to LIBOR plus 1.30% and is payable in full in July 2002. The interest rate at September 30, 2001 was 3.832%.
- (2) John Kontrabecki, one of the limited partners, has guaranteed approximately \$12.0 million of this debt.

CURRENT PROPERTIES SUBJECT TO OUR ACQUISITION AGREEMENT WITH THE BERG GROUP

The following table presents certain projected information at September 30, 2001 concerning projects for which the Company, through its interests in the operating partnerships, has the right to acquire under the Berg land holdings option agreement.

Approximate

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| Property | Number of Buildings | Rentable Area (Square Feet) | Anticipated Acquisition Date | Ac |
|---------------------------|---------------------|-----------------------------|------------------------------|----|
| BERG LAND HOLDINGS OPTION | | | | |
| UNDER DEVELOPMENT | | | | |
| Silver Creek | 1 | 98,000 | 4th Quarter 2001 | |
| Morgan Hill (JV I) (2) | 2 | 160,000 | 4th Quarter 2001 | |
| Morgan Hill (JV II) (2) | 1 | 151,242 | 1st Quarter 2002 | |
| 5345 Hellyer | 1 | 125,000 | 1st Quarter 2002 | |
| Piercy & Hellyer | 1 | 165,000 | 3rd Quarter 2002 | |
| | - | ----- | | |
| SUBTOTAL | 6 | 699,242 | | |
| AVAILABLE LAND | | | | |
| Piercy & Hellyer | | 490,000 | | |
| Morgan Hill (2) | | 368,025 | | |
| King Ranch | | 207,000 | | |
| Fremont & Cushing | | 387,000 | | |
| Evergreen | | 2,480,000 | | |
| | | ----- | | |
| SUBTOTAL | | 3,932,025 | | |
| TOTAL | 6 | 4,631,267 | | |
| | = | ===== | | |

- (1) The estimated acquisition value represents the estimated cash price for acquiring the projects under the terms of the Berg land holdings option agreement, which may differ from the actual acquisition cost as determined under GAAP, if O.P units or any other securities based on the market value of our common stock are issued in the transaction.
- (2) The Company expects to own an approximate 50% interest in the partnership through one of its operating partnerships. The property will be operated and managed by the other partner in the entity. The rentable area and estimated acquisition value shown above reflect both the Company's and the other partner's combined interest in these properties.

Pursuant to the Berg land holdings option agreement between the Company and the Berg Group, the Company currently has the option to acquire any future R&D, office and industrial property developed by the Berg Group on land it currently owns or has under option, or acquires for these purposes in the future, directly or indirectly by certain members of the Berg Group.

The time required to complete the leasing of developments varies from project to project. The acquisition dates and acquisition costs set forth in the table are only estimates by management. Generally, the Company will not acquire any of the above projects until they are fully completed and leased. There can be no assurance that the acquisition date and final cost to the Company as indicated above would be realized. No estimate can be given at this time as to the Company's total cost to acquire projects under the Berg land holdings option agreement, nor can we be certain of the period in which we will acquire any of the projects.

Although the Company expects to acquire the new properties available to it under the terms of the Berg land holdings option agreement, subsequent to the approval by the independent directors committee, there can be no assurance that the Company actually will consummate any intended transactions, including all of those discussed above. Furthermore, the Company has not yet determined the means

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by which it would acquire and pay for any such properties or the impact of any of the acquisitions on its business, results of operations, financial condition, FFO or available cash for distribution.

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For example, in July 2001, the Berg Group informed the Company that tenants under five R&D properties being developed by the Berg Group were unlikely to perform under their existing leases. The five properties represent a total of approximately 422,000 rentable square feet that the Company had intended to purchase for approximately \$62.0 million by exercising its option under the Berg land holdings option agreement. The Company has no obligation to purchase these properties, however, and failure to acquire them when originally anticipated will not adversely impact the Company's financial condition or current operating results. The Company does not expect to acquire any of these properties, if at all, until each property is fully completed and leased by a tenant capable of performing its lease obligations. Management considers this unlikely in the near term and believes the Company will not receive as much as \$2.0 million additional rental revenues that it had projected for the fourth quarter of this year. If none of these properties are acquired by the Company next year, the Company will forego as much as \$18.0 million of anticipated additional revenues in 2002. The Berg Group will continue to own and bear the entire risk with respect to these properties, and will receive any rent that these tenants pay if their existing obligations under the leases are enforced successfully or settled by partial payment.

The Company believes that one of its tenants which currently pays rent at two properties representing approximately 284,000 rentable square feet is likely to file for protection under the federal bankruptcy laws at the end of the year. One of the properties, consisting of approximately 239,000 square feet, may take twelve months or more to re-lease if vacated. If this tenant declares bankruptcy, the Company will forego as much as \$6.0 million of projected additional rent revenues in 2002. Another tenant, Exodus Communications, Inc. ("Exodus"), filed a voluntary petition for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code on September 26, 2001. Exodus has not disavowed its lease agreement with the Company and has continued to pay its monthly obligations under the lease. The Exodus lease has been guaranteed by Citizens Communications Company in the event of default by Exodus. The Company currently believes that it will receive the lease payments due under the Exodus lease but cannot provide assurances that all payments will be timely or that some legal action to enforce its payments rights will not be necessary.

In addition, leasing activity for new build-to-suit and vacated R&D properties has slowed considerably during the past nine months. Consequently, the Company believes that the projected acquisition dates for other development properties subject to the Berg land holdings option agreement may be delayed for an indefinite period of time. Such delays could reduce future growth in revenues, operating income and Funds Available for Distribution ("FAD").

HISTORICAL CASH FLOWS

Net cash provided by operating activities for the nine months ended September 30, 2001 was \$81.4 million compared to \$63.8 million for the same period in 2000, a 28% increase. The change was a direct result of rent increases and newly acquired properties.

Net cash used in investing activities was approximately \$1.9 million and \$2 million for the nine months ended September 30, 2001 and 2000, respectively. Of the \$1.9 million net cash used in investing activities, \$0.4 million were related to tenant improvements and \$1.5 million related to the Xilinx purchase option agreement where Xilinx and the Company agreed to reduce the deposit by

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\$167 per month commencing August 1, 2000 until the later of: (1) the transfer of title to the property to Xilinx or (2) December 31, 2002. In the event Xilinx does not exercise its option, the Company must refund the remaining deposit to Xilinx, without interest.

Net cash used in financing activities was \$78.7 million for the nine months ended September 30, 2001 compared to \$64.1 million for the same period in 2000, a 23% increase. Of the \$78.7 million net cash used in financing activities, \$66.4 million were used to pay outstanding debt, \$2.5 million for minority interest distributions, \$10.2 million for dividend payments, and \$0.4 million received from exercised stock options. During the nine months ended September 30, 2001, the Company paid its debt outstanding and made distributions to holders of its common stock and O.P. units by utilizing cash generated from operating activities.

CAPITAL EXPENDITURES

The Company's existing R&D properties require periodic investments of capital for tenant-related capital expenditures and for general capital improvements. For the years ended December 31, 1995 through December 31, 2000, the recurring tenant improvement costs and leasing commissions incurred with respect to new leases and lease renewals of the properties that were owned or controlled by members of the Berg Group prior to July 1, 1998 averaged approximately \$1.75 million annually. The Company expects that the average annual cost of recurring tenant improvements and leasing commissions, related to the properties, will be approximately \$2.0 million during 2001. The Company believes it will recover substantially all of these sums from the tenants under new or renewed leases through increases in rental rates. The Company expects to meet its long-term liquidity requirements for the funding of property development, property acquisitions and other material non-recurring capital improvements through long-term secured and unsecured indebtedness and the issuance of additional equity securities by the Company.

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FUNDS FROM OPERATIONS

As defined by the National Association of Real Estate Investment Trusts ("NAREIT"), FFO represents net income (loss) before minority interest of unit holders (computed in accordance with GAAP), excluding gains (or losses) from debt restructuring and sales of property, plus real estate related depreciation and amortization (excluding amortization of deferred financing costs and depreciation of non-real estate assets) and after adjustments for unconsolidated partnerships and joint ventures. Management considers FFO an appropriate measure of performance of an equity REIT because, along with cash flows from operating activities, financing activities and investing activities, it provides investors with an understanding of the Company's ability to incur and service debt, and make capital expenditures. FFO should not be considered as an alternative for net income as a measure of profitability and it is not comparable to cash flows provided by operating activities determined in accordance with GAAP, nor is FFO necessarily indicative of funds available to meet the Company's cash needs, including its need to make cash distributions to satisfy REIT requirements.

The Company's definition of FFO also assumes conversion at the beginning of the period of all convertible securities, including minority interests that might be exchanged for common stock. FFO does not represent the amount available for management's discretionary use as such funds may be needed for capital replacement or expansion, debt service obligations or other commitments and uncertainties.

The minority interest in earnings for unrelated parties are deducted from total

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minority interest in earnings in calculating FFO.

Furthermore, FFO is not comparable to similarly entitled items reported by other REITs that do not define them exactly as the Company defines FFO. FFO for the three and nine months ended September 30, 2001 and 2000 are summarized in the tables below:

| | Three Months Ended September 30, | | Nine Months Ended |
|------------------------|----------------------------------|----------|-------------------|
| | 2001 | 2000 | 2001 |
| | (\$ in thousands) | | (\$ in thous |
| Net income | \$ 5,730 | \$ 3,357 | \$13,932 |
| Add: | | | |
| Minority interest (1) | 28,897 | 15,894 | 69,593 |
| Depreciation | 4,326 | 3,950 | 12,592 |
| Less: | | | |
| Gain on sale of assets | 8,452 | - | 11,553 |
| FFO | \$30,501 | \$23,201 | \$84,564 |

(1) The minority interest for unrelated parties was deducted from total minority interest in calculating FFO.

DISTRIBUTION POLICY

The Company intends to pay distributions to stockholders and O.P. unit holders based upon total Funds Available for Distribution ("FAD"), which is calculated as FFO less adjustment for straight-lined rent included in net income, leasing commissions paid and capital expenditures made during the respective period. The calculations of FAD for the three and nine months ended September 30, 2001 and 2000 are as follows:

| | Three Months Ended September 30, | | Nine Months Ended |
|----------------------|----------------------------------|----------|-------------------|
| | 2001 | 2000 | 2001 |
| | (\$ in thousands) | | (\$ in tho |
| FFO | \$30,501 | \$23,201 | \$84,564 |
| Less: | | | |
| Straight-line rents | 1,025 | 1,947 | 5,352 |
| Leasing commissions | 71 | 436 | 653 |
| Capital expenditures | 87 | 223 | 411 |
| FAD | \$29,318 | \$20,595 | \$78,148 |

The Company intends to make regular quarterly distributions to holders of common stock and O.P. units based on its FAD. The Company's ability to make such

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distributions will be affected by numerous factors, including, most

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importantly, the receipt of distributions from rental operations payable to the Company as the sole general partner of the operating partnerships.

FAD does not represent cash generated from operating activities in accordance with GAAP and is not necessarily indicative of cash available to fund cash needs. The actual return that the Company will realize and the amount available for distributions to its stockholders will be affected by a number of factors, including the revenues received from its properties, its operating expenses, the interest expense incurred on borrowings and planned and unanticipated capital expenditures.

The Company anticipates that FAD will exceed earnings and profits for federal income tax purposes, as the latter figure is reduced by non-cash expenses, such as depreciation and amortization, that the Company will incur. Distributions, other than capital gain distributions, by the Company to the extent of its current and accumulated earnings and profits for federal income tax purposes most likely will be taxable to U.S. stockholders as ordinary dividend income unless a stockholder is a tax-exempt entity. Distributions in excess of earnings and profits generally will be treated as a non-taxable reduction of the U.S. stockholder's basis in the common stock to the extent of such basis, and thereafter as a taxable gain. The percentage of such distributions in excess of earnings and profits, if any, may vary from period to period. The Company anticipates that 100% of the distributions to stockholders for the year ending December 31, 2001 will constitute taxable ordinary dividend income to its shareholders.

Distributions will be determined by the Company's board of directors and will depend on actual FAD, the Company's financial condition, capital requirements, the annual distribution requirements under the REIT provisions of the Code and such other factors as the board of directors deems relevant.

IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

The Company does not believe recently issued accounting standards will materially impact the Company's financial statements.

FORWARD-LOOKING INFORMATION

This quarterly report contains forward-looking statements within the meaning of the federal securities laws. The Company intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Reform Act of 1995, and is including this statement for purposes of complying with these safe harbor provisions. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies and expectations of the Company, are generally identifiable by use of the words "believe," "expect," "intend," "anticipate," "estimate," "project" or similar expressions. The Company's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations and future prospects of the Company include, but are not limited to, changes in: economic conditions generally and the real estate market specifically, legislative or regulatory provisions affecting the Company (including changes to laws governing the taxation of REITs), availability of capital, interest rates, competition, supply of and demand for R&D, office and industrial properties in the Company's current and proposed market areas, tenant defaults and

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bankruptcies, and general accounting principles, policies and guidelines applicable to REITs. In addition, the actual timing of development, construction, and leasing on the projects that the Company believes it may acquire in the future under the Berg land holdings option agreement is unknown presently, and reliance should not be placed on the estimates concerning these projects set forth under the caption, "Acquiring Properties Developed by the Berg Group," above. These risks and uncertainties, together with the other risks described from time to time in the Company's reports and other documents filed with the Securities and Exchange Commission, should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements.

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ITEM 3
QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

No material changes have occurred since the Annual Report on Form 10-K for the year ended December 31, 2000.

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PART II - OTHER INFORMATION

ITEM 6
EXHIBITS AND REPORTS ON FORM 8-K

- a. Exhibits
10.27 Revolving Credit - \$100,000,000 Secured Promissory Note
- b. Reports on Form 8-K
None

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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 thereto duly authorized.

Mission West Properties, Inc.
(Registrant)

Date: November 12, 2001

By: /s/ Wayne N. Pham

Wayne N. Pham
Vice President of Finance and Controller
(Principal Accounting Officer and Duly
Authorized Officer)

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EXHIBIT 10.27

REVOLVING CREDIT
SECURED PROMISSORY NOTE
("Note")

\$100,000,000.00

July 1, 2001

FOR VALUE RECEIVED, Mission West Properties, L.P., a Delaware limited partnership, Mission West Properties, L.P. I, a Delaware limited partnership, Mission West Properties L.P. II, a Delaware limited partnership, and Mission West Properties, L.P. III, a Delaware limited partnership (collectively "Borrower"), promises to pay to the order of Berg & Berg Enterprises, LLC, a California limited liability company ("Lender") or its assigns, at 10050 Bandle Drive, Cupertino, California 95014, or at such other place as the holder of this Note may from time to time designate, the principal sum of One Hundred Million Dollars (\$100,000,000.00) (the "Credit Amount") or so much of that sum as may be advanced under this Note from time to time by any holder, plus interest as computed herein.

Interest on the principal sum of this Note from time to time outstanding will be computed from the date of each advance of principal at LIBOR plus 1.30% (the "Applicable Interest Rate"). Interest will be computed on the basis of a three hundred sixty (360) day year and the actual number of days elapsed, which will result in the payment of more interest than if a 365-day year were used.

All accrued and unpaid principal and interest shall be due and payable no later than July 1, 2002.

Advances under this Note may be drawn by Borrower, up to the Credit Amount, upon not less than 5 days notice to Lender.

Each payment shall be credited first on the interest then due and the remainder on the principal sum.

The undersigned agrees that the holder of this Note may, without notice to the undersigned and without affecting the liability of the undersigned, accept additional or substitute security for this Note, or release any security or any party liable for this Note, or extend or renew this Note.

If the undersigned consists of more than one person or entity, their liability and obligations under this Note will be joint and several. Borrower jointly and severally waives diligence, presentment, protest and demand, notice of protest, dishonor and non-payment of this Note, expressly agrees that this Note or any payment hereunder, may be extended from time to time, and consents to the acceptance of further security for this Note, including other types of security, all without in any way affecting the liability of the Borrower. The right to plead any and all statutes of limitations as a defense to any demand on this Note, or on any guaranty hereof, or to any agreement to pay the same, or to any demand secured by the Deed of Trust, or other security, securing this Note, against Borrower, the holder of any property encumbered by the Deed of Trust or other instrument securing this Note, and any guarantors or sureties, is expressly waived by each and all said parties.

All amounts payable under this Note are payable in lawful money of the United

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States, free from any offset, deduction or counterclaim. Checks will constitute payment only when collected.

Upon any default in the payment of any amounts due under this Note or upon any default under the Deed of Trust, the holder may, at its option and upon ten (10) days' written notice to the undersigned, declare the entire unpaid principal sum of this Note together with all accrued interest to be due and payable provided, however, that if the undersigned should cure such default under this Note or the Deed of Trust within the time period described above, the right of the holder to declare the entire unpaid principal sum of this Note together with all accrued interest immediately due and payable shall terminate as to such default as if no such default occurred.

The undersigned agrees to pay all costs of collection when incurred, including but not limited to reasonable attorneys' fees. If any suit or action is instituted to enforce this Note, the undersigned promises to pay, in addition to the costs and disbursements otherwise allowed by law, such sum as the court may adjudge as reasonable attorneys' fees in such suit or action.

This Note may be prepaid in whole or in part at any time without penalty. Until the maturity date, including all extensions thereof, amounts repaid may be subsequently advanced under this Note, up to the Credit Amount.

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This Note will be governed by the laws of the State of California.

This Note is a non-recourse loan secured by a Deed of Trust and Assignment of Rents (the "Deed of Trust") executed by the undersigned in favor of Lender and covering real property located in San Jose, California. The Deed of Trust contains provisions for the acceleration of the maturity of this Note.

Mission West Properties, L.P.,
Mission West Properties, L.P. I,
Mission West Properties, L.P. II, and
Mission West Properties, L.P. III

By: Mission West Properties, Inc., their general partner

/s/ Wayne N. Pham

By: Wayne N. Pham, VP of Finance & Controller

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