ASSOCIATED ESTATES REALTY CORP
Form 10-Q
August 03, 2010

**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, 2010**

**OR**

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

**For the transition period from ____________ to ______**

**Commission File Number 1-12486**

**Associated Estates Realty Corporation**
*(Exact name of registrant as specified in its charter)*

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

**1 AEC Parkway, Richmond Hts., Ohio 44143-1467**
*(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 (subsection 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes [ ] No [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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 [ ] Accelerated filer [x] 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 shares outstanding as of July 30, 2010 was 32,119,426 shares.

**ASSOCIATED ESTATES REALTY CORPORATION**

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**PART 1. FINANCIAL INFORMATION**
**ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS**

**ASSOCIATED ESTATES REALTY CORPORATION**
**CONSOLIDATED BALANCE SHEETS**
**(UNAUDITED)**

| *(In thousands, except share amounts)* | June 30, | December 31, |
|---|---|---|
| **ASSETS** | 2010 | 2009 |
| Real estate assets | | |
| Land | $ 122,127 | $ 107,815 |
| Buildings and improvements | 846,967 | 798,321 |
| Furniture and fixtures | 30,847 | 29,710 |
| | 999,941 | 935,846 |
| Less: accumulated depreciation | (318,159) | (302,108) |
| | 681,782 | 633,738 |
| Construction in progress | 661 | 4,797 |
| Real estate, net | 682,443 | 638,535 |
| Cash and cash equivalents | 6,127 | 3,600 |
| Restricted cash | 7,868 | 7,093 |
| Accounts and notes receivable, net | | |
| Rents | 1,164 | 1,115 |
| Affiliates | 91 | 135 |
| Other | 2,349 | 1,910 |
| Goodwill | 1,725 | 1,725 |
| Other assets, net | 7,621 | 8,392 |
| **Total assets** | $ 709,388 | $ 662,505 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Mortgage notes payable | $ 428,716 | $ 487,556 |
| Unsecured revolving credit facility | 35,000 | 12,500 |
| Unsecured debt | - | 25,780 |
| Total debt | 463,716 | 525,836 |
| Accounts payable, accrued expenses and other liabilities | 21,233 | 27,307 |
| Dividends payable | 5,539 | 2,849 |
| Resident security deposits | 3,047 | 2,956 |
| Accrued interest | 2,108 | 2,288 |
| **Total liabilities** | 495,643 | 561,236 |
| Noncontrolling redeemable interest | 1,734 | 1,829 |
| Shareholders' equity | | |
| Preferred shares, without par value; 9,000,000 shares authorized; 8.70% Class B Series II cumulative redeemable, $250 per share liquidation preference, 232,000 issued and 193,050 outstanding at December 31, 2009 | - | 48,263 |

| | | |
|---|---|---|
| Common shares, without par value, $.10 stated value; 91,000,000 authorized; 37,370,763 issued and 32,120,206 outstanding at June 30, 2010 and 41,000,000 authorized; 22,995,763 issued and 16,675,826 outstanding at December 31, 2009 | 3,737 | 2,300 |
| Paid-in capital | 455,104 | 283,090 |
| Accumulated distributions in excess of accumulated net income | (187,633) | (168,822) |
| Accumulated other comprehensive loss | (296) | (1,420) |
| Less: Treasury shares, at cost, 5,250,557 and 6,319,937 shares at June 30, 2010 and December 31, 2009, respectively | (58,901) | (63,971) |
| **Total shareholders' equity** | 212,011 | 99,440 |
| **Total liabilities and shareholders' equity** | $ 709,388 | $ 662,505 |

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

**ASSOCIATED ESTATES REALTY CORPORATION**
**CONSOLIDATED STATEMENTS OF OPERATIONS**
**(UNAUDITED)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| *(In thousands, except per share amounts)* | 2010 | 2009 | 2010 | 2009 |
| **Revenue** | | | | |
| Property revenue | $32,962 | $32,138 | $64,607 | $63,962 |
| Management and service company revenue: | | | | |
| Fees, reimbursements and other | 290 | 357 | 498 | 825 |
| Construction and other services | 1,628 | 253 | 2,731 | 350 |
| Total revenue | 34,880 | 32,748 | 67,836 | 65,137 |
| **Expenses** | | | | |
| Property operating and maintenance | 14,262 | 13,812 | 28,186 | 27,566 |
| Depreciation and amortization | 8,971 | 8,587 | 17,591 | 17,795 |
| Direct property management and service company expense | 277 | 348 | 409 | 708 |
| Construction and other services | 1,885 | 322 | 3,301 | 535 |
| General and administrative | 3,692 | 3,165 | 7,397 | 6,304 |
| Costs associated with acquisitions | 61 | - | 61 | - |
| Total expenses | 29,148 | 26,234 | 56,945 | 52,908 |
| Operating income | 5,732 | 6,514 | 10,891 | 12,229 |
| Interest income | 11 | 18 | 20 | 33 |
| Interest expense | (8,304) | (8,736) | (16,365) | (16,919) |
| (Loss) income before gain on insurance recoveries and income from discontinued operations | (2,561) | (2,204) | (5,454) | (4,657) |
| Gain on insurance recoveries | - | 544 | - | 544 |
| (Loss) income from continuing operations | (2,561) | (1,660) | (5,454) | (4,113) |
| Income from discontinued operations: | | | | |
| Operating income | - | 267 | - | 569 |
| Gain on disposition of properties | - | 13,135 | - | 15,413 |
| Income from discontinued operations | - | 13,402 | - | 15,982 |
| **Net (loss) income** | (2,561) | 11,742 | (5,454) | 11,869 |
| Net income attributable to noncontrolling redeemable interest | (13) | (14) | (26) | (27) |
| **Net (loss) income attributable to AERC** | (2,574) | 11,728 | (5,480) | 11,842 |
| Preferred share dividends | (980) | (1,049) | (2,030) | (2,100) |
| Preferred share redemption costs | (993) | - | (993) | - |
| Allocation to participating securities | - | (429) | - | (482) |
| **Net (loss) income applicable to common shares** | $(4,547) | $10,250 | $(8,503) | $9,260 |
| | | | | |
| **Earnings per common share - basic and diluted:** | | | | |
| (Loss) income from continuing operations applicable to common shares | $(0.17) | $(0.16) | $(0.35) | $(0.38) |

| | | | | |
|---|---|---|---|---|
| Income from discontinued operations | - | 0.78 | - | 0.94 |
| Net (loss) income applicable to common shares | $(0.17) | $0.62 | $(0.35) | $0.56 |
| | | | | |
| **Weighted average number of common shares outstanding - basic and diluted** | 27,433 | 16,528 | 24,316 | 16,481 |

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

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

| | Six Months Ended June 30, | |
|---|---|---|
| *(In thousands)* | 2010 | 2009 |
| **Cash flow from operations:** | | |
| Net (loss) income | $ (5,454) | $ 11,869 |
| Adjustments to reconcile net (loss) income to net cash provided by operations: | | |
| Depreciation and amortization (including discontinued operations) | 17,591 | 18,269 |
| Loss on fixed asset replacements write-off | 13 | 5 |
| Gain on disposition of properties | - | (15,413) |
| Gain on insurance recoveries | - | (544) |
| Amortization of deferred financing costs and other | 697 | 624 |
| Write-off of unamortized debt procurement costs | 727 | - |
| Share-based compensation | 1,502 | 1,049 |
| Net change in assets and liabilities: | | |
| Accounts and notes receivable | (476) | 408 |
| Accounts payable and accrued expenses | (3,183) | (974) |
| Other operating assets and liabilities | 622 | 1,011 |
| Restricted cash | (775) | (989) |
| Total adjustments | 16,718 | 3,446 |
| Net cash flow provided by operations | 11,264 | 15,315 |
| **Cash flow from investing activities:** | | |
| Recurring fixed asset additions | (3,595) | (3,872) |
| Revenue enhancing/non-recurring fixed asset additions | (2,930) | (691) |
| Acquisition/development fixed asset additions | (56,769) | (1,514) |
| Net proceeds from disposition of operating properties | - | 32,714 |
| Other investing activity | 33 | - |
| Net cash flow (used for) provided by investing activities | (63,261) | 26,637 |
| **Cash flow from financing activities:** | | |
| Principal amortization payments on mortgage notes payable | (1,572) | (1,421) |
| Principal repayments of mortgage notes payable | (57,268) | (72,096) |
| Payment of debt procurement costs | - | (686) |
| Proceeds from mortgage notes obtained | - | 52,450 |
| Revolving credit facility borrowings | 73,500 | 95,400 |
| Revolving credit facility repayments | (51,000) | (106,900) |
| Principal repayments of unsecured trust preferred securities | (25,780) | - |
| Common share dividends paid | (6,523) | (5,625) |
| Preferred share dividends paid | (2,029) | (2,100) |
| Operating partnership distributions paid | (26) | (27) |
| Purchase of operating partnership units | (59) | - |
| Exercise of stock options | 4,570 | - |
| Issuance of common shares | 169,568 | - |

| | | |
|---|---|---|
| Purchase of treasury shares | (594) | (177) |
| Redemption of preferred shares | (48,263) | - |
| Net cash flow provided by (used for) financing activities | 54,524 | (41,182) |
| Increase in cash and cash equivalents | 2,527 | 770 |
| Cash and cash equivalents, beginning of period | 3,600 | 3,551 |
| **Cash and cash equivalents, end of period** | $ 6,127 | $ 4,321 |
| | | |
| Supplemental disclosure of cash flow information: | | |
| Dividends declared but not paid | $ 5,539 | $ 2,979 |
| Cash paid for interest, net of capitalized interest | 15,546 | 16,544 |
| Net change in accounts payable related to fixed asset additions | (584) | (287) |
| Reclassification of deferred directors' compensation | 2,233 | - |

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

**ASSOCIATED ESTATES REALTY CORPORATION**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**UNAUDITED**

## 1. BASIS OF PRESENTATION AND ACCOUNTING POLICIES

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

### Business

We are a fully-integrated, self-administered and self-managed equity real estate investment trust ("REIT") specializing in multifamily ownership, operation, acquisition, development, construction, disposition, property management and advisory activities. Our primary source of income is rental revenue. Additional income is derived primarily from construction and other services.

As of June 30, 2010, our property portfolio consisted of: (i) 49 apartment communities containing 12,472 units in seven states that are wholly owned, either directly or indirectly through subsidiaries; (ii) one apartment community that we manage for a third party owner consisting of 258 units; and (iii) a 186-unit apartment community and a commercial property containing approximately 145,000 square feet that we asset manage for a government sponsored pension fund.

### 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. 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, 2009.

### Segment Reporting

All of our owned properties are multifamily communities that have similar economic characteristics. Management evaluates the performance of our properties on an individual basis. Our multifamily properties provided approximately 95.2% of our consolidated revenue for the six months ended June 30, 2010; we have only one reportable segment, which is multifamily properties.

### Share-Based Compensation

During the three and six months ended June 30, 2010, we recognized total share-based compensation cost of $624,000 and $1.5 million, respectively, in "General and administrative expense" in the Consolidated Statements of Operations. During the three and six months ended June 30, 2009, we recognized total share based compensation cost of $450,000 and $1.0 million, respectively, in General and administrative expense. A portion of this increase is due to a change in the Directors' Deferred Compensation Plan, which now will be paid with common shares instead of cash (see Note 10 for additional information regarding the Directors' Deferred Compensation Plan).

*Stock Options.* During the six months ended June 30, 2010, there were no stock options awarded and 563,300 options exercised. During the six months ended June 30, 2009, there were 8,000 stock options awarded and no stock options were exercised. We use the Black-Scholes option pricing model to estimate the fair value of share-based awards. The weighted average Black-Scholes assumptions and fair value for options awarded during the six months ended June 30, 2009, were as follows:

| | |
|---|---|
| Expected volatility | 36.5% |
| Risk-free interest rate | 2.0% |
| Expected life of options (in years) | 7.2 |
| Dividend yield | 12.2% |
| Grant-date fair value | $ 0.44 |

The expected volatility was based upon the historical volatility of our weekly share closing prices over a period equal to the expected life of the options granted. The risk-free interest rate used was the yield from U.S. Treasury bonds on the date of grant with a maturity approximating the expected life of the options. The expected life of the options was derived using our historical experience for similar awards. The dividend yield was derived using our annual dividend rate as a percentage of the price of our shares on the date of grant.

*Restricted Shares.* The following table represents restricted share activity for the six months ended June 30, 2010:

| | Number of Shares | Weighted Average Grant-Date Fair Value |
|---|---|---|
| Nonvested at beginning of period | 184,339 | $ 7.15 |
| Granted | 557,975 | $ 7.53 |
| Vested | 146,383 | $ 8.01 |
| Forfeited | 3,050 | $ 8.60 |
| Nonvested at end of period | 592,881 | $ 6.85 |

At June 30, 2010, there was $3.4 million of unrecognized compensation cost related to non-vested restricted share awards that we expect to recognize over a weighted average period of 2.3 years.

A portion of the restricted shares granted during 2010 were awards in which the number of shares that will ultimately vest are subject to satisfaction of certain market conditions, which include total shareholder return on an absolute basis and on a relative basis against a peer group consisting of other multifamily apartment companies. The total estimated grant-date fair value of these awards was $1.1 million. We used the Monte Carlo method to estimate the fair value of these awards. The Monte Carlo method, which is similar to the binomial analysis, evaluates the award for changing stock prices over the term of vesting and uses random situations that are averaged based on past stock characteristics.

There were one million simulation paths used to estimate the fair value of these awards. The risk-free interest rate used was based on a yield curve derived from U.S. Treasury zero-coupon bonds on the date of grant with a maturity equal to the market condition performance periods. The expected life used was the market condition performance period. The expected volatility used for AERC was based upon the historical volatility of our daily share closing prices over a period equal to the market condition performance periods. The expected volatility used for the peer group was a 50%/50% blend of historical volatility and implied volatility. Implied volatility was calculated using each company's stock call option contracts.

The following represents the assumption ranges used in the Monte Carlo method during 2010:

| | |
|---|---|
| Expected volatility - AERC | 39.5% to 63.1% |
| Expected volatility - peer group | 29.0% to 65.4% |
| Risk-free interest rate | 0.1% to 1.5% |
| Expected life (performance period) | 3 years |

**Derivative Instruments and Hedging Activities**

We record all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives used to hedge the exposure to changes in the fair value of an asset, liability or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives used to hedge the exposure to variability in expected future cash flows or other types of forecasted transactions are considered cash flow hedges.

For derivatives designated as fair value hedges, changes in the fair value of the derivative and the hedged item related to the hedged risk are recognized in earnings. For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of the derivative is initially reported in other comprehensive income (outside of earnings) and subsequently reclassified to earnings when the hedged transaction affects earnings, and the ineffective portion of changes in the fair value of the derivative is recognized directly in earnings. Hedge ineffectiveness is measured by comparing the changes in fair value or cash flows of the derivative hedging instrument with the changes in fair value or cash flows of the designated hedged item or transaction. For derivatives not designated as hedges, changes in fair value are recognized in earnings.

We do not use derivatives for trading or speculative purposes. Further, we have a policy of only entering into contracts with major financial institutions based upon their credit ratings and other factors. When viewed in conjunction with the underlying and offsetting exposure that the derivatives are designed to hedge, we have not sustained a material loss from these hedges.

We have utilized interest rate swaps and caps to add stability to interest expense and to manage our exposure to interest rate movements. Interest rate swaps designated as cash flow hedges involve the receipt of variable-rate amounts in exchange for fixed-rate payments over the life of the agreements without exchange of the underlying principal amount. Interest rate caps designated as cash flow hedges involve the receipt of variable-rate amounts if interest rates rise above a certain level in exchange for an up front premium.

Interest Rate Hedge Activity: During 2007, we executed two interest rate swaps to hedge the cash flows of two existing variable rate loans. In January 2010, we prepaid one of these loans but we did not terminate the corresponding interest rate swap and as a result reclassified the fair value of the related interest rate swap of $777,000 from other comprehensive income to earnings during the three months ended March 31, 2010. The change in fair value of this derivative is recorded in earnings and the net effect of the reclassification and the change in fair value at March 31, 2010 resulted in a net reduction to earnings of $320,000. No hedge ineffectiveness on the remaining cash flow hedge was recognized during the six months ended June 30, 2010. Amounts reported in "Accumulated other comprehensive loss" related to the cash flow hedge will be reclassified to "Interest expense" as interest payments are made on the related variable-rate loan. During the next twelve months, we estimate that approximately $296,000 will be reclassified from "Accumulated other comprehensive loss" as an increase to "Interest expense." The following table presents the notional amounts of the swaps as of June 30, 2010:

| *(Dollar amount in thousands)* | Number of | Notional |
|---|---|---|
| Interest Rate Derivative | Instruments | Amounts |
| Interest rate swaps | 1 | $21,000 |

The following table presents the fair value of our derivative financial instruments as well as their classification on the Consolidated Balance Sheets (see Note 8 for additional information regarding the fair value of these derivative instruments):

Fair Value of Derivative Instruments

| | Liability Derivatives As of June 30, 2010 | | As of December 31, 2009 | |
|---|---|---|---|---|
| *(In thousands)* | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Derivatives designated as hedging instruments: | | | | |
| Interest rate swaps | Accounts payable, accrued expenses and other liabilities | $ 296 | Accounts payable, accrued expenses and other liabilities | $ 1,420 |

The following tables present the effect of our derivative financial instruments on the Consolidated Statements of Operations (see Note 5 for additional information regarding the effect of these derivative instruments on total comprehensive income):

The Effect of Derivative Instruments on the Consolidated Statements of Operations

| *(In thousands)* Derivatives in Cash Flow Hedging Relationships | Amount of Gain or (Loss) Recognized in OCI on Derivative (Effective Portion) Three Months Ended June 30, 2010 | Six Months Ended June 30, 2010 | Location of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) | Amount of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) Three Months Ended June 30, 2010 | Six Months Ended June 30, 2010 | Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing | Amount of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing Three Months Ended June 30, 2010 | Six Months Ended June 30, 2010 |
|---|---|---|---|---|---|---|---|---|
| Interest rate swaps | $(15) | $(38) | Interest expense | $(191) | $(384) | Interest expense | $- | $(777) |

The Effect of Derivative Instruments on the Consolidated Statements of Operations

Amount

| *(In thousands)* Derivatives in Cash Flow Hedging Relationships | Amount of Gain or (Loss) Recognized in OCI on Derivative (Effective Portion) Three Months Ended June 30, 2009 | Six Months Ended June 30, 2009 | Location of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) | Amount of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) Three Months Ended June 30, 2009 | Six Months Ended June 30, 2009 | Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing | of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing Three Months Ended June 30, 2009 | Six Months Ended June 30, 2009 |
|---|---|---|---|---|---|---|---|---|
| Interest rate swaps | $ (487) | $ (215) | Interest expense | $ 546 | $ 964 | Interest expense | $ - | $ - |

We have an agreement with our derivative counterparty that contains a provision where if we either default or are capable of being declared in default on any of our indebtedness, then such counterparty can declare us to be in default on our derivative obligations.

We have an agreement with a derivative counterparty that incorporates the loan covenant provisions of our indebtedness with a lender affiliate of the derivative counterparty. Failure to comply with the loan covenant provisions would result in our being in default on any derivative instrument obligations covered by the agreement.

As of June 30, 2010, the fair value of derivatives in a net liability position, which includes accrued interest but excludes any adjustment for nonperformance risk, related to these agreements was $357,000. As of June 30, 2010, we have not posted any collateral related to these agreements. If we had breached any of these provisions at June 30, 2010, we would have been required to settle our obligations under the agreements at their termination value of $357,000.

**Classification of Fixed Asset Additions**

We define recurring fixed asset additions to a property to be capital expenditures made to replace worn out assets to maintain the property's value. Revenue enhancing/non-recurring fixed asset additions are defined as capital expenditures that increase the value of the property and/or enable us to increase rents. Acquisition/development fixed asset additions are defined as capital expenditures for the purchase or construction of new properties to be added to our portfolio, or fixed asset additions identified at the time of purchase that are not made until subsequent periods.

**2. ACQUISITION, DEVELOPMENT AND DISPOSITION ACTIVITY**

**Acquisition Activity**

On May 18, 2010, we acquired Riverside Station, a 304-unit apartment community located in Woodbridge, Virginia for a purchase price of $54.6 million. We paid cash for this acquisition, a portion of which was funded with proceeds from our May 12, 2010 equity offering. We determined that the fair value of the property was the same as the purchase price.

During the three months and six months ended June 30, 2010 we recorded $626,000 of property revenue and reported net income of $64,000. In connection with this acquisition we incurred $61,000 of costs, which are included in the Consolidated Statements of Operation under expenses on its own line item titled Costs associated with acquisitions.

The following pro forma financial information is presented as if the 2010 acquisition had occurred at the beginning of each period presented. This information is presented for informational purposes only and is not necessarily indicative of what the Company s actual results of operations would have been had the acquisition occurred at such times:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, | | June 30, | |
| *(Unaudited; in thousands, except per share data)* | 2010 | 2009 | 2010 | 2009 |

| | | | | |
|---|---|---|---|---|
| Pro forma revenue | $ 35,506 | $ 33,988 | $ 69,801 | $ 67,714 |
| Pro forma net (loss) income applicable to common shares | (4,483) | 9,966 | (8,315) | 9,129 |
| | | | | |
| Earnings per common share - basic and diluted: | | | | |
| Proforma net (loss) income applicable to common shares | $ (0.16) | $ 0.60 | $ (0.34) | $ 0.55 |

The purchase price allocation for the property acquired on May 18, 2010 was as follows:

| *(In thousands)* | |
|---|---|
| Land | $ 13,680 |
| Buildings and improvements | 38,695 |
| Furniture and fixtures | 442 |
| Existing leases and tenant relationships (Other assets) (1) | 1,733 |
| | $ 54,550 |

| | |
|---|---|
| (1) | See Note 4 for additional information related to intangible assets identified as existing leases and tenant relationships. |

**Development Activity**

On June 30, 2010 we placed in service, a 60-unit expansion of the existing 240-unit River Forest apartment community located in the Richmond, Virginia metropolitan market area. Total cost of development was approximately $6.8 million, which included $311,000 of capitalized interest.

**Construction Activity**

Our subsidiary, Merit Enterprises, Inc., ( Merit ) is engaged as a general contractor and construction manager that acts as our in-house construction division and also provides general contracting and construction management services to third parties. Merit concentrates its efforts on rehabilitation and ground-up construction projects. We account for construction contracts using the percentage-of-completion method. We compute the percentage of completion for each project as the ratio of costs incurred (excluding costs that do not represent progress as of the end of the reporting period, such as certain material purchases) to total estimated costs based on the most recent information. This percentage is applied to the revenue expected to be received by each project. Any change in estimates are recognized in the period in which they are known on a prospective basis. We recognized $1.6 million and $2.7 million in revenue and $1.5 million and $2.5 million in expense under this method during the three and six months ended June 30, 2010, respectively. The remaining costs included in construction and other services expenses include overhead costs, such as payroll and other fixed costs related to Merit. The total costs incurred in excess of amounts recognized as expense are included in "Other assets, net," and totaled $48,000 and $72,000 at June 30, 2010 and December 31, 2009, respectively. Funds received on uncompleted contracts in excess of revenue recognized, if any, are included in "Accounts payable, accrued expenses and other liabilities," and were immaterial at June 30, 2010 and December 31, 2009.

**Disposition Activity**

We report the results of operations and gain/loss related to the sale of real estate assets as discontinued operations. Real estate assets that are classified as held for sale are also reported as discontinued operations. We classify properties as held for sale when all significant contingencies surrounding the closing have been resolved. In most transactions, these contingencies are not satisfied until the actual closing of the transaction. Interest expense included in discontinued operations is limited to interest on mortgage debt specifically associated with properties sold or classified as held for sale.

"Income from discontinued operations" in the accompanying Consolidated Statements of Operations for the three and six months ended June 30, 2010 and 2009, includes the operating results for the properties sold in 2009, as well as the gains recognized on properties sold during each reporting period.  The following table summarizes "Income from discontinued operations:"

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| *(In thousands)* | 2010 | 2009 | 2010 | 2009 |
| **REVENUE** | | | | |
| Property revenue | $ - | $ 925 | $ - | $ 2,021 |
| | | | | |
| **EXPENSES** | | | | |
| Property operating and maintenance | - | 442 | - | 948 |
| Depreciation and amortization | - | 216 | - | 474 |
| Total expenses | - | 658 | - | 1,422 |
| Operating income | - | 267 | - | 599 |
| Interest expense | - | - | - | (30) |
| Gain on disposition of properties | - | 13,135 | - | 15,413 |
| **Income from discontinued operations** | $ - | $ 13,402 | $ - | $ 15,982 |

## 3. DEBT

The following table identifies our total debt outstanding and weighted average interest rates:

| | June 30, 2010 | | December 31, 2009 | |
|---|---|---|---|---|
| *(Dollar amounts in thousands)* | Balance Outstanding | Weighted Average Interest Rate | Balance Outstanding | Weighted Average Interest Rate |
| | | | | |
| **FIXED RATE DEBT** | | | | |
| Mortgages payable - CMBS | $ 99,191 | 7.7% | $ 115,464 | 7.7% |
| Mortgages payable - other [(1)] | 294,947 | 5.8% | 337,241 | 5.8% |
| Unsecured borrowings | - | - | 25,780 | 7.9% |
| **Total fixed rate debt** | 394,138 | 6.3% | 478,485 | 6.4% |
| | | | | |
| **VARIABLE RATE DEBT** | | | | |
| Mortgages payable | 34,578 | 4.8% | 34,851 | 4.7% |
| Unsecured revolving credit facility | 35,000 | 1.8% | 12,500 | 2.6% |
| **Total variable rate debt** | 69,578 | 3.3% | 47,351 | 4.1% |
| **Total debt** | $ 463,716 | 5.8% | $ 525,836 | 6.2% |

| | |
|---|---|
| (1) | Includes $21.0 million of variable rate debt swapped to fixed as of June 30, 2010 and $63.0 million of variable rate debt |
| | swapped to fixed as of December 31, 2009. |

**Mortgage Notes Payable**

The following table provides information on mortgage loans repaid during 2010:

| *(Dollar amounts in thousands)* Property | Loans Repaid Amount | | Interest Rate |
|---|---|---|---|
| Idlewylde | $ | 42,000 | 5.9% |
| Sterling Park | 2,910 | | 7.9% |
| Kensington Grove | 3,172 | | 7.9% |
| Spring Brook | 4,351 | | 7.9% |
| Western Reserve | 4,835 | | 7.9% |
| Total / weighted average rate | $ | 57,268 | 6.4% |

During 2008, 2007 and 2006, we defeased 21 CMBS loans. These loans were defeased pursuant to the terms of the underlying loan documents. In accordance with GAAP, we removed those financial assets and the mortgage loans from our financial records. All risk of loss associated with these defeasances have been transferred from us to the successor borrower and any ongoing relationship between the successor borrower and us was deemed inconsequential at the time of completion of the respective transfers. However, we subsequently learned that for certain defeasance transactions completed prior to June 2007, the successor borrower may be able to prepay the loans thus enabling us to receive a refund of a portion of the costs incurred in connection with the transaction. We received defeasance refunds of $553,000 and $563,000 for the six months ended June 30, 2010 and 2009, respectively, which were included as a reduction to interest expense. It is possible that we may receive additional refunds in the future, however such amounts cannot be estimated due to the uncertainty of future payments, and we believe that any amounts we may receive would not be material to our consolidated financial position, cash flow or results of operations.

Cash paid for interest, excluding $192,000 of capitalized interest, was $15.5 million and $16.5 million for the six months ended June 30, 2010 and 2009, respectively. Included in cash paid for interest are the defeasance refunds received of $553,000 and $563,000 for the six months ended June 30, 2010 and 2009, respectively, as discussed above. Additionally excluded in the cash paid for interest is a one-time non cash charge to interest expense of $727,000 related to the redemption of the 7.92% Trust Preferred Securities for the six months ended June 30, 2010, as discussed below.

**Unsecured Debt**

On June 30, 2010, the Company redeemed all of its 7.92% Trust Preferred Securities at a cost of $26.3 million, which included accrued and unpaid interest up to but excluding the redemption date. In connection with the issuance of the 7.92% Trust Preferred Securities in March 2005, the Company incurred issuance costs that were recorded as other assets and subsequently charged to interest expense each period over the life of the securities. In accordance with GAAP, the Company recognized the remaining balance of $727,000 of issuance costs as a one-time non cash charge to interest expense for the three and six months ended June 30, 2010.

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## 4. GOODWILL AND OTHER INTANGIBLE ASSETS

**Goodwill**

In June 1998, we recorded goodwill in connection with the MIG Realty Advisors, Inc. merger. We have a policy of completing our annual review of goodwill during the first quarter of each year and more frequently if events or changes in circumstances indicate that the carrying value may not be recoverable. The review that was completed during the three months ended March 31, 2010 determined that goodwill was not impaired and no other events have occurred which would require that goodwill be reevaluated, as such there were no changes to the carrying value of goodwill as of June 30, 2010. In performing this analysis, we use a multiple of revenues to the range of potential alternatives and assign a probability of the various alternatives under consideration by management. Should the estimates used to determine alternatives or the probabilities of the occurrence thereof change, impairment may result which could materially impact our results of operations for the period in which it is recorded.

**Intangible Assets**

We allocate a portion of the total purchase price of a property acquisition to any intangible assets identified, such as existing leases and tenant relationships. The intangible assets are amortized over the remaining lease terms or estimated life of the tenant relationship, which is approximately 12 to 16 months. Due to the short term nature of residential leases, we believe that existing lease rates approximate market rates; therefore, no allocation is made for above/below market leases.

In connection with our property acquisition completed on May 18, 2010, as discussed in Note 2, we recorded total intangible assets in the amount of $1.4 million related to existing leases, which are being amortized over 12 months, and $300,000 related to tenant relationships, which are being amortized over 16 months.

## 5. SHAREHOLDERS' EQUITY

The following table provides a reconciliation of activity in Shareholders' equity accounts:

| | Six Months Ended June 30, 2010 | | | | |
|---|---|---|---|---|---|
| *(In thousands)* | Common Shares (at $.10 stated value) | Paid-In Capital | Accumulated Distributions In Excess of Accumulated Net Income | Accumulated Other Comprehensive Income | Treasury Shares (at Cost) |
| Balance, December 31, 2009 | $2,300 | $283,090 | $(168,822) | $(1,420) | $(63,971) |
| Total comprehensive (loss) income | - | - | (5,480) | 1,124 | - |
| Share-based compensation | - | 858 | 4 | - | 1,095 |

| | | | | | |
|---|---|---|---|---|---|
| Reclassification of deferred directors' compensation | - | 2,233 | - | - | - |
| Purchase of common shares | - | - | - | - | (594) |
| Issuance of common shares | 1,437 | 167,614 | - | - | - |
| Option exercises from treasury shares | - | 316 | - | - | 4,569 |
| Redemption of class B cumulative redeemable preferred shares | - | 993 | (993) | - | - |
| Common share dividends declared | - | - | (10,312) | - | - |
| Preferred share dividends declared | - | - | (2,030) | - | - |
| Balance, June 30, 2010 | $3,737 | $455,104 | $(187,633) | $(296) | $(58,901) |

The following table identifies total comprehensive (loss) income:

| | Six Months Ended June 30, | |
|---|---|---|
| *(In thousands)* | 2010 | 2009 |
| Comprehensive (loss) income: | | |
| Net (loss) income attributable to AERC | $ (5,480) | $ 11,842 |
| Other comprehensive income: | | |
| Change in fair value and reclassification of hedge instruments | 1,124 | 749 |
| Total comprehensive (loss) income | $ (4,356) | $ 12,591 |

## 6. COMMON AND PREFERRED SHARES

**Common Shares**

On January 15, 2010, we sold 5,175,000 of our common shares in a public offering at a price of $11.10 per share, which resulted in total net proceeds of approximately $54.9 million.

On May 12, 2010, we sold 9,200,000 common shares in a public offering at a price of $13.00 per share, which resulted in total net proceeds of approximately $114.3 million.

**Preferred Shares**

On June 7, 2010, the Company redeemed all of its 8.70% Class B Series II Cumulative Redeemable Preferred Shares at a cost of approximately $48.3 million, plus accrued and unpaid dividends through the redemption date. In connection with the issuance of the 8.70% Class B preferred shares in December 2004, the Company incurred approximately $1.0 million in issuance costs and recorded such costs as a reduction to shareholders equity. In accordance with GAAP, the Company recognized the $1.0 million of issuance costs as a reduction in net earnings to arrive at net (loss) income applicable to common shares for the three and six months ended June 30, 2010.

## 7. EARNINGS PER SHARE

There were approximately 800,000 and 1.4 million options to purchase common shares outstanding at June 30, 2010 and 2009, respectively. The dilutive effect of these options were not included in the calculation of diluted earnings per share for the periods presented as their inclusion would be anti-dilutive to the net loss applicable to common shares from continuing operations.

The exchange of operating partnership non-controlling interests into common shares was also not included in the computation of diluted EPS because we intend to settle these OP units in cash.

The following table presents a reconciliation of basic and diluted earnings per common share:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, | | June 30, | |
| *(In thousands)* | 2010 | 2009 | 2010 | 2009 |
| **Numerator - basic and diluted:** | | | | |
| (Loss) income from continuing operations | $(2,561) | $(1,660) | $(5,454) | $(4,113) |
| Net income attributable to noncontrolling redeemable interest | (13) | (14) | (26) | (27) |
| Preferred share dividends | (980) | (1,049) | (2,030) | (2,100) |
| Preferred share redemption costs | (993) | - | (993) | - |
| (Loss) income from continuing operations applicable to common shares | $(4,547) | $(2,723) | $ | |