

ASSOCIATED ESTATES REALTY CORP

Form 10-Q

May 01, 2007

**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 March 31, 2007

**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**

(State or other jurisdiction of  
incorporation or organization)

**34-1747603**

(I.R.S. Employer  
Identification Number)

**1 AEC Parkway, Richmond Hts., Ohio**

(Address of principal executive offices)

**44143-1467**

(Zip Code)

Registrant's telephone number, including area code **(216) 261-5000**

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company

(as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares outstanding as of April 27, 2007 was 17,495,548 shares

**ASSOCIATED ESTATES REALTY CORPORATION**

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*Index***PART I. FINANCIAL INFORMATION****ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)****ASSOCIATED ESTATES REALTY CORPORATION****CONSOLIDATED BALANCE SHEETS****(UNAUDITED)**

| (In thousands, except share and per share amounts) | March 31,<br><u>2007</u> | December 31,<br><u>2006</u> |
|--|--------------------------|-----------------------------|
| <b>ASSETS</b>                                      |                          |                             |
| Real estate assets                                 |                          |                             |
| Land   | \$ 92,340                | \$ 92,341                   |

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|  |                   |                   |
|--|-------------------|-------------------|
| Buildings and improvements   | 751,718           | 751,393           |
| Furniture and fixtures   | 28,427            | 28,126            |
|  | 872,485           | 871,860           |
| Less: accumulated depreciation   | (289,240)         | (281,994)         |
|  | 583,245           | 589,866           |
| Construction in progress   | 1,399             | 1,323             |
| Real estate associated with property held for sale, net  | =                 | 331               |
| Real estate, net   | 584,644           | 591,520           |
| Cash and cash equivalents  | 5,867             | 30,010            |
| Restricted cash  | 6,402             | 7,279             |
| Accounts and notes receivable, net   |                   |                   |
| Rents  | 1,068             | 1,582             |
| Affiliates   | 1,088             | 322               |
| Other  | 2,257             | 1,955             |
| Investments in joint ventures, net   | 5,221             | 5,247             |
| Goodwill   | 1,725             | 1,725             |
| Other assets, net  | 9,428             | 9,155             |
| Other assets associated with property held for sale, net   | =                 | 34                |
| <b>Total assets</b>  | <b>\$ 617,700</b> | <b>\$ 648,829</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                   |                   |
| Mortgage notes payable   | \$ 445,285        | \$ 472,854        |
| Unsecured debt   | 25,780            | 25,780            |
| Total debt   | 471,065           | 498,634           |
| Accounts payable, accrued expenses and other liabilities   | 23,845            | 24,568            |
| Dividends payable  | 2,975             | 2,934             |
| Resident security deposits   | 3,712             | 3,601             |
| Funds held on behalf of managed properties   |                   |                   |
| Affiliates   | 311               | 200               |
| Other  | 3,025             | 1,978             |
| Accrued interest   | 2,353             | 2,992             |
| Other liabilities associated with property held for sale   | =                 | 20                |
| <b>Total liabilities</b>   | <b>507,286</b>    | <b>534,927</b>    |
| Operating partnership minority interest  | 1,837             | 1,851             |
| Shareholders' equity   |                   |                   |
| Preferred shares, without par value; 9,000,000 shares authorized:<br>8.70% Class B Series II cumulative redeemable, \$250 per share  |                   |                   |
| liquidation preference, 232,000 issued and outstanding   | 58,000            | 58,000            |
| Common shares, without par value, \$.10 stated value; 41,000,000<br>authorized; 22,995,763 issued and 17,495,416 and 17,261,224<br>outstanding at March 31, 2007 and December 31, 2006, respectively | 2,300             | 2,300             |
| Paid-in capital  | 280,085           | 280,369           |
| Accumulated distributions in excess of accumulated net income  | (177,746)         | (173,962)         |
| Accumulated other comprehensive income   | -                 | (71)              |
| Less: Treasury shares, at cost, 5,500,347 and 5,734,539 shares<br>at March 31, 2007 and December 31, 2006, respectively  | (54,062)          | (54,585)          |
| <b>Total shareholders' equity</b>  | <b>108,577</b>    | <b>112,051</b>    |
| <b>Total liabilities and shareholders' equity</b>  | <b>\$ 617,700</b> | <b>\$ 648,829</b> |

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

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

|  | For the three months |                   |
|--|----------------------|-------------------|
|  | ended March 31,      |                   |
| (In thousands, except per share amounts)   | <u>2007</u>          | <u>2006</u>       |
| Revenue  |                      |                   |
| Property revenue   | \$ 33,855            | \$ 32,301         |
| Management and service company revenue:  |                      |                   |
| Fees, reimbursements and other   | 2,694                | 3,079             |
| Painting services  | <u>616</u>           | <u>312</u>        |
| Total revenue  | 37,165               | 35,692            |
| Expenses   |                      |                   |
| Property operating and maintenance   | 15,565               | 15,866            |
| Depreciation and amortization  | 7,762                | 8,048             |
| Direct property management and service company expenses  | 3,241                | 3,223             |
| Painting services  | 591                  | 407               |
| General and administrative   | <u>2,712</u>         | <u>2,346</u>      |
| Total expenses   | <u>29,871</u>        | <u>29,890</u>     |
| Operating income   | 7,294                | 5,802             |
| Interest income  | 271                  | 378               |
| Interest expense   | <u>(11,562)</u>      | <u>(12,511)</u>   |
| (Loss) income before equity in net loss of joint ventures,<br>minority interest and income (loss) from discontinued operations | (3,997)              | (6,331)           |
| Equity in net loss of joint ventures   | (72)                 | (106)             |
| Minority interest in operating partnership   | <u>(13)</u>          | <u>(16)</u>       |
| (Loss) income from continuing operations   | (4,082)              | (6,453)           |
| Income (loss) from discontinued operations:  |                      |                   |
| Operating loss   | (29)                 | (1,170)           |
| Gain on disposition of properties  | <u>4,561</u>         | -                 |
| Income (loss) from discontinued operations   | <u>4,532</u>         | <u>(1,170)</u>    |
| <b>Net income (loss)</b>   | 450                  | (7,623)           |
| Preferred share dividends  | <u>(1,262)</u>       | <u>(1,262)</u>    |
| <b>Net (loss) income applicable to common shares</b>   | <u>\$ (812)</u>      | <u>\$ (8,885)</u> |
| <b>Earnings per common share - basic and diluted:</b>  |                      |                   |

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|   |          |          |
|---|----------|----------|
| (Loss) income from continuing operations applicable to common shares            | \$ (.31) | \$ (.44) |
| Income (loss) from discontinued operations                                      | .26      | (.07)    |
| Net (loss) income applicable to common shares                                   | \$ (.05) | \$ (.51) |
| <b>Dividends declared per common share</b>                                      | \$ .17   | \$ .17   |
| <b>Weighted average number of common shares outstanding - basic and diluted</b> | 17,109   | 17,283   |

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

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**ASSOCIATED ESTATES REALTY CORPORATION**  
**CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY**  
**(UNAUDITED)**

|  | Total      | Class B                                |                                       | Total           | Accumulated                                       |  | Treasury         |
|--|------------|--|---------------------------------------|-----------------|---|--|------------------|
|  |            | Cumulative Redeemable Preferred Shares | Common Shares (at \$.10 stated value) |                 | Distributions In Excess of Accumulated Net Income | Accumulated Other Comprehensive Income |                  |
| (In thousands, except share amounts)   |            | Shares                                 |                                       | Paid-In Capital | Net Income  | Income                                 | Shares (at cost) |
| Balance, December 31, 2006   | \$ 112,051 | \$ 58,000                              | \$ 2,300                              | \$ 280,369      | \$ (173,962)                                      | \$ (71)                                | \$ (54,585)      |
| Comprehensive income:  |            |  |                                       |                 |   |  |                  |
| Net income   | 450        | -                                      | -                                     | -               | 450   | -                                      | -                |
| Other comprehensive income:  |            |  |                                       |                 |   |  |                  |
| Change in fair value of hedge instruments  | 71         | -                                      | -                                     | -               | -   | 71                                     | -                |
| Total comprehensive income   | 521        | -                                      | -                                     | -               | 450   | 71                                     | -                |
| Share-based compensation   | 413        | -                                      | -                                     | (251)           | 3   | -                                      | 661              |
| Purchase of 18,844 common shares   | (301)      | -                                      | -                                     | -               | -   | -                                      | (301)            |
| Issuance of 13,979 common shares for stock option exercises from treasury shares | 130        | -                                      | -                                     | (33)            | -   | -                                      | 163              |
| Common share dividends   | (2,975)    | -                                      | -                                     | -               | (2,975)   | -                                      | -                |
| Preferred share dividends  | (1,262)    | -                                      | -                                     | -               | (1,262)   | -                                      | -                |
| Balance, March 31, 2007  | \$ 108,577 | \$ 58,000                              | \$ 2,300                              | \$ 280,085      | \$ (177,746)                                      | \$ -                                   | \$ (54,062)      |

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of these consolidated financial statements

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## ASSOCIATED ESTATES REALTY CORPORATION

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

| (In thousands)   | For the three months |               |
|--|----------------------|---------------|
|  | ended March 31,      |               |
|  | <u>2007</u>          | <u>2006</u>   |
| Cash flow from operating activities:   |                      |               |
| Net income (loss)  | \$ 450               | \$ (7,623)    |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                      |               |
| Depreciation and amortization (including discontinued operations)                        | 7,762                | 8,689         |
| Loss on fixed asset replacements write-off   | 23                   | 46            |
| Gain on disposition of properties  | (4,561)              | -             |
| Minority interest in operating partnership   | 13                   | 16            |
| Amortization of deferred financing costs and other                                       | 399                  | 515           |
| Amortization of swap termination payments received                                       | (66)                 | (153)         |
| Share-based compensation   | 317                  | 215           |
| Equity in net loss of joint ventures   | 72                   | 106           |
| Distribution from joint ventures   | -                    | 123           |
| Net change in assets and liabilities:  |                      |               |
| - Accounts and notes receivable  | 213                  | 1,060         |
| - Accounts and notes receivable of affiliates  | (766)                | 261           |
| - Accounts payable and accrued expenses  | (1,074)              | (319)         |
| - Other operating assets and liabilities   | (989)                | (668)         |
| - Restricted cash  | 877                  | 1,087         |
| - Funds held for non-owned managed properties  | 1,048                | 411           |
| - Funds held for non-owned managed properties of affiliates                              | <u>111</u>           | <u>(525)</u>  |
| Total adjustments  | <u>3,379</u>         | <u>10,864</u> |
| Net cash flow provided by operations   | 3,829                | 3,241         |
| Cash flow from investing activities:   |                      |               |
| Recurring fixed asset additions  | (431)                | (2,272)       |
| Revenue enhancing/non-recurring fixed asset additions                                    | (249)                | (235)         |
| Purchase of operating partnership units  | (14)                 | -             |
| Net proceeds from disposition of operating properties                                    | 4,825                | -             |
| Contributions to joint ventures  | <u>(46)</u>          | -             |
| Net cash flow provided by (used for) investing activities                                | 4,085                | (2,507)       |
| Cash flow from financing activities:   |                      |               |
| Principal payments on mortgage notes payable   | (46,569)             | (36,884)      |
| Payment of debt procurement costs  | (107)                | -             |
| Proceeds from mortgage notes payable   | 19,000               | -             |
| Line of credit borrowings  | -                    | 20,000        |
| Line of credit repayments  | -                    | (8,700)       |

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|   |          |          |
|---|----------|----------|
| Common share dividends paid   | (2,934)  | (3,054)  |
| Preferred share dividends paid  | (1,262)  | (1,262)  |
| Operating partnership distributions paid                                  | (14)     | (16)     |
| Exercise of stock options   | 130      | 269      |
| Purchase of treasury shares under repurchase plan                         | -        | (10,185) |
| Other financing activities, net   | (301)    | (65)     |
| Net cash flow used for financing activities                               | (32,057) | (39,897) |
| Decrease in cash and cash equivalents                                     | (24,143) | (39,163) |
| Cash and cash equivalents, beginning of period                            | 30,010   | 39,733   |
| Cash and cash equivalents, end of period                                  | \$ 5,867 | \$ 570   |
| Supplemental disclosure of cash flow information:                         |          |          |
| Dividends declared but not paid   | \$ 2,975 | \$ 2,895 |
| Cash paid for interest  | 11,966   | 14,008   |
| Fixed asset replacement and other write-offs                              | 530      | 590      |
| Net change in accounts payable related to recurring fixed asset additions | 548      | -        |

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of these consolidated financial statements

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**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" and the "Company" in this report collectively refer to Associated Estates Realty Corporation and its consolidated subsidiaries.*

**Business**

We are a self-administered and self-managed equity real estate investment trust ("REIT") specializing in multifamily property management, advisory, development, acquisition, disposition, operation and ownership activities. In addition to rental revenue, we receive certain property, asset management and disposition fees.



As of March 31, 2007, we owned or property managed 99 apartment communities in nine states consisting of 20,650 units. We own, either directly or indirectly through subsidiaries, or hold ownership interests in 65 of those 99 apartment communities containing 15,235 units in eight states, 12 of which are Affordable Housing communities. We also property manage 34 apartment communities consisting of 5,415 units. Additionally, we asset manage a 186-unit apartment community and a commercial property containing approximately 145,000 square feet.

### **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 presentation 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, 2006.

### **Share-Based Compensation**

The Amended and Restated 2001 Equity-Based Award Plan (the "Plan") was the only share-based compensation plan in effect on March 31, 2007. The Plan provides for equity award grants to our officers, employees, and directors. Equity awards available under the Plan include stock options, share appreciation rights, restricted shares, deferred shares, and other awards based on common shares. The aggregate number of common shares subject to awards under the Plan is 2,250,000. At March 31, 2007, there were 521,070 common shares available for awards under the Plan. We also have share-based awards outstanding that had been issued under two other plans that have since expired, and outstanding stock option awards that had been issued to our outside directors. For additional information regarding these share-based compensation plans, see Note 17 of the Notes to the Consolidated Financial Statements of our report on Form 10-K for the year ended December 31, 2006.

Our share-based compensation awards, which consist primarily of restricted shares, contain service and/or performance conditions that may affect the number and timing of shares that ultimately vest. In 2007, an award consisting solely of restricted shares was granted in which the majority of the shares are subject to market and service conditions, with the remaining shares being subject to performance and service conditions. Compensation cost for awards with performance conditions is recognized based on our best estimate of the number of awards that will vest and the period of time in which they will vest. Compensation cost for the award containing market conditions is based on the estimated fair value of the award on the date granted, as described below, and the vesting period.

During the three months ended March 31, 2007 and 2006, we recognized total share-based compensation cost of \$292,000 and \$215,000, respectively, in "General and administrative expense" in the Consolidated Statements of Operations. Additionally, we allocate an immaterial

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amount of equity compensation expense to individual properties which is included in "Property operating and maintenance expense" in the Consolidated Statements of Operations.

*Stock Options.* We use the Black-Scholes option pricing model to estimate the fair value of stock option awards. There were 4,000 and 227,155 stock options awarded during the three months ended March 31, 2007 and 2006, respectively. The weighted average Black-Scholes assumptions and fair value for the three months ended March 31, 2007 and 2006 were as follows:

|                                     | For the three months |             |
|-------------------------------------|----------------------|-------------|
|                                     | ended March 31,      |             |
|                                     | <u>2007</u>          | <u>2006</u> |
| Expected volatility                 | 27.5%                | 27.7%       |
| Risk-free interest rate             | 4.5%                 | 4.6%        |
| Expected life of options (in years) | 7.0                  | 6.0         |
| Dividend yield                      | 4.3%                 | 6.0%        |
| Grant-date fair value               | \$ 3.45              | \$ 1.83     |

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 zero coupon bonds on the date of grant with a maturity equal to the expected life of the options. The expected life of the options was derived using the "simplified" method as allowed under the provisions of the Securities and Exchange Commission's Staff Accounting Bulletin No. 107. The dividend yield was derived using our annual dividend rate as a percentage of the price of our shares on the date of grant.

The following table represents stock option activity for the three months ended March 31, 2007:

|                                    | Number of            | Weighted-Average      | Weighted-Average               |
|------------------------------------|----------------------|-----------------------|--------------------------------|
|                                    | <u>Stock Options</u> | <u>Exercise Price</u> | <u>Remaining Contract Life</u> |
| Outstanding at beginning of period | 1,920,864            | \$ 12.08              |                                |
| Granted                            | 4,000                | \$ 15.99              |                                |
| Exercised                          | 13,979               | \$ 9.29               |                                |
| Forfeited or expired               | -                    | -                     |                                |
| Outstanding at end of period       | 1,910,885            | \$ 12.10              | 4.8 years                      |
| Exercisable at end of period       | 1,485,793            | \$ 12.55              | 4.0 years                      |

*Restricted Shares.* The following table represents restricted share activity for the three months ended March 31, 2007:

|                                  | Number of     | Weighted Average             |
|----------------------------------|---------------|------------------------------|
|                                  | <u>Shares</u> | <u>Grant-Date Fair Value</u> |
| Nonvested at beginning of period | 171,509       | \$ 10.26                     |
| Granted                          | 240,250       | \$ 7.63                      |

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|                            |         |          |
|----------------------------|---------|----------|
| Vested                     | 56,941  | \$ 6.58  |
| Forfeited                  | 1,193   | \$ 12.25 |
| Nonvested at end of period | 353,625 | \$ 8.59  |

A portion of the restricted share awards granted during the three months ended March 31, 2007, were awards in which the number of shares that will ultimately vest are subject to market conditions. The total estimated grant-date fair value of these awards was \$1.4 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 1.0 million simulation paths used to estimate the fair value of these awards. The expected volatility was based upon the historical volatility of our daily share closing prices over a period equal to the market condition performance periods. 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 periods.

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

|                                    | For the three months<br>ended March 31, 2007 |
|------------------------------------|--|
| Expected volatility                | 25.7% to 27.7%                               |
| Risk-free interest rate            | 4.5% to 5.1%                                 |
| Expected life (performance period) | One to three years                           |

Effective January 1, 2006, we adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised), "Share-Based Payment" ("SFAS 123(R)") using the modified prospective application method. As a result, during the three months ended March 31, 2006, we reversed \$599,000 of unearned compensation, transferred \$1.5 million to treasury shares from unearned compensation, and transferred accrued compensation cost of \$561,000 related to nonvested restricted shares to additional paid in capital from unearned compensation.

#### Operating Partnership Minority Interest

In conjunction with the 1998 acquisition of an operating partnership that owned two apartment communities, we issued a total of 522,032 operating partnership units ("OP units"). In January 2007, 942 of the OP units were redeemed. As of March 31, 2007, there were 78,335 OP units remaining.

#### Classification of Fixed Asset Additions

We consider recurring fixed asset additions to a property to be capital expenditures made to replace worn out assets to maintain the property's value. We consider investment/revenue enhancing and/or non-recurring fixed assets to be capital expenditures if such improvements increase the value of the property and/or enable us to increase rents. We consider acquisition and development fixed asset additions to be 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.

### **Recent Accounting Pronouncements**

The Financial Accounting Standards Board ("FASB") Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" - an interpretation of FASB Statement No. 109 "Accounting for Income Taxes" ("FIN 48") became effective January 1, 2007. We adopted FIN 48 and it had no material impact on our financial condition, results of operations and cash flows.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS 157"), which upon adoption will replace various definitions of fair value in existing accounting literature with a single definition, will establish a framework for measuring fair value, and will require additional disclosures about fair value measurements. The statement clarifies that fair value is the price that would be received to sell an asset or the price paid to transfer a liability in the most advantageous market available to the entity and emphasizes that fair value is a market-based measurement and should be based on the assumptions market participants would use. The statement also creates a three-level hierarchy under which individual fair value estimates are to be ranked based on the relative reliability of the inputs used in the valuation. This hierarchy is the basis for the disclosure requirements, with fair value estimates based on the least reliable inputs requiring more extensive disclosures about the valuation method used and the gains and losses associated with those estimates. SFAS 157 is required to be applied whenever another financial accounting standard requires or permits an asset or liability to be measured at fair value. The statement does not expand the use of fair value to any new circumstances. We will be required to apply the new guidance beginning January 1, 2008. We are currently evaluating the impact that this statement will have on our financial condition, results of operations and cash flows.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS 159"), which permits the option to measure financial instruments and certain other items at fair value, with changes in fair value recorded in earnings. This Statement, which will be effective for us beginning January 1, 2008, is not expected to have a material impact on our financial condition, results of operations and cash flows.

### **Reclassifications**

Certain reclassifications have been made to the 2006 financial statements to conform to the 2007 presentation.

**2. PROPERTIES SOLD OR HELD FOR SALE**

We report the results of operations and gain/loss related to the sale of real estate assets as discontinued operations in accordance with SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"). Real estate assets that are classified as held for sale are also reported as discontinued operations. We generally classify properties as held for sale when all significant contingencies surrounding the closing have been resolved. In many 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. As of March 31, 2007, there were no properties classified as held for sale.

On February 20, 2007, we completed the sale of a congregate care Market-Rate property located in Northeast Ohio. The sales price was \$5.2 million and we recorded a gain of \$4.6 million. We expect to use the proceeds of this sale to fund investment capital and other capital expenditures during 2007.

"Income from discontinued operations" in the accompanying Consolidated Statements of Operations for the three months ended March 31, 2007 and 2006 includes the operating results for eight properties that were sold in 2006 and one property that was sold in 2007 and the gain recognized on the one property sold in 2007. The following chart summarizes "Income from discontinued operations":

|   | For the three months |                   |
|---|----------------------|-------------------|
|   | ended March 31,      |                   |
|   | <u>2007</u>          | <u>2006</u>       |
| (In thousands)                                    |                      |                   |
| Property revenue                                  | \$ 172               | \$ 3,836          |
| Property operating and maintenance expense        | (201)                | (2,684)           |
| Real estate asset depreciation and amortization   | -                    | (641)             |
| Interest income                                   | -                    | 3                 |
| Interest expense                                  | =                    | (1,684)           |
| Operating (loss) income                           | (29)                 | (1,170)           |
| Gain on disposition of properties                 | 4,561                | -                 |
| <b>Income (loss) from discontinued operations</b> | <b>\$ 4,532</b>      | <b>\$ (1,170)</b> |

**3. DEBT****Mortgage Notes Payable**

During the three months ended March 31, 2007, we defeased/prepaid two fixed rate mortgage loans totaling \$30.9 million and recognized \$2.7 million in defeasance costs, which are included in "Interest expense" in the Consolidated Statements of Operations. Additionally, we completed

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the refinancing of one \$14.6 million fixed rate mortgage loan that was to mature in May 2007. The new loan is in the amount of \$19.0 million and matures in February 2009. Interest on this loan accrues at a rate of LIBOR plus 1.5%.

During the three months ended March 31, 2006, we defeased/prepaid four fixed rate mortgage loans totaling \$35.3 million and recognized \$3.6 million in defeasance costs, \$2.4 million of which is included in "Interest expense" and \$1.2 million of which is included in "Income (loss) from discontinued operations" in the Consolidated Statements of Operations.

### Lines of Credit

At March 31, 2007, we had a \$17.0 million secured line of credit that is available for regular borrowings, which is secured by one of our properties. Interest on this line accrued at a rate of LIBOR plus 1.5%. This line matures March 1, 2008. Borrowings under the line may be restricted based upon the operating performance of the property. There were no borrowings outstanding on this line of credit at March 31, 2007 or December 31, 2006.

At March 31, 2007, we also had a \$14.0 million secured line of credit which matures in December 2007. Interest on this line accrues at a rate of LIBOR plus 1.8% or the one month reference rate. A letter of credit in the amount of \$63,000 was outstanding on this line at March 31, 2007. There were no regular borrowings outstanding under this line at March 31, 2007 or December 31, 2006.

See Note 11 for further discussion concerning our debt structure.

## 4. GOODWILL AND OTHER INTANGIBLE ASSETS

### Goodwill

*MIG Realty Advisors, Inc.* In June 1998, we recorded goodwill in connection with the MIG Realty Advisors, Inc. merger. The goodwill was allocated fully to the Management and Service Operations Segment.

We completed our annual review of goodwill during the three months ended March 31, 2007. 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. Based on this analysis, we determined that goodwill was not impaired as of March 31, 2007. Should the estimates used to determine alternatives or the probabilities of the occurrence thereof change, an impairment may result which could materially impact our results of operations for the period in which it is recorded.

**Intangible Assets**

*Property Acquisitions.* In accordance with SFAS 141, "Business Combinations", 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 twelve to sixteen months. Due to the short term nature of residential leases, we believe that existing lease rates approximate market rates, and therefore, no allocation is made for above/below market leases.

**5. TRANSACTIONS WITH AFFILIATES AND JOINT VENTURES**

We provide management and other services to (and are reimbursed for certain expenses incurred on behalf of) certain non-owned properties in which our Chief Executive Officer ("CEO") and/or other related parties have varying ownership interests. The entities which own these properties, as well as other related parties, are referred to as "affiliates." We also provide similar services to joint venture properties.

In the normal course of business, we have advanced funds on behalf of affiliates and joint ventures and held funds for the benefit of affiliates and joint ventures.

Merit Painting Services ("Merit"), a subsidiary of ours, has provided services to JAS Construction, Inc. ("JAS") related to property rehabilitation and other work from time to time. JAS is owned by a son of our CEO. Reported revenue related to work performed by Merit for JAS is included in the table below. Accounts receivable from affiliates related to JAS at March 31, 2007 and 2006 respectively were \$478,000 and \$164,000.

Summarized affiliate and joint venture transaction activity was as follows:

|  | For the three months |             |
|--|----------------------|-------------|
|  | ended March 31,      |             |
| (In thousands)                                       | <u>2007</u>          | <u>2006</u> |
| Property management fee and other                    |                      |             |
| miscellaneous service revenue                        | \$ 124               | \$ 190      |
| Painting service revenue related to JAS Construction | 484                  | 161         |

|   |     |     |
|---|-----|-----|
| Expenses incurred on behalf of and reimbursed by <sup>(1)</sup> | 185 | 333 |
|---|-----|-----|

<sup>(1)</sup> Primarily payroll and employee benefits, reimbursed at cost.

## 6. SHARES

During the three months ended March 31, 2007, a total of 56,941 restricted shares vested and were issued from treasury shares. At March 31, 2007, there were 5,500,347 shares in treasury which included 353,625 non-vested restricted shares. At December 31, 2006, there were 5,734,539 shares in treasury which included 171,509 non-vested restricted shares.

## 7. EARNINGS PER SHARE

Earnings per share ("EPS") has been computed pursuant to the provisions of SFAS 128, "Earnings per Share." There were 1.9 million and 2.2 million options to purchase common shares outstanding at March 31, 2007 and 2006, respectively. None of the options were included in the calculation of diluted earnings per share for the periods presented as their inclusion would be antidilutive to the net loss applicable to common shares from continuing operations.

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

## 8. INTERIM SEGMENT REPORTING

We have four reportable segments: (1) Acquisition/Disposition Multifamily Properties; (2) Same Community Market-Rate ("Market-Rate") Multifamily Properties; (3) Affordable Housing Multifamily Properties; and (4) Management and Service Operations. We have identified these segments based upon how we make decisions regarding resource allocation and performance assessment. The Acquisition/Disposition segment represents acquired or developed properties which have not yet reached stabilization (we consider a property stabilized when its occupancy rate reaches 93.0% and we have owned the property for one year), and properties that have been sold or are classified as held for sale in accordance with SFAS 144. The Market-Rate segment represents same community (owned during the entirety of the comparison periods) conventional multifamily residential properties. The Affordable Housing segment represents multifamily properties for which the rents are subsidized and certain aspects of the operations are regulated by HUD pursuant to Section 8 of the National Housing Act of 1937. The Management and Service Operations provide management and advisory services to the Acquisition/Disposition, Market-Rate and Affordable Housing properties that we own, as well as to third party clients and properties. All of our segments are located in the United States.



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The accounting policies of the reportable segments are the same as those described in the "Basis of Presentation and Significant Accounting Policies" in our Annual Report on Form 10-K for the year ended December 31, 2006. We evaluate the performance of our reportable segments based on Net Operating Income ("NOI"). NOI is determined by deducting property operating and maintenance expenses from property revenue for the Acquisition/Disposition (excluding amounts classified as discontinued operations), Market-Rate and Affordable Housing segments and deducting direct property management and service companies expenses and painting services expenses from Management and Service Company revenue for the Management and Service Operations segment. We consider NOI to be an appropriate supplemental measure of our performance because it reflects the operating performance of our real estate portfolio and management and service companies at the property and management and service company level and is used to assess regional property level performance. NOI should not be considered (i) as an alternative to net income (determined in accordance with GAAP), (ii) as an indicator of financial performance, (iii) as cash flow from operating activities (determined in accordance with GAAP) or (iv) as a measure of liquidity; nor is it necessarily indicative of sufficient cash flow to fund all of our needs. Certain other real estate companies may define NOI in a different manner.

Segment information for the three months ended March 31, 2007 and 2006 is as follows:

|   | <u>For the three months ended March 31, 2007</u> |             |                       |   |                       |
|---|--|-------------|-----------------------|---|-----------------------|
|   | Acquisition/<br>Disposition                      | Market-Rate | Affordable<br>Housing | Management<br>and Service<br>Operations | Total<br>Consolidated |
|   | (In thousands)                                   |             |                       |   |                       |
| Total segment revenue                       | \$ -   | \$ 31,472   | \$ 2,402              | \$ 5,132                                | \$ 39,006             |
| Elimination of intersegment revenue         | -  | (9)         | (10)                  | (1,822)                                 | (1,841)               |
| Consolidated revenue                        | -  | 31,463      | 2,392                 | 3,310                                   | 37,165                |
| Equity in net loss of joint ventures        | -  | (39)        | (33)                  | -                                       | (72)                  |
| Operating loss from discontinued operations | (29)   | -           | -                     | -                                       | (29)                  |
| *NOI  | -  | 17,184      | 1,106                 | (522)                                   | 17,768                |
| Total assets                                | \$ -   | \$ 588,528  | \$ 6,850              | \$ 22,322                               | \$ 617,700            |

\*Intersegment revenue and expenses have been eliminated in the computation of NOI for each of the segments.

|   | <u>For the three months ended March 31, 2006</u> |             |                       |   |                       |
|---|--|-------------|-----------------------|---|-----------------------|
|   | Acquisition/<br>Disposition                      | Market-Rate | Affordable<br>Housing | Management<br>and Service<br>Operations | Total<br>Consolidated |
|   | (In thousands)                                   |             |                       |   |                       |
| Total segment revenue                       | \$ -   | \$ 29,998   | \$ 2,322              | \$ 5,355                                | \$ 37,675             |
| Elimination of intersegment revenue         | -  | (11)        | (8)                   | (1,964)                                 | (1,983)               |
| Consolidated revenue                        | -  | 29,987      | 2,314                 | 3,391                                   | 35,692                |
| Equity in net loss of joint ventures        | -  | (68)        | (38)                  | -                                       | (106)                 |
| Operating loss from discontinued operations | (1,170)  | -           | -                     | -                                       | (1,170)               |

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|                |           |            |          |           |            |
|----------------|-----------|------------|----------|-----------|------------|
| *NOI           | -         | 15,581     | 854      | (239)     | 16,196     |
| **Total assets | \$ 38,825 | \$ 605,766 | \$ 7,327 | \$ 19,432 | \$ 671,350 |

\* Intersegment revenue and expenses have been eliminated in the computation of NOI for each of the segments.

\*\* Total assets shown for the Acquisition/Disposition segment represent the total assets for the properties sold subsequent to March 31, 2006.

A reconciliation of total NOI to total consolidated net income (loss) is as follows:

| (In thousands)                              | For the three months |            |
|---|----------------------|------------|
|   | ended March 31,      |            |
|   | 2007                 | 2006       |
| Total NOI for reportable segments           | \$ 17,768            | \$ 16,196  |
| Depreciation and amortization               | (7,762)              | (8,048)    |
| General and administrative expense          | (2,712)              | (2,346)    |
| Interest income                             | 271                  | 378        |
| Interest expense                            | (11,562)             | (12,511)   |
| Equity in net loss of joint ventures        | (72)                 | (106)      |
| Minority interest in operating partnership  | (13)                 | (16)       |
| Income (loss) from discontinued operations: |                      |            |
| Operating loss                              | (29)                 | (1,170)    |
| Gain on disposition of properties           | 4,561                | -          |
| Income (loss) from discontinued operations  | 4,532                | (1,170)    |
| Consolidated net income (loss)              | \$ 450               | \$ (7,623) |

## 9. CONTINGENCIES

### *Legal Proceedings*

We are subject to legal proceedings, lawsuits and other claims, including proceedings by government authorities (collectively "Litigation"). Litigation is subject to uncertainties and outcomes are difficult to predict. Consequently, we are unable to estimate ultimate aggregate monetary liability or financial impact with respect to the Litigation matters described in the following paragraphs as of March 31, 2007, and no accruals have been made for these matters other than those identified in the following paragraphs. We believe that other Litigation will not have a material adverse impact on us after final disposition. However, because of the uncertainties of Litigation, one or more lawsuits could ultimately result in a material obligation.

***Pending Lawsuits***

On or about April 14, 2002, Melanie and Kyle Kopp commenced an action against us in the Franklin County, Ohio Court of Common Pleas seeking undetermined damages, injunctive relief and class action certification. This case arose out of our Suredeposit program. This program allowed cash short prospective residents to purchase a bond in lieu of paying a security deposit. The bond serves as a fund to pay those resident obligations that would otherwise have been funded by the security deposit. Plaintiffs allege that the non-refundable premium paid for the bond is a disguised form of security deposit, which is otherwise required to be refundable in accordance with Ohio's Landlord-Tenant Act. Plaintiffs further allege that certain pet deposits and other non-refundable deposits required by us are similarly security deposits that must be refundable in accordance with Ohio's Landlord-Tenant Act. On or about January 15, 2004, the plaintiffs filed a motion for class certification. We subsequently filed a motion for summary judgment. Both motions are pending before the Court. We intend to vigorously defend ourselves against these claims.

***Government Investigations***

On or about August 7, 2002, the Maryland Attorney General served us with a subpoena seeking information concerning certain of our leasing practices in connection with our Maryland properties. The subpoena sought extensive information going back a number of years, including information about our Suredeposit programs and certain non-refundable deposits. The Maryland Attorney General completed its review of the information we furnished and based upon that information contends that certain of our leasing practices are in violation of Maryland's landlord tenant laws. We have reached an out of court settlement with the Maryland Attorney General for the purpose of resolving this matter and recorded our estimate of the settlement amount in "General and administrative expense" in the Consolidated Statements of Operations during the second and third quarters of 2006.

On or about December 22, 2003, the Montgomery County, Maryland Office of Landlord-Tenant Affairs commenced an investigation into possible violations of state and county Landlord-Tenant laws involving two properties operated by us located in Montgomery County, Maryland. The matters that were the subject of this investigation were for the most part the same leasing practices being investigated by the Maryland Attorney General. Although these Montgomery County charges were never formally withdrawn, we believe that Montgomery County will not pursue these matters based upon our settlement with the Maryland Attorney General.

Montgomery County commenced additional investigations concerning the charging of trash fees. We have reached an out of court settlement with Montgomery concerning this matter and our estimate of the settlement amount was recorded in "General and administrative expense" in the Consolidated Statements of Operations during the second and third quarters of 2006.

## 10. GUARANTEES

We are a 49.0% partner in the joint venture partnership that owns Idlewylde Apartments, an 843-unit multifamily community, located in Atlanta, Georgia. In connection with the \$42.0 million mortgage loan encumbering this property, we have guaranteed certain obligations of the partnership including environmental indemnification obligations and typical non-recourse carveouts. Although we have not recorded a liability for a potential loss, we are required by GAAP to estimate the fair value of this guaranty. We have estimated the fair value of the guaranty to be \$290,000, and this amount is included as an asset in "Investments in joint ventures, net" and as a liability in "Accounts payable, accrued expenses and other liabilities" in the accompanying Consolidated Balance Sheet. In addition, we routinely guaranty mortgage debt of our wholly owned subsidiaries.

## 11. SUBSEQUENT EVENTS

### *Debt*

In April 2007, we obtained a revolving credit facility ("the revolver") in the amount of \$100.0 million to be used for the refinancing of existing debt, general corporate purposes, and/or the acquisition of properties. This revolver accrues interest at a variable rate and matures in April 2010. In connection with obtaining the revolver, we terminated our \$17.0 million and \$14.0 million lines of credit. Additionally, at the time of the closing, the revolver was used to prepay two mortgage loans totaling \$15.7 million.

### *Legal Proceedings*

In April 2007, we settled a pending lawsuit which we expect to result in our recording \$1.5 million of additional revenue in the second quarter of 2007.

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

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The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included in Part I, Item 1 of this report on Form 10-Q. This discussion may contain forward-looking statements based on current judgments and current knowledge of management, which are subject to certain risks, trends and uncertainties that could cause actual results to vary from those projected, including but not limited to, expectations regarding our 2007 performance, which are based on certain assumptions. Accordingly, readers are cautioned not to place undue reliance on forward-looking statements which speak only as of the dates of the document. These forward-looking statements are intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The words "expects", "projects", "believes", "plans", "anticipates" and similar expressions are intended to identify forward-looking statements. Investors are cautioned that these forward-looking statements involve risks and uncertainty, that could cause actual results to differ from estimates or projections contained in these forward-looking statements, including without limitation the following:

- changes in the economic climate in the markets in which we own and manage properties, including interest rates, our ability to consummate the sale of properties pursuant to our current plan, the overall level of economic activity, the availability of consumer credit and mortgage financing, unemployment rates and other similar factors;
- the ability for us to refinance debt on favorable terms at maturity;
- the ability for us to defease or prepay debt pursuant to our current plans;
- a lessening of demand for the multifamily units that we own or manage;
- competition from other available multifamily units and changes in market rental rates;
- increases in property and liability insurance costs;
- unanticipated increases in real estate taxes and other operating expenses (e.g., cleaning, utilities, repair and maintenance costs, insurance and administrative costs, security, landscaping, staffing and other general costs);
- weather conditions that adversely affect operating expenses;
- expenditures that cannot be anticipated, such as utility rate and usage increases, unanticipated repairs and real estate tax valuation reassessments or millage rate increases;
- our inability to control operating expenses or achieve increases in revenue;
- the results of litigation filed or to be filed against us;

changes in tax legislation;

risks of personal injury claims and property damage related to mold claims because of diminished insurance coverage;

catastrophic property damage losses that are not covered by our insurance;

risks associated with property acquisitions such as environmental liabilities, among others;

changes in government regulations affecting properties the rents of which are subsidized and certain aspects of which are regulated by the United States Department of Housing and Urban Development ("HUD") and other properties we own;

- our inability to renew current contracts with HUD for rent-subsidized properties at existing rents;
- changes in or termination of contracts relating to our third party management and advisory business;
- risks related to our joint ventures;
- the perception of residents and prospective residents as to the attractiveness, convenience and safety of our properties or the neighborhoods in which they are located; and

our ability to acquire properties at prices consistent with our investment criteria.

**Overview.** We are engaged primarily in the ownership and operation of multifamily residential units. We also provide asset and property management services to third party owners of multifamily residential units for which we are paid fees. Our primary source of cash and revenue from operations is rents from the leasing of owned apartment units. Approximately 91.1% of our consolidated revenue was generated from the leasing of these owned units for the three months ended March 31, 2007, and approximately 92.9% of the rental revenue generated by these owned properties during the three months ended March 31, 2007, was related to the Market-Rate properties.

The operating performance of the Market-Rate properties is affected by factors such as interest rates, unemployment rates, and the supply and demand of rental housing in particular markets. Rental revenue collections are a combination of rental rates and occupancy levels and rent concessions. We attempt to adjust these factors from time to time, based on market conditions, in order to maximize rental revenue. Indicators that we use in measuring these factors include physical occupancy and net collected rent. These indicators are more fully described in the Results of Operations comparison. Additionally, we consider property net operating income ("NOI") to be an important indicator of our overall performance. Property NOI (property operating revenue less property operating and maintenance expenses) is a measure of the profitability of our properties, which has the largest impact of all of our sources of income and expense on our financial condition and operating results. See Note 8 of the Notes to Consolidated Financial Statements presented in Part I, Item 1 of this report on Form 10-Q for additional information regarding property NOI and total NOI, in addition to a reconciliation of total NOI to consolidated net income (loss) in accordance with GAAP.

#### **2007 Expectations.**

- **Portfolio performance** - We expect to increase our Market-Rate property NOI by approximately 3.7% to 4.2% in 2007. We expect our Midwest portfolio to deliver increased NOI of 3.4% to 3.9% driven by property revenue increases of 3.3% to 3.8%. We also expect our Mid-Atlantic and Southeast portfolio to deliver NOI increases of 4.3% to 4.9% as a result of property revenue increases of 2.9% to 3.4%.
- **Property acquisitions and sales** - We plan to acquire approximately \$50.0 million of properties, while disposing of approximately \$50.0 million to \$75.0 million of properties.
- **Defeasance and other prepayment costs** - We expect to incur approximately \$5.0 million in costs to defease/prepay or refinance debt during 2007.

#### **LIQUIDITY AND CAPITAL RESOURCES**

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**Cash Flows and Liquidity.** Significant sources and uses of cash in the three months ended March 31, 2007 and 2006, are summarized as follows:

Significant Cash Sources (Uses):

| (In thousands)  | For the three months |             |
|---|----------------------|-------------|
|   | ended March 31,      |             |
|   | <u>2007</u>          | <u>2006</u> |
| Net cash provided by operating activities                   | \$ 3,829             | \$ 3,241    |
| Fixed assets:   |                      |             |
| Property disposition proceeds, net                          | 4,825                | -           |
| Recurring and non-recurring capital expenditures            | (680)                | (2,507)     |
| Debt:   |                      |             |
| Decrease in mortgage notes                                  | (27,569)             | (36,884)    |
| Increase in line of credit borrowings                       | -                    | 11,300      |
| Cash dividends and operating partnership distributions paid | (4,210)              | (4,332)     |
| Purchase of treasury shares and other                       | (301)                | (10,250)    |

Our primary sources of liquidity are cash flow provided by operations, short term borrowings on our lines of credit and proceeds from property sales. Cash provided by operations in 2007 increased compared to 2006 primarily due to increased property revenue and reduced interest expense in 2007, which was partially offset by changes in accounts payable and accounts receivable resulting from the timing of cash payments and cash receipts.

During the three months ended March 31, 2007, we received \$4.8 million from the sale of one property and \$4.4 million from the refinancing of a mortgage loan. We reduced total mortgage debt by \$27.6 million and paid related defeasance/prepayment costs of \$2.5 million (of the recorded \$2.7 million) primarily with funds from properties sold during the fourth quarter of 2006. Additionally, we paid dividends and distributions totaling \$4.2 million and paid a total of \$680,000 for recurring and non-recurring capital additions.

The overall reduction of \$27.6 million in mortgage debt was primarily accomplished through the defeasance/prepayment of two fixed rate mortgage loans totaling \$30.9 million that were scheduled to mature in May 2009 and June 2010, and the refinancing of one \$14.6 million fixed rate mortgage loan that was to mature in May 2007 with a new loan in the amount of \$19.0 million that matures in February 2009.

At March 31, 2007, there were no borrowings outstanding on our two secured lines of credit. There was one letter of credit in the amount of \$63,000 outstanding, leaving approximately \$30.9 million available for borrowing.

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In April 2007, we obtained the revolver in the amount of \$100.0 million to be used for the refinancing of existing debt, general corporate purposes, and/or the acquisition of properties. This revolver accrues interest at a variable rate and matures in April 2010. In connection with the revolver, we terminated our \$17.0 million and \$14.0 million secured lines of credit. Additionally, we used revolver proceeds to prepay two mortgage loans totaling \$15.7 million.

In April 2007, we entered into an agreement to settle a pending lawsuit. As a result of this agreement, we expect to receive proceeds of \$1.5 million during the second quarter of 2007.

We anticipate funding approximately \$12.7 million for recurring, investment/revenue enhancing and non-recurring capital expenditures for the remainder of 2007. These expenditures are expected to be funded from cash flow provided by operating activities and the sale of properties.

Any future multifamily property acquisitions or developments would be financed with the most appropriate sources of capital, which may include borrowings on the revolver, the assumption of mortgage indebtedness, bank and other institutional borrowings, the exchange of properties, undistributed earnings, secured or unsecured debt financings, or the issuance of shares or units exchangeable into common shares.

We anticipate that we will meet our liquidity requirements for the remainder of 2007 generally through net cash provided by operations and property sale proceeds. We believe that these and other sources, such as the revolver, should be sufficient to meet operating requirements, capital additions, mortgage amortization payments and the payment of dividends in accordance with REIT requirements. We anticipate that we will continue paying quarterly dividends and that we will sustain our current dividend rate.

**Guarantees.** We routinely guaranty mortgage debt of our wholly owned subsidiaries. Additionally, we had one guaranty at March 31, 2007, related to a mortgage loan secured by one of our joint venture properties. See Note 10 of the Notes to Consolidated Financial Statements presented in Part I, Item 1 of this report on Form 10-Q for information related to this guaranty. In the normal course of business, we may enter into contractual arrangements under which we may agree to indemnify the third party to such arrangement from any losses incurred relating to the services they perform on our behalf or for losses arising from certain events as defined within the particular contract, which may include, for example, litigation or claims relating to past performance. Such indemnification obligations may not be subject to maximum loss clauses. Historically, payments made related to these indemnifications have not been material.

**Off-Balance Sheet Investments and Financing Commitments.** We have investments in two joint ventures which own multifamily apartment communities. One of these properties is a Market-Rate property and the other property is an Affordable Housing property. The operations of these properties are similar to the operations of our wholly owned portfolio. These investments enable us to exercise influence over the operations of the properties and share in their profits, while earning additional fee income. We account for our investments in unconsolidated joint ventures under the equity method of accounting as we exercise significant influence, but do not control these entities and are not required to consolidate them in accordance with FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" or under EITF 04-05, "Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights". These investments are initially recorded at cost, as investments in joint ventures and subsequently adjusted for equity in earnings and cash contributions and distributions.



The Affordable Housing joint venture property had negative cash flow during 2006 and is expected to have negative cash flow during 2007 as a result of operating expenses exceeding tenant rents and the housing assistance payments from HUD. We are pursuing a request to HUD for an increase in housing assistance payments in order to address the deficit. The joint venture partnership that owns this property intends to sell it. Additional cash contributions that may be required of us to pay deficits, if any, are not expected to be material.

We have one guaranty obligation related to our joint ventures which was previously discussed under Guarantees. Both of these joint venture properties were encumbered by debt at March 31, 2007. Our proportionate share of this debt was \$22.7 million.

**Dispositions.** On February 20, 2007, we completed the sale of a congregate care Market-Rate property located in Northeast Ohio. The sales price was \$5.2 million and we recorded a gain of \$4.6 million. We expect to use the proceeds of this sale to fund investment capital and other capital expenditures during 2007.

**Management and Service Operations.** In January 2007, we entered into a management contract for a property located in Pennsylvania for which we anticipate receiving approximately \$64,000 in annual fee revenue.

## ***RESULTS OF OPERATIONS***

### ***Comparison of the three months ended March 31, 2007 to the three months ended March 31, 2006.***

In the following discussion, the Market-Rate segment represents 52 wholly owned Same Community Market-Rate properties that we have owned during the entirety of the comparison periods. The Affordable Housing segment represents 11 properties subject to HUD regulations, and the Acquired/Disposed segment represents sold properties.

Overall, the net loss from continuing operations decreased in 2007 primarily due to an increase in rental revenue and a decrease in interest expense during 2007.

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The following chart reflects the amount and percentage change in line items that are relevant to the changes in overall operating performance when comparing the three months ended March 31, 2007 to the three months ended March 31, 2006:

|   | Increase (decrease) in |         |
|---|------------------------|---------|
|   | three month comparison |         |
|   | period ended           |         |
|   | March 31, 2007         |         |
|   | to March 31, 2006      |         |
| (Amounts in thousands)                            |                        |         |
| Property revenue                                  | \$ 1,554               | 4.8%    |
| Fees, reimbursements and other                    | (385)                  | (12.5)% |
| Property operating and maintenance expense items: |                        |         |
| Real estate taxes and insurance                   | (409)                  | (8.6)%  |
| Other operating expenses                          | 302                    | 29.3%   |
| General and administrative expense                | 366                    | 15.6%   |
| Interest expense                                  | (949)                  | (7.6)%  |

*Property Revenue.* Property revenue is impacted by a combination of rental rates, rent concessions and occupancy levels. We measure these factors using indicators such as physical occupancy (number of units occupied divided by total number of units at the end of the period) and average monthly net collected rent per unit (gross potential rents less vacancies and concessions divided by total number of units). This information is presented in the following table for the three months ended March 31, 2007 and 2006 (information for the three months ended March 31, 2006, reflects results based upon the operating properties and their respective segments as of March 31, 2007):

|                         | For the three months ended |                      |                       |                      |
|-------------------------|----------------------------|----------------------|-----------------------|----------------------|
|                         | <u>March 31, 2007</u>      |                      | <u>March 31, 2006</u> |                      |
|                         |                            | Average Monthly      |                       | Average Monthly      |
|                         | Physical                   | Net Collected        | Physical              | Net Collected        |
|                         | <u>Occupancy</u>           | <u>Rent Per Unit</u> | <u>Occupancy</u>      | <u>Rent Per Unit</u> |
| Market-Rate Properties: |                            |                      |                       |                      |
| Midwest                 | 95.5%                      | \$ 700               | 94.4%                 | \$ 665               |
| Mid-Atlantic/Southeast  | 95.2%                      | \$ 1,042             | 96.6%                 | \$ 998               |
| Total Market-Rate       | 95.5%                      | \$ 776               | 94.9%                 | \$ 739               |
| Affordable Housing      | 99.0%                      | \$ 654               | 99.9%                 | \$ 643               |

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Property revenue increased in 2007 primarily as a result of increased occupancy and a combination of rental rate increases and an overall reduction in concessions being offered in the Market-Rate segment. During the second quarter of 2007, we expect to record non-recurring revenue of \$1.5 million as proceeds from the settlement of legal proceedings.

*Fees, Reimbursements and Other.* The management and service operations recognized a decrease in fee revenue of \$170,000 primarily as a result of the loss of five management contracts in 2006, three of which were a result of the sale of the properties. Other revenue decreased \$100,000 primarily as a result of liquidated damages that we received in 2006 when a prospective buyer did not perform under the terms of a contract to sell one of our properties.

*Property Operating and Maintenance Expenses.* Property operating and maintenance expenses decreased slightly in 2007 primarily as a result of a credit recorded in 2007 related to our self-insurance property plan resulting from favorable loss experiences, which was partially offset by an increase in real estate tax expense and expense related to uncollectible tenant rent receivables and associated collection costs.

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*General and Administrative Expense.* General and administrative expense increased primarily due to increases in salaries, benefit costs, and expense related to equity compensation during 2007. These increases were partially offset by the recording of a smaller valuation adjustment of deferred directors' compensation, which is held as share units and valued using the closing price of our common shares at the end of each period. The share price increased \$0.35 during the three months ended March 31, 2007, compared to an increase of \$2.21 during the three months ended March 31, 2006.

*Interest Expense.* Interest expense decreased in 2007 primarily due to a \$1.2 million reduction in mortgage interest expense resulting from the defeasance/prepayment of debt during 2006 and the first quarter of 2007.

*Income from Discontinued Operations.* Discontinued operations includes the operating results of the properties that were sold during 2007 and 2006. For further details on "Income from discontinued operations," see Note 2 of the Notes to Consolidated Financial Statements presented in Part I, Item 1 of this report on Form 10-Q.

## **CONTINGENCIES**

For a discussion of contingencies, see Note 9 of the Notes to Consolidated Financial Statements presented in Part I, Item 1 of this report on Form 10-Q.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to interest rate changes associated with variable rate debt as well as refinancing risk on our fixed-rate debt. We occasionally use derivative instruments to manage our exposure to interest rates. See our Form 10-K "Item 7A Qualitative and Quantitative Disclosures About Market Risk" for a more complete discussion of interest rate sensitive assets and liabilities.

### **ITEM 4. CONTROLS AND PROCEDURES**

*Disclosure Controls and Procedures.* We have evaluated the design and operation of our disclosure controls and procedures to determine whether they are effective in ensuring that the disclosure of required information is timely made in accordance with the Securities Exchange Act of 1934 ("Exchange Act") and the rules and forms of the Securities and Exchange Commission. This evaluation was made under the supervision and with the participation of management, including our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), as of the end of the period covered by this report on Form 10-Q. The CEO and CFO have concluded, based on their review, that our disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e), are effective to ensure that information required to be disclosed in reports that we file under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

*Changes in Internal Control over Financial Reporting.* There were no changes in our internal control over financial reporting during the first quarter of 2007 that materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

We believe that because of its inherent limitations, internal control over financial reporting may not always prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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## **PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

For information related to legal proceedings, see Note 9 of the Notes to Consolidated Financial Statements presented in Part I, Item 1 of this Report on Form 10-Q.

**ITEM 1A. RISK FACTORS**

See "Risk Factors" in Part I, Item 1A of our report on Form 10-K for the year ended December 31, 2006.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

| <u>Issuer Purchases of Equity Securities for the three months ended March 31, 2007</u> |                         |                  |                          |                       |
|--|-------------------------|------------------|--------------------------|-----------------------|
|  |                         |                  |                          | Approximate           |
|  |                         |                  |                          | Dollar Value of       |
|  |                         |                  | Total Number of          | Shares That May       |
|  |                         |                  | Shares Purchased         | Yet Be Purchased      |
|  |                         | Average          | As Part of Publicly      | Under the Plans or    |
|  | Total Number of         | Price Paid       | Announced                | Programs              |
| <u>Period</u>  | <u>Shares Purchased</u> | <u>Per Share</u> | <u>Plans or Programs</u> | <u>(in thousands)</u> |
| January 1 through  |                         |                  |                          |                       |
| January 31   | 556                     | \$ 15.99         | -                        | \$ 22,433             |
| February 1 through   |                         |                  |                          |                       |
| February 28  | 17,121                  | \$ 16.06         | -                        | \$ 22,433             |
| March 1 through  |                         |                  |                          |                       |
| March 31   | 1,167                   | \$ 14.76         | -                        | \$ 22,433             |
| Total  | 18,844                  | \$ 15.98         | -                        |                       |

On July 27, 2005, our Board of Directors authorized the repurchase of up to \$50.0 million of our common shares. On October 20, 2006, our Board of Directors expanded this authorization to include the repurchase of our Class B Series II Preferred Shares. Additionally, we have a policy which allows employees to pay their portion of the payroll taxes related to restricted share vesting by surrendering shares equal in value on the day of vesting to the amount of taxes due.

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**ITEM 6. EXHIBITS**

| <u>Number</u> | <u>Title</u>  | <b>Filed herewith or<br/>incorporated<br/>herein by<br/>reference</b>            |
|---------------|---|--|
| 3.1           | Amendment to Second Amended and Restated Articles of Incorporation  | Exhibit 3.1 to Form 8-K filed December 8, 2004.                                  |
| 3.2           | Second Amended and Restated Articles of Incorporation, as amended by the Company.   | Exhibit 3.2 to Form 8-K filed December 8, 2004.                                  |
| 3.3           | Amended and Restated Code of Regulations of the Company.  | Exhibit 3.3 to Form 10-Q filed August 1, 2006.                                   |
| 4.1           | Specimen Common Share Certificate.  | Exhibit 3.1 to Form S-11 filed September 2, 1993 (File No. 33-68276 as amended). |
| 4.2           | Specimen 8.70% Class B Series II Cumulative Redeemable Preferred Shares   | Exhibit 4.3 to Form 8-A filed December 8, 2004.                                  |
| 4.3           | Deposit Agreement by and among Associated Estates Realty Corporation and National City Bank and Depository Receipts                                       | Exhibit 4.5 to Form 8-A filed December 8, 2004                                   |
| 4.4           | Form of Indemnification Agreement.  | Exhibit 4.2 to Form S-11 filed September 2, 1993 (File No. 33-68276 as amended). |
| 4.5           | Form of Promissory Note and Form of Mortgage and Security Agreement dated May 10, 1999 from AERC to The Chase Manhattan Bank.                             | Exhibit 4.5 to Form 10-Q filed August 13, 1999.                                  |
| 4.5a          | Form of Promissory Note and Form of Mortgage and Security Agreement dated September 10, 1999 from AERC to The Chase Manhattan Bank.                       | Exhibit 4.5a to Form 10-Q filed November 12, 1999.                               |
| 4.5b          | Form of Promissory Note and Form of Mortgage and Security Agreement<br><br>dated November 18, 1999 from AERC to The Chase Manhattan Bank.                 | Exhibit 4.5b to Form 10-K filed March 15, 2000.                                  |
| 4.9           | Second Amended and Restated Loan Agreement dated April 19, 2002 between Associated Estates Realty Corporation and National City Bank.                     | Exhibit 4.13a to Form 10-Q filed August 13, 2002.                                |
| 4.9a          | Third Amended and Restated Loan Agreement dated November 1, 2005 between Associated Estates Realty Corporation and National City Bank.                    | Exhibit 4.9a to Form 10-K filed March 1, 2006.                                   |
| 4.9a(i)       | Amendment No. 1 to Third Amended and Restated Loan Agreement dated May 15, 2006 between Associated Estates Realty Corporation and National City Bank      | Exhibit 4.9a(i) to Form 10-Q filed August 1, 2006.                               |
| 4.9b          | First Amendment to Second Amended and Restated Loan Agreement dated May 14, 2002 between Associated Estates Realty Corporation and National City Bank.    | Exhibit 4.13b to Form 10-Q filed August 13, 2002.                                |
| 4.9c          | Second Amendment to Second Amended and Restated Loan Agreement dated April 17, 2003 between Associated Estates Realty Corporation and National City Bank. | Exhibit 4.13c to Form 10-Q filed August 1, 2003.                                 |
| 4.9d          | Third Amendment to Second Amended and Restated Loan Agreement dated July 15, 2003 between Associated Estates Realty Corporation and National City Bank.   | Exhibit 4.13d to Form 10-Q filed November 20, 2003.                              |
| 4.9e          |   |  |

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|  |   |
|--|---|
| Fourth Amendment to Second Amended and Restated Loan Agreement dated September 7, 2004 between Associated Estates Realty Corporation and National City Bank.   | Exhibit 4.13e to Form 10-Q filed November 2, 2004.                                |
| 4.11 Loan Agreement dated July 22, 2003 between The Huntington National Bank and MIG/Orlando Development, Ltd.   | Exhibit 4.15 to Form 10-Q filed November 20, 2003.                                |
| 4.12 Amended and Restated Loan Agreement dated February 20, 2006 between The Huntington National Bank and MIG/Orlando Development, Ltd.  | Exhibit 4.12 to Form 10-Q filed May 2, 2006.                                      |
| Certain of the Registrant's assets are subject to mortgage obligations each of which individually relates to indebtedness totaling less than 10.0% of the total assets of the Registrant. The Registrant hereby agrees to furnish a copy of such agreements to the Commission upon its request.  |   |
| The Registrant issued unsecured debt in the form of Trust Preferred Securities on March 15, 2005 in a private placement in an amount less than 10.0% of the total assets of the Registrant. The Registrant hereby agrees to furnish a copy of the Purchase Agreement dated March 15, 2005 between Associated Estates Realty Corporation, AERC Delaware Trust and Taberna Preferred Funding 1, Ltd. and a specimen Preferred Securities Certificate to the Commission upon its request. |   |
| 10 Associated Estates Realty Corporation Directors' Deferred Compensation Plan.  | Exhibit 10 to Form 10-Q filed November 14, 1996.                                  |
| 10.1 Stock Option Plan.  | Exhibit 10.2 to Form S-11 filed September 2, 1993 (File No. 33-68276 as amended). |
| 10.2 Amended and Restated Employment Agreement between the Company and Jeffrey I. Friedman.  | Exhibit 10.1 to Form 10-Q filed May 13, 1996.                                     |
| 10.3 Equity-Based Incentive Compensation Plan.   | Exhibit 10.4 to Form 10-K filed March 29, 1995.                                   |
| 10.4 Form of Restricted Agreement dated by and among the Company and Its Independent Directors.  | Exhibit 10.9 to Form 10-K filed March 28, 1996.                                   |
| 10.8 Form of Share Option Agreement by and among the Company and Its Independent Directors.  | Exhibit 10.14 to Form 10-K filed March 30, 1993.                                  |
| 10.10 Associated Estates Realty Corporation Amended and Restated 2001 Equity-Based Plan (as amended on May 4, 2005). Incorporated by reference to Appendix 1 to the Definitive Proxy Statement filed March 28, 2005.   | Exhibit 99.01 to Form S-8 filed May 26, 2005.                                     |
| 10.11 Form of Equity Award Agreement   | Exhibit 10.11 to Form 10-Q filed August 2, 2005.                                  |
| 10.12 Long Term Incentive Compensation Plan  | Exhibit 10.12 to Form 10-Q filed November 1, 2005.                                |
| 31 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes Oxley Act.   | Exhibit 31 to Form 10-Q filed herewith.   |
| 31.1 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes Oxley Act.   | Exhibit 31.1 to Form 10-Q filed herewith.   |
| 32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes Oxley Act.   | Exhibit 32 to Form 10-Q filed herewith.   |

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**SIGNATURES**

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

May 1, 2007

(Date)

ASSOCIATED ESTATES REALTY CORPORATION

/s/ Lou Fatica

Lou Fatica, Vice President,  
Chief Financial Officer and Treasurer