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MISSION WEST PROPERTIES INC

Form 10-Q

August 10, 2001

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
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Form 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2001

COMMISSION FILE NUMBER 1-8383

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

Maryland  
-----

95-2635431  
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(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer Identification Number)

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

Registrant's telephone number, including area code is (408) 725-0700  
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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

APPLICABLE ONLY TO CORPORATE ISSUERS

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

17,120,279 shares outstanding as of August 9, 2001

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Mission West Properties, Inc.

FORM 10-Q  
FOR THE QUARTER ENDED JUNE 31, 2001

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PART I - FINANCIAL INFORMATION  
 ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS

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

	June 30, 2001
	----- (Unaudited)
ASSETS	
Real estate assets, at cost	
Land	\$ 205,489
Buildings	671,293
	-----
	876,782
Less accumulated depreciation	(42,088)
	-----

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Net real estate assets	834,694
Cash and cash equivalents	5,724
Deferred rent	15,196
Other assets	11,740
	-----
Total assets	\$867,354
	=====

LIABILITIES AND STOCKHOLDERS' EQUITY

Liabilities:	
Line of credit (related parties)	\$ 66,895
Mortgage notes payable	128,384
Mortgage notes payable (related parties)	11,510
Interest payable	345
Security deposits	5,620
Prepaid rental income	11,948
Dividends/distributions payable	22,428
Refundable option payment	19,835
Accounts payable and accrued expenses	3,941
	-----
Total liabilities	270,906
Commitments and contingencies (Note 9)	
Minority interest	492,279
Stockholders' equity:	
Preferred stock, \$.001 par value, 20,000,000 shares authorized, none issued and outstanding	-
Common stock, \$.001 par value, 200,000,000 shares authorized, 17,120,276 and 17,025,365 shares issued and outstanding at June 30, 2001 and December 31, 2000, respectively	17
Paid-in-capital	124,036
Accumulated deficit	(19,884)
	-----
Total stockholders' equity	104,169
	-----
Total liabilities and stockholders' equity	\$ 867,354
	=====

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

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MISSION WEST PROPERTIES, INC  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(Dollars in thousands, except share and per share amounts)  
(Unaudited)  
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Three months ended June 30,	Six m
2001	2001
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Revenues:			
Rental revenues from real estate	\$ 31,654	\$ 23,899	\$ 61,
Tenant reimbursements	3,756	2,930	7,
Other income, including interest and gain on sale of assets	825	643	4,
	-----	-----	-----
Total revenues	36,235	27,472	73,
	-----	-----	-----
Expenses:			
Operating expenses	1,717	1,403	2,
Real estate taxes	2,576	2,065	4,
Depreciation of real estate	4,165	3,863	8,
General and administrative	483	206	
Interest	2,216	2,246	4,
Interest (related parties)	1,163	1,134	2,
	-----	-----	-----
Total expenses	12,320	10,917	23,
	-----	-----	-----
Income before minority interest	23,915	16,555	49,
Minority interest	19,932	13,625	41,
	-----	-----	-----
Net income to common stockholders	\$ 3,983	\$ 2,930	\$ 8,
	=====	=====	=====
Basic net income per share	\$ 0.23	\$ 0.17	\$ 0
	=====	=====	=====
Diluted net income per share	\$ 0.23	\$ 0.17	\$ 0
	=====	=====	=====
Weighted average number of common shares outstanding (basic)	17,093,710	17,025,365	17,065,
	=====	=====	=====
Weighted average number of common shares outstanding (diluted)	17,308,601	17,113,346	17,293,
	=====	=====	=====

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

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MISSION WEST PROPERTIES, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Dollars in thousands)  
(Unaudited)  
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Cash flows from operating activities:	
Net income	\$
Adjustments to reconcile net income to net cash provided by operating activities:	
Minority interest	4
Depreciation	
Gain on sale of real estate	(
Gain on sale of securities	
Other	
Changes in assets and liabilities:	
Deferred rent	(
Other assets	
Interest payable	
Security deposits	
Prepaid rental income	
Accounts payable and accrued expenses	
Net cash provided by operating activities	5
Cash flows from investing activities:	
Improvements to real estate assets	(
Refundable option payment	2
Proceeds from sale of real estate	(2
Restricted cash exchanged for properties	)
Net cash used in investing activities	(
Cash flows from financing activities:	
Principal payments on mortgage notes payable	(
Principal payments on mortgage notes payable (related parties)	(3
Net payments under line of credit (related parties)	)
Proceeds from stock options exercised	
Minority interest distributions	
Dividends paid	(
Net cash used in financing activities	(4
Net increase in cash and cash equivalents	
Cash and cash equivalents, beginning	
Cash and cash equivalents, ending	\$
Supplemental information:	
Cash paid for interest	\$
Supplemental schedule of non-cash investing and financing activities:	
Advances under line of credit (related parties)	\$ 3
Debt incurred in connection with property acquisitions	\$ 2
Assumption of other liabilities in connection with property acquisitions	\$
Issuance of operating partnership units in connection with property acquisitions	\$ 1

The accompanying notes are an integral part of these consolidated

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financial statements.

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MISSION WEST PROPERTIES, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Amounts in thousands, except share, per share, square footage and  
operating partnership unit amounts)  
(Unaudited)  
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## 1. Principles of Consolidation and Basis of Presentation

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

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

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

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

## 2. Real Estate

### BERG LAND HOLDINGS OPTION AGREEMENT

Under the terms of the Berg land holdings option agreement, the Company, through the operating partnerships, has the option to acquire any future Research & Development ("R&D"), office and industrial buildings developed by the Berg Group on land currently owned, optioned, or acquired for these purposes in the future, directly or indirectly by certain members of the Berg Group. At present, there are approximately 341 acres of Silicon Valley

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land, including land under development, owned directly or under 50% joint venture by certain members of the Berg Group that are subject to the terms of the Berg land holdings option agreement. The owners of the future R&D property developments may obtain cash or, at their option, Operating Partnership ("O.P.") Units valued at the average closing price of shares of common stock over the 30-trading-day period preceding the acquisition date. As of June 30, 2001, the Company had completed eleven acquisitions under the Berg land holdings option agreement representing approximately 1,154,000 rentable square feet. Upon the Company's exercise of an option to purchase any of the future R&D property developments under the terms of the Berg land holdings option agreement, the acquisition price will equal the sum of (a) the full construction cost of the building; (b) 10% of the full construction cost of the building; (c) the acquisition value of the parcel as defined in the agreement upon which the improvements are constructed (currently ranging from \$8.50 to \$20.00 per square foot); (d) 10% per annum of the acquisition value of the parcel for the period from January 1, 1998 to the close of escrow; and (e) interest at LIBOR (London Interbank Offer Rate) plus 1.65% per annum on the full construction costs of the building for the period from the date funds were disbursed by the developer to the close of escrow; less (f) any debt encumbering the property, or a lesser amount as approved by the independent directors committee.

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No estimate can be given at this time as to the total cost to the Company to acquire projects under the Berg land holdings option agreement, or the timing of the Company's acquisition of any of such projects. However, the Berg Group currently has 13 properties under development with a total of approximately 1,250,000 rentable square feet of R&D properties that the Company has the right to acquire under this agreement. Of the 13 properties, six are joint ventures in which the Berg Group holds an approximately 50% interest. The joint venture properties represent a total of approximately 541,000 rentable square feet. As of June 30, 2001, the estimated acquisition price to the operating partnerships for these 13 projects would be approximately \$139,700. The final acquisition price of these 13 properties could differ significantly from this estimate. In addition to projects currently under development, the Company has the right to acquire future developments by the Berg Group on up to 261 additional acres of land currently controlled by the Berg Group, which could support approximately 4.2 million square feet of new developments. Under the Berg land holdings option agreement, as long as the Berg Group's percentage ownership interest in the Company and the operating partnerships taken as a whole is at least 65%, the Company also has an option to purchase all land acquired, directly or indirectly, by Carl E. Berg or Clyde J. Berg in the future which has not been improved with completed buildings and which is zoned for, intended for or appropriate for research and development, office and/or industrial development or use in the states of California, Oregon, and Washington.

### PROPERTY ACQUISITIONS

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

Effective February 1, 2001, the Company acquired an approximately 117,740 rentable square foot newly constructed R&D building located at 5500 Hellyer

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Avenue in San Jose, California from the Berg Group under the Berg land holdings option agreement. The total acquisition price for this property was \$17,809. The Company acquired this property by borrowing \$11,000 under its line of credit from the Berg Group and issuing 506,599 O.P. Units to various members of the Berg Group.

Effective April 1, 2001, the Company acquired an approximately 59,400 rentable square foot property located at 245 Caspian Drive in Sunnyvale, California from the Berg Group in a tax-deferred exchange. The total acquisition price for this property was \$13,388. The Company funded the acquisition with proceeds from a property disposition that were held as restricted cash for the use in tax-deferred property exchanges and was included in restricted cash at March 31, 2001. No debt or O.P. Units were issued for this acquisition. The lessee of the property has not authorized the completion of construction of the building as of June 30, 2001. The Berg Group has the obligation to build the building upon the request of the lessee at no cost to the Company. The lessee of the property has a 15-year lease and is making the lease payments on the property.

Effective May 1, 2001, the Company acquired an approximately 67,912 rentable square foot newly constructed R&D building located at 855 Branham Lane East in San Jose, California from the Berg Group in a tax-deferred exchange. The total acquisition price for this property was \$9,809. The Company funded the acquisition with proceeds from a property disposition that were held as restricted cash for the use in tax-deferred property exchanges and was included in restricted cash at March 31, 2001. No debt or O.P. Units were issued for this acquisition.

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

### PROPERTY DISPOSITION

In January 2001, the Company completed the sale of 200,484 rentable square feet of the R&D property at 4949 Hellyer Avenue, San Jose, California to Cisco Systems, Inc., which exercised its purchase option in November 2000. The Company realized a gain of \$3,102, which is included in other income, on the total sale price of \$23,130.

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### 3. Restricted Cash

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

### 4. Stock Transactions

During the six months ended June 30, 2001, stock options to purchase 14,588 shares of common stock were exercised at \$4.50 per share, stock options to



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purchase 38,000 shares of common stock were exercised at \$8.25 per share, and stock options to purchase 6,000 shares of common stock were exercised at \$13.00 per share. Total proceeds to the Company were \$457. Also one minority interest holder exchanged 36,323 O.P. Units, under the exchange rights agreement, for the Company's common stock on an exchange ratio of 1:1.

### 5. Other Income

As explained in Note 2 "Property Disposition" above, the Company realized a gain of \$3,102 on the total sale price of \$23,130 in the first quarter of 2001. Interest income generated from the proceeds was approximately \$481 for the six months ended June 30, 2001.

### 6. Net Income Per Share

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

The computation for weighted average shares is detailed below:

	Three Months Ended June 30,		Six
	2001	2000	Months
Weighted average shares outstanding (basic)	17,093,710	17,025,365	17,0
Incremental shares from assumed option exercise	214,891	87,981	2
Weighted average shares outstanding (diluted)	17,308,601	17,113,346	17,2

The outstanding O.P. Units, which are exchangeable at the unit holder's option, subject to certain conditions, for shares of common stock on a one-for-one basis have been excluded from the diluted net income per share calculation, as there would be no effect on the amounts because the minority interests' share of income would also be added back to net income. The total number of O.P. Units outstanding at June 30, 2001 and 2000 was 84,824,911 and 81,200,850, respectively.

### 7. Related Party Transactions

As of June 30, 2001, the Berg Group owned 79,364,181 O.P. Units. Along with the Company's common shares owned by the Berg Group, the Berg Group's ownership as of June 30, 2001 represented approximately 78% of the equity interests of the Company, assuming conversion of the 84,824,911 O.P. Units outstanding into the common stock of the Company.

As of June 30, 2001, debt in the amount of \$66,895 was due the Berg Group under the line of credit established March 1, 2000. The \$50,000 line of credit from the Berg Group was increased to \$75,000 effective April 1, 2000. The Berg Group line of credit is currently collateralized by seven properties, bears interest at LIBOR plus 1.30%, and matures in March 2002. The Company believes that the terms of the Berg Group line of credit are more favorable than those available from commercial lenders. As of June 30,

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2001, debt in the amount of \$11,510 was due the Berg Group under a mortgage note established May 15, 2000 in connection with the acquisition of a 50% interest in Hellyer Avenue Limited Partnership, the obligor under the mortgage note. The mortgage note bears interest at 7.65%, and is due in 10 years with principal payments amortized over 20 years.

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

The Company currently leases office space owned by Berg & Berg Enterprises, Inc., an affiliate of Carl E. Berg and Clyde J. Berg. Rental amounts and overhead reimbursements paid to Berg & Berg Enterprises, Inc. were \$20 for the three months ended June 30, 2001 and 2000, and \$43 and \$40 for the six months ended June 30, 2001 and 2000, respectively.

### 8. Subsequent Events

On July 12, 2001 the Company paid \$0.22 per share dividend on its common stock to all common stockholders of record as of June 29, 2001. On the same date, the operating partnerships paid a distribution of \$0.22 per O.P. Unit.

### 9. Commitments and Contingencies

The Company and the operating partnerships are or may become, from time to time, parties to litigation arising out of the normal course of business. Management does not expect that such matters would have a material adverse effect on the consolidated financial position, results of operations or cash flows of the Company.

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

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

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

### OVERVIEW

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Mission West Properties, Inc. (the "Company") acquires, markets, leases, and manages R&D properties, primarily located in the Silicon Valley portion of the San Francisco Bay Area. As of June 30, 2001, the Company owned and managed 93 properties totaling approximately 6.4 million rentable square feet of R&D properties through four limited partnerships, or operating partnerships, for which it is the sole general partner. This class of property is designed for research and development and office uses and, in some cases, includes space for light manufacturing operations with loading docks. The Company believes that it has one of the largest portfolios of R&D properties in the Silicon Valley. The four tenants who lease the most square footage from the Company are Microsoft Corporation, Amdahl Corporation (a subsidiary of Fujitsu Limited), Apple Computer, Inc. and JDS Uniphase Corporation. For federal income tax purposes the Company has operated as a self-managed, self-administered and fully integrated real estate investment trust ("REIT") since 1999.

Our acquisition and growth strategy incorporates the following elements:

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

The Company has elected, under the Internal Revenue Code of 1986, as amended (the "Code"), to be taxed as a REIT commencing with the taxable year ended December 31, 1999.

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

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### RESULTS OF OPERATIONS

Comparison of the three and six months ended June 30, 2001 to the three and six months ended June 30, 2000.

As of June 30, 2001, the Company, through its controlling interests in the operating partnerships, owned 93 properties totaling approximately 6.4 million square feet compared to 86 properties totaling approximately 5.9 million square feet owned by the Company as of June 30, 2000. This represents an increase of approximately 8% in total rentable square footage from one year ago. The increase resulted from the following acquisitions less the disposition of 200,484 rentable square feet at 4949 Hellyer Avenue as discussed under Note 2 of Notes to Consolidated Financial Statements, "Property Disposition":

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Date of Acquisition	Address	Rentable Square Footage
07/00	5400 Hellyer Avenue	77,184
10/00	45365 Northport Loop	64,218
12/00	1768 Automation Parkway	110,592
01/01	5325 Hellyer Avenue	131,500
02/01	5500 Hellyer Avenue	117,740
04/01	245 Caspian Drive (1)	59,400
05/01	855 Branham Lane East	67,912
06/01	5550 Hellyer Avenue	78,794
		707,340

(1) The lessee of the property has not authorized the completion of construction of the building as of June 30, 2001. The Berg Group has the obligation to build the building upon the request of the lessee at no cost to the Company. The lessee of the property has a 15-year lease and is making the lease payments on the property.

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

	Three months ended June 30,			
	2001	2000	\$ Change	Percenta
	(\$ in thousands)			
Same Property (1)	\$17,293	\$14,758	\$ 2,535	1
1998 Acquisitions	582	586	(4)	
1999 Acquisitions	6,512	5,718	794	1
2000 Acquisitions (2)	5,089	2,836	2,253	7
2001 Acquisitions	2,178	-	2,178	10
	\$31,654	\$23,898	\$ 7,756	3

	Six months ended June 30,			
	2001	2000	\$ Change	Percenta
	(\$ in thousands)			
Same Property (1)	\$33,340	\$28,420	\$ 4,920	1
1998 Acquisitions	1,165	1,171	(6)	
1999 Acquisitions	13,037	11,939	1,098	
2000 Acquisitions (2)	10,177	3,604	6,573	18
2001 Acquisitions	3,614	-	3,614	10
	\$61,333	\$45,134	\$16,199	3

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- (1) "Same Property" is defined as properties owned as of July 1, 1998 and still owned as of June 30, 2001.
- (2) The difference in comparison of 2000 acquisitions is due to the timing of the acquired property during the year 2000.

For the quarter ended June 30, 2001, rental revenues increased by \$7.75 million from \$23.90 million for the three months ended June 30, 2000 to \$31.65 million for the same period of 2001. Of the \$7.75 million increase in rental revenues, \$2.53 million resulted from the Company's "Same Property" portfolio, \$0.79 million resulted from properties acquired in 1999, \$2.25 million resulted from properties acquired in 2000, and \$2.18 million resulted from properties acquired in 2001. Rental revenues increased by \$16.20 million from \$45.13 million for the six months ended June 30, 2000 to \$61.33 million for the same period of 2001. Of the \$16.20 million increase in rental revenues, \$4.92 million was generated by the Company's "Same Property" portfolio, \$1.10 million was generated by properties acquired in 1999, \$6.57 million was generated by properties acquired in 2000, and \$3.61 million resulted from properties acquired in 2001.

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Tenant reimbursements increased by \$0.83 million, or 28% from \$2.93 million for the three months ended June 30, 2000 to \$3.76 million for the three months ended June 30, 2001. Operating expenses and real estate taxes, on a combined basis, increased by \$0.82 million, or 24% from \$3.47 million to \$4.29 million for the three months ended June 30, 2000 and 2001, respectively. Tenant reimbursements increased by \$0.80 million, or 12% from \$6.44 million for the six months ended June 30, 2000 to \$7.24 million for the six months ended June 30, 2001. Operating expenses and real estate taxes, on a combined basis, increased by \$0.91 million, or 13% from \$6.93 million to \$7.84 million for the six months ended June 30, 2000 and 2001, respectively. The increases in all categories resulted primarily from the increase in the total rentable square footage during the periods presented.

Depreciation expense increased by \$302,000 and \$772,000 for the three and six-month period ended June 30, 2001, respectively, over the same period a year ago. The increase was attributable to the acquisition of eight R&D properties since June 30, 2000.

Interest expense decreased by \$30,000 or 1% from \$2.25 million for the three months ended June 30, 2000 to \$2.22 million for the three months ended June 30, 2001 due to debt repayment. Interest expense (related parties) increased by \$30,000 or 3% from \$1.13 million for the three months ended June 30, 2000 to \$1.16 million for the three months ended June 30, 2001 from increased borrowing under the Berg Group line of credit for property acquisitions. As a result, overall interest expense (including amounts to related parties) for the quarter ended June 30, 2001 slightly changed compared to the second quarter a year ago. Interest expense decreased by \$70,000 or 2% from \$4.50 million for the six months ended June 30, 2000 to \$4.43 million for the six months ended June 30, 2001. Interest expense (related parties) increased by \$580,000 or 31% from \$1.88 million for the six months ended June 30, 2000 to \$2.46 million for the six months ended June 30, 2001. Overall interest expense for the six months ended June 30, 2001 increased by \$501,000 compared to the six months ended June 30, 2000. The eight R&D property acquisitions increased total debt outstanding, including amounts due related parties, by \$18.68 million, or 10% from \$188.11 million as of June 30, 2000 to \$206.79 million as of June 30, 2001. Management expects interest expense to increase as new debt is incurred in connection with property acquisitions and as it seeks alternative sources of credit.

The minority interest portion of income was \$19.93 million, resulting in net

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income to stockholders of \$3.98 million for the three months ended June 30, 2001. For the six months ended June 30, 2001, the minority interest portion of income was \$41.02 million, resulting in net income to stockholders of \$8.20 million. Minority interest represents the ownership interest of all limited partners in the operating partnerships taken as a whole, which was 83% as of June 30, 2001 and 2000.

### RECENT RENTAL MARKET DEVELOPMENTS

All of the Company's properties are located in the Northern California area known as Silicon Valley, which generally consists of portions of Santa Clara County, Southwestern Alameda County, Southeastern San Mateo County and Eastern Santa Cruz County. The Silicon Valley economy and business activity have slowed markedly during the first half of 2001, most noticeably in the last quarter, after fast-paced growth in 1999 and 2000. In the past several years, the Silicon Valley R&D property market has fluctuated with the local economy. According to a recent report by BT Commercial Real Estate, vacancy rates for Silicon Valley R&D property increased from approximately 3.6% in late 2000 to 10.2% at the end of the second quarter of 2001. The total vacant R&D square footage in Silicon Valley at the end of the second quarter of 2001 amounted to 15.7 million square feet of which 48% or 7.5 million square feet was sublease space. Total net absorption in 2000 amounted to approximately 12.8 million square feet. During the first six months of 2001 there was a total negative net absorption of approximately (9.1) million square feet. The impact of this decline has not been uniform throughout the area, however. The Silicon Valley R&D property market has been characterized by a substantial number of submarkets. Rent and vacancy rates vary considerably by submarket and location within each submarket. The Company's average occupancy rate for the three and six-month periods ended June 30, 2001 was 98% and 99%, respectively. The Company does not currently anticipate a material decline in occupancy or rental rates for its existing R&D properties. Nonetheless, the Company's operating results and ability to pay dividends at current levels remain subject to a number of material risks, as indicated under the caption "Forward-Looking Information" below and in the section entitled "Risk Factors" in the Company's most recent annual report on Form 10-K.

### CHANGES IN FINANCIAL CONDITION

In January 2001, the Company completed the sale of 200,484 rentable square feet of the R&D property at 4949 Hellyer Avenue, San Jose, California to Cisco Systems, Inc., which exercised its purchase option in November 2000. The Company realized a gain of \$3,102, which is included in other income, on the total sale price of \$23,130. The proceeds were held as restricted cash to be used in tax-deferred property exchanges.

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During the first six months of 2001, the Company acquired three additional properties representing approximately 328,000 rentable square feet of R&D properties located in Silicon Valley. These properties were acquired from the Berg Group under the Berg land holdings option agreement. The aggregate acquisition price for these properties was approximately \$40.4 million. The Company financed these acquisitions by a) borrowing \$23.0 million under the Berg Group line of credit; and b) the issuance of 1,285,207 O.P. Units. In addition to the acquisitions, the Company also acquired two R&D properties representing 127,312 rentable square feet for approximately \$23.2 million in a tax-deferred exchange. The lessee for one of these tax-deferred exchanged properties has not authorized the completion of construction of the building as of June 30, 2001. The Berg Group has the obligation to build the building upon the request of the lessee at no cost to the Company. The lessee of the property has a 15-year lease and is making the lease payments on the property. The Company funded the acquisitions with proceeds from a property disposition that were held as

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restricted cash for the use in tax-deferred property exchanges and was included in restricted cash at March 31, 2001. No debt or O.P. Units were issued for these acquisitions.

During the six months ended June 30, 2001, stock options to purchase 14,588 shares of common stock were exercised at \$4.50 per share, stock options to purchase 38,000 shares of common stock were exercised at \$8.25 per share, and stock options to purchase 6,000 shares of common stock were exercised at \$13.00 per share. Total proceeds to the Company were approximately \$457,000. Also one minority interest holder exchanged 36,323 O.P. Units, under the exchange rights agreement, for the Company's common stock on an exchange ratio of 1:1.

### LIQUIDITY AND CAPITAL RESOURCES

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

The Company's \$50 million line of credit with Wells Fargo Bank expired on February 29, 2000 and was repaid with proceeds from and replaced by a \$50 million line of credit from the Berg Group. On April 1, 2000, the \$50 million credit line with the Berg Group was increased to \$75 million with all other terms remaining the same. The Berg Group line of credit is currently collateralized by seven properties, bears interest at LIBOR plus 1.30%, and matures in March 2002. The Company is continually evaluating alternative sources of credit. There can be no assurance that the Company will be able to obtain a line of credit with terms similar to the Berg Group line of credit, and its cost of borrowing could increase substantially. The Company believes that the terms of the Berg Group line of credit are more favorable than those available from Wells Fargo or similar lenders.

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

At June 30, 2001, the Company had total indebtedness of \$206.8 million, including \$128.4 million of fixed rate mortgage debt, \$11.5 million under the Berg Group mortgage note (related parties), and \$66.9 million under the Berg Group line of credit (related parties). During the second quarter the Company paid approximately \$2.7 million to close out one of its outstanding debt to Mellon Mortgage Company, which matured in June 2001.

As of June 30, 2001, the Company's Debt to Total Market Capitalization ratio was approximately 14.3%. The Company computed this ratio by dividing the Company's total debt outstanding by the sum of this debt plus the market value of common stock (based upon the closing price of \$12.10 per share on June 29, 2001) on a fully diluted basis, taking into account the conversion of all O.P. Units into common stock. On June 29, 2001, the last trading day during the period, Total Market Capitalization was approximately \$1.4 billion.

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MORTGAGE DEBT

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

Debt Description	Collateral Properties	Balance
		(\$ in thousands)
Line of Credit:		
Berg Group (related parties)	2033-2043 Samaritan Drive, San Jose, CA	\$ 66,
	2133 Samaritan Drive, San Jose, CA	
	2233-2243 Samaritan Drive, San Jose, CA	
	1310-1450 McCandless Drive, Milpitas, CA	
	1315-1375 McCandless Drive, Milpitas, CA	
	1650-1690 McCandless Drive, Milpitas, CA	
	1650-1690 McCandless Drive, Milpitas, CA	
Mortgage Notes Payable (related parties):	5300 & 5350 Hellyer Avenue, San Jose, CA	11,
Mortgage Notes Payable:		
Prudential Capital Group	20400 Mariani Avenue, Cupertino, CA	1,
New York Life Insurance Company	10440 Bubb Road, Cupertino, CA	
Home Savings & Loan Association	10460 Bubb Road, Cupertino, CA	
Prudential Insurance Company of America	10300 Bubb Road, Cupertino, CA	125,
	10500 N. DeAnza Blvd, Cupertino, CA	
	4050 Starboard Drive, Fremont, CA	
	45700 Northport Loop, Fremont, CA	
	45738 Northport Loop, Fremont, CA	
	450-460 National Avenue, Mountain View, CA	
	6311 San Ignacio Avenue, San Jose, CA	
	6321 San Ignacio Avenue, San Jose, CA	
	6325 San Ignacio Avenue, San Jose, CA	
	6331 San Ignacio Avenue, San Jose, CA	
	6341 San Ignacio Avenue, San Jose, CA	
	6351 San Ignacio Avenue, San Jose, CA	
	3236 Scott Blvd, Santa Clara, CA	
	3560 Bassett Street, Santa Clara, CA	
	3570 Bassett Street, Santa Clara, CA	
	3580 Bassett Street, Santa Clara, CA	
	1135 Kern Avenue, Sunnyvale, CA	
	1212 Bordeaux Lane, Sunnyvale, CA	
	1230 E. Arques, Sunnyvale, CA	
	1250 E. Arques, Sunnyvale, CA	
	1170 Morse Avenue, Sunnyvale, CA	
	1600 Memorex Drive, Santa Clara, CA	
	1688 Richard Avenue, Santa Clara, CA	
	1700 Richard Avenue, Santa Clara, CA	
	3540 Bassett Street, Santa Clara, CA	
	3542 Bassett Street, Santa Clara, CA	
	3544 Bassett Street, Santa Clara, CA	
	3550 Bassett Street, Santa Clara, CA	



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Mortgage Notes Payable Subtotal

-----  
128,  
-----

Total

-----  
\$ 206,  
=====

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

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CURRENT PROPERTIES SUBJECT TO OUR ACQUISITION AGREEMENT WITH THE BERG GROUP

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

Property	Number of Buildings	Approximate Rentable Area (Square Feet)	Anticipated Acquisition Date
Berg Land Holdings Option			
Under Development			
Silver Creek	4	346,000	3rd Quarter 2001
5750 Hellyer	1	73,312	3rd Quarter 2001
Morgan Hill (JV I) (2)	1	155,000	3rd Quarter 2001
Morgan Hill (JV IA) (2)	1	126,000	3rd Quarter 2001
Morgan Hill (JV IV) (2)	2	160,000	4th Quarter 2001
5345 Hellyer	1	125,000	1st Quarter 2002
Piercy & Hellyer	1	165,000	3rd Quarter 2002
Morgan Hill (JV II) (2) (3)	1	60,000	4th Quarter 2002
Morgan Hill (JV III) (2) (3)	1	40,000	4th Quarter 2002
	---	-----	
Subtotal	13	1,250,312	
Available Land			
Construction in Progress (3)		490,000	
Piercy & Hellyer		165,000	
Morgan Hill (2)		420,000	
King Ranch		248,500	
Fremont & Cushing		387,000	
Evergreen		2,480,000	
		-----	
Subtotal		4,190,500	
TOTAL	13	5,440,812	
	==	=====	

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

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

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

Although the Company expects to acquire the new properties available to it under the terms of the Berg land holdings option agreement, subsequent to the approval by the independent directors committee, there can be no assurance that the

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Company actually will consummate any intended transactions, including all of those discussed above. Furthermore, the Company has not yet determined the means by which it would acquire and pay for any such properties or the impact of any of the acquisitions on its business, results of operations, financial condition, FFO or available cash for distribution.

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

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

### HISTORICAL CASH FLOWS

Net cash provided by operating activities for the six months ended June 30, 2001 was \$51.5 million compared to \$43.0 million for the same period in 2000, a 20% increase. The change was a direct result of rent increases and newly acquired properties.

Net cash used in investing activities was approximately \$1.3 million and \$1.1 million for the six months ended June 30, 2001 and 2000, respectively, an 18% increase. Of the \$1.3 million net cash used in investing activities, \$324 were related to tenant improvements and \$1.0 million related to the Xilinx agreement.

Net cash used in financing activities was \$49.1 million for the six months ended June 30, 2001 compared to \$41.6 million for the same period in 2000, an 18% increase. Of the \$49.1 million net cash used in financing activities, \$42.3 million were used to pay outstanding debt, \$789,000 for minority interest distributions, \$6.5 million for dividend payments, and \$457,000 received from exercised stock options. During the six months ended June 30, 2001, the Company paid its debt outstanding and made distributions to holders of its common stock and O.P. Units by utilizing cash generated from operating activities.

### CAPITAL EXPENDITURES

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

### FUNDS FROM OPERATIONS

As defined by the National Association of Real Estate Investment Trusts ("NAREIT"), FFO represents net income (loss) before minority interest of unit holders (computed in accordance with GAAP), excluding gains (or losses) from debt restructuring and sales of property, plus real estate related depreciation and amortization (excluding amortization of deferred financing costs and depreciation of non-real estate assets) and after adjustments for unconsolidated partnerships and joint ventures. Management considers FFO an appropriate measure of performance of an equity REIT because, along

with cash flows from operating activities, financing activities and investing activities, it provides investors with an understanding of the Company's ability

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to incur and service debt, and make capital expenditures. FFO should not be considered as an alternative for net income as a measure of profitability and it is not comparable to cash flows provided by operating activities determined in accordance with GAAP, nor is FFO necessarily indicative of funds available to meet the Company's cash needs, including its need to make cash distributions to satisfy REIT requirements.

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

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

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

	Three Months Ended June 30,		Six Months Ended
	2001	2000	2001
	(\$ in thousands)		(\$ in thousands)
Net income	\$3,983	\$2,930	\$8,202
Add:			
Minority interest (1)	19,779	13,558	40,696
Depreciation	4,165	3,863	8,267
Less:			
Gain on sale of assets	-	501	3,102
FFO	\$27,927	\$19,850	\$54,063

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

### DISTRIBUTION POLICY

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

	Three Months Ended June 30,		Six Months Ended
	2001	2000	2001

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	(\$ in thousands)		(\$ in thou)
FFO	\$27,927	\$19,850	\$54,063
Less:			
Straight-line rents	2,238	357	4,327
Leasing commissions	419	753	582
Capital expenditures	170	248	324
	-----	-----	-----
FAD	\$25,100	\$18,492	\$48,830
	=====	=====	=====

The Company intends to make regular quarterly distributions to holders of common stock and O.P. Units based on its FAD. The Company's ability to make such distributions will be affected by numerous factors, including, most importantly, the receipt of distributions from rental operations payable to the Company as the sole general partner of the operating partnerships.

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

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

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

#### IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

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

#### FORWARD-LOOKING INFORMATION

This quarterly report contains forward-looking statements within the meaning of the federal securities laws. The Company intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements

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contained in the Private Securities Reform Act of 1995, and is including this statement for purposes of complying with these safe harbor provisions. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies and expectations of the Company, are generally identifiable by use of the words "believe," "expect," "intend," "anticipate," "estimate," "project" or similar expressions. The Company's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations and future prospects of the Company include, but are not limited to, changes in: economic conditions generally and the real estate market specifically, legislative or regulatory provisions affecting the Company (including changes to laws governing the taxation of REITs), availability of capital, interest rates, competition, supply of and demand for R&D, office and industrial properties in the Company's current and proposed market areas, tenant defaults and bankruptcies, and general accounting principles, policies and guidelines applicable to REITs. In addition, the actual timing of development, construction, and leasing on the projects that the Company believes it may acquire in the future under the Berg land holdings option agreement is unknown presently, and reliance should not be placed on the estimates concerning these projects set forth under the caption, "Acquiring Properties Developed by the Berg Group," above. These risks and uncertainties, together with the other risks described from time to time in the Company's reports and other documents filed with the Securities and Exchange Commission, should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements.

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ITEM 3  
QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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Part II - Other Information

ITEM 4  
SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

- a) The annual meeting of stockholders of the Company was held on May 17, 2001 in which proxies representing 13,946,753 shares of common stocks, or 81.6% of the total outstanding shares, voted.
- b) At the annual meeting of stockholders, Mr. Carl E. Berg, John C. Bolger, William A. Hasler, and Lawrence B. Helzel were elected as directors for the ensuing year, all of who were currently serving on the board of directors of the Company.
- c) The following proposals were voted upon at the meeting:

Proposal No. 1: Election of Directors

Directors	Total Vote for Each Director	Total Vote Withheld from Each Directors	Total Eac
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Carl E. Berg	13,566,952	379,733
John C. Bolger	13,566,952	379,733
William A. Hasler	13,566,952	379,733
Lawrence B. Helzel	13,566,952	379,733

Proposal No. 2: The second matter voted upon was the ratification of the selection of PricewaterhouseCoopers, LLP as independent public accountants for the Company for the year ending December 31, 2001. There were 13,936,678 votes in favor of the proposal, 6,855 votes against the proposal, and 3,220 abstentions.

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Signatures

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

Mission West Properties, Inc.  
(Registrant)

Date: August 10, 2001

By: /s/ Wayne N. Pham

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

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