ASSOCIATED ESTATES REALTY CORP
Form 10-Q
August 01, 2014

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

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

For the quarterly period ended June 30, 2014

OR

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

For the transition period from _________ to _________

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

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

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

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

The number of shares outstanding as of July 25, 2014 was 57,644,341 shares.

ASSOCIATED ESTATES REALTY CORPORATION

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

(In thousands, except share and per share amounts)	June 30, 2014	December 31, 2013
ASSETS		
Real estate assets		
Land	$248,321	$298,441
Buildings and improvements	1,324,579	1,370,560
Furniture and fixtures	38,390	39,725
Construction in progress	70,248	42,793
Gross real estate	1,681,538	1,751,519
Less: accumulated depreciation	(382,054)	(386,841)
Net real estate owned	1,299,484	1,364,678
Investment in unconsolidated entities	39,836	9,321
Total net real estate	1,339,320	1,373,999
Cash and cash equivalents	8,884	4,586
Restricted cash	23,364	3,465
Accounts receivable, net		
Rents	1,066	1,230
Other	3,411	1,258
Other assets, net	31,337	37,959
Total assets	$1,407,382	$1,422,497
LIABILITIES AND EQUITY		
Mortgage notes payable	$278,792	$279,474
Unsecured notes	250,000	250,000
Unsecured revolving credit facility	36,000	133,500
Unsecured term loan	150,000	150,000
Total debt	714,792	812,974
Accounts payable and other liabilities	42,512	42,882
Dividends payable	11,495	12,178
Resident security deposits	3,860	4,112
Accrued interest	5,268	5,551
Total liabilities	777,927	877,697
Equity		
Common shares, without par value, $.10 stated value; 91,000,000 authorized; 57,704,675 issued and 57,640,475 outstanding at June 30, 2014 and 57,595,479 issued and 57,476,192 outstanding at December 31, 2013, respectively	5,770	5,760
Paid-in capital	756,583	754,582
Accumulated distributions in excess of accumulated net income	(130,758)	(213,275)
Accumulated other comprehensive loss	(1,448)	(702)
Less: Treasury shares, at cost, 64,200 and 119,287 shares at June 30, 2014 and December 31, 2013, respectively	(1,042)	(1,915)
Total shareholders' equity attributable to AERC	629,105	544,450
Noncontrolling interest	350	350
Total equity	629,455	544,800

Total liabilities and equity	$1,407,382	$1,422,497

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands, except per share amounts)	2014	2013	2014	2013
REVENUE				
Property revenue	$47,268	$43,246	$96,417	$85,789
Office revenue	455	238	933	550
Property management and construction services revenue	179	—	267	—
Total revenue	47,902	43,484	97,617	86,339
EXPENSES				
Property operating and maintenance	18,132	16,662	37,500	32,857
Depreciation and amortization	15,885	13,857	32,180	27,748
General and administrative	4,596	4,398	9,915	9,356
Development costs	198	181	528	443
Construction services	33	—	90	—
Costs associated with acquisitions	27	64	113	64
Total expenses	38,871	35,162	80,326	70,468
Operating income	9,031	8,322	17,291	15,871
Interest expense	(6,587)	(7,395)	(13,540)	(14,816)
Gain on disposition of properties	59,904	—	100,870	—
Income from continuing operations	62,348	927	104,621	1,055
Income from discontinued operations:				
Operating income, net of interest expense	—	725	—	2,164
Gain on disposition of properties	—	—	—	8,796
Income from discontinued operations	—	725	—	10,960
Net income	62,348	1,652	104,621	12,015
Net income attributable to noncontrolling interests	—	(14)	—	(31)
Net income attributable to AERC	$62,348	$1,638	$104,621	$11,984
Allocation to participating securities	(212)	—	(355)	—
Net income applicable to common shares	$62,136	$1,638	$104,266	$11,984
Earnings per common share - basic:				
Income from continuing operations applicable to common shares	$1.08	$0.02	$1.82	$0.02
Income from discontinued operations	—	0.01	—	0.22
Net income applicable to common shares - basic	$1.08	$0.03	$1.82	$0.24
Earnings per common share - diluted:				
Income from continuing operations applicable to common shares	$1.07	$0.02	$1.80	$0.02
Income from discontinued operations	—	0.01	—	0.22
Net income applicable to common shares - diluted	$1.07	$0.03	$1.80	$0.24
Comprehensive income:				
Net income	$62,348	$1,652	$104,621	$12,015
Other comprehensive income:				
Change in fair value and reclassification of hedge instruments	(683)	2,421	(746)	2,309
Total comprehensive income	61,665	4,073	103,875	14,324
Comprehensive income attributable to noncontrolling interests	—	(14)	—	(31)
Total comprehensive income attributable to AERC	$61,665	$4,059	$103,875	$14,293

Dividends declared per common share	$0.19	$0.19	$0.38	$0.38
Weighted average shares outstanding - basic	57,475	49,864	57,419	49,749
Weighted average shares outstanding - diluted	57,919	50,583	57,876	50,431

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

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

	Six Months Ended June 30,	
(In thousands)	2014	2013
Cash flow from operating activities:		
Net income	$104,621	$12,015
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	32,180	28,918
Gain on disposition of properties	(100,870)	(8,796)
Amortization of deferred financing costs and other	549	656
Share-based compensation expense	2,170	2,406
Net change in assets and liabilities:		
Accounts receivable	16	(1,088)
Accounts payable and accrued expenses	(4,180)	(861)
Other operating assets and liabilities	667	4,292
Total adjustments	(69,468)	25,527
Net cash flow provided by operating activities	35,153	37,542
Cash flow from investing activities:		
Recurring fixed asset additions	(4,203)	(4,564)
Revenue enhancing/non-recurring fixed asset additions	(696)	(392)
Acquisition fixed asset additions	(46,385)	(731)
Development fixed asset additions	(27,609)	(59,237)
Net proceeds from disposition of operating properties	168,756	61,970
Contributions to joint ventures	(5,636)	(1,598)
Deposits on potential future acquisitions	3,193	—
Cash proceeds from sale of equity interest in development property	24,075	—
Escrow deposits related to property sales	(72,292)	—
Escrow disbursements related to property acquisition	52,414	—
Costs paid on behalf of joint venture	(5,639)	—
Reimbursements of costs paid on behalf of joint venture	4,420	—
Other investing activity	(589)	(1,985)
Net cash flow provided by (used for) investing activities	89,809	(6,537)
Cash flow from financing activities:		
Principal amortization payments on mortgage notes payable	(1,041)	(1,593)
Principal repayments of mortgage notes payable	(20,038)	—
Payment of debt procurement costs	(130)	(2,453)
Proceeds from secured construction loans	20,782	—
Proceeds from issuance of unsecured notes	—	150,000
Revolving credit facility borrowings	117,000	115,700
Revolving credit facility repayments	(214,500)	(272,700)
Common share dividends paid	(22,579)	(18,747)
Operating partnership distributions paid	—	(28)
Exercise of stock options	714	1,550
Issuance of common shares	—	1,870
Purchase of treasury shares	(999)	(697)
Purchase of noncontrolling interest in partnership	—	(4,544)
Other financing activities, net	127	116
Net cash flow used for financing activities	(120,664)	(31,526)

Increase in cash and cash equivalents	4,298	(521)
Cash and cash equivalents, beginning of period	4,586	4,740
Cash and cash equivalents, end of period	$8,884	$4,219
Supplemental disclosure of non-cash transactions:		
Dividends declared but not paid	$11,495	$10,489
Net change in accounts payable related to fixed asset additions	5,028	5,105
Net change in accounts payable and security deposits related to disposition of operating properties	(486)	(322)
Deconsolidation of net assets	26,238	—

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

ASSOCIATED ESTATES REALTY CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
UNAUDITED

1. BUSINESS

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

We are a fully-integrated, self-administered and self-managed equity real estate investment trust ("REIT") specializing in multifamily ownership, operation, acquisition, development, construction, disposition and property management activities. Our primary source of income is rental revenue. Additional income is derived from property management and construction services revenue. We own a taxable REIT subsidiary that performs construction services for our own account in connection with the development of multifamily properties that we own and operate, including consolidated and unconsolidated joint ventures. As of June 30, 2014, our operating portfolio consisted of 50 apartment communities containing 13,034 units in eight states that are owned, either directly or indirectly, through subsidiaries. In conjunction with our acquisition of land for development of an apartment community, we acquired a commercial building in Los Angeles, California containing approximately 78,800 total square feet of office and commercial space. Additionally, we provide property management services for three apartment communities that we expect to acquire pursuant to existing contracts.

2. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared by management in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and applicable rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments consisting only of normal and recurring adjustments considered necessary for a fair statement have been included. The reported results of operations are not necessarily indicative of the results that may be expected for the full year. These financial statements should be read in conjunction with the audited financial statements and accompanying notes in our Annual Report on Form 10-K for the year ended December 31, 2013.

Segment Reporting

Substantially all of our properties are multifamily communities and, while the economic climate of the markets in which they are located may vary from time to time, the communities offer similar products and services and have similar economic characteristics. Management evaluates the performance of our properties and makes acquisition/disposition decisions on an individual basis. During the six months ended June 30, 2014, substantially all of our consolidated revenue was provided by our multifamily properties. We have determined that, as of June 30, 2014, we have one reportable segment which is multifamily properties.

Derivative Instruments and Hedging Activities

We utilize interest rate swaps to add stability to interest expense and to manage our exposure to interest rate movements. Interest rate swaps designated as cash flow hedges involve the receipt of variable-rate amounts in exchange for fixed-rate payments over the life of the agreements without exchange of the underlying principal amount.

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

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

For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of the derivative is initially reported in other comprehensive income (outside of earnings) and subsequently reclassified to earnings when the hedged transaction affects earnings, and the ineffective portion of changes in the fair value of the derivative is recognized directly in earnings. Hedge ineffectiveness is measured by comparing the changes in fair value or cash flows of the derivative hedging instrument with the changes in fair value or cash flows of the designated hedged item or transaction. For derivatives not designated as hedges, changes in fair value are recognized in earnings. See Note 11 for additional information related to our derivative and hedging activities.

Real Estate Capitalization Policies and Depreciation

Real estate assets are stated at cost less accumulated depreciation. Depreciation is provided on a straight-line basis over the estimated useful lives of the assets as follows:

Buildings and improvements	5 - 30 years
Furniture, fixtures and equipment	5 - 10 years

We capitalize replacements and improvements, such as HVAC equipment, structural replacements, windows, appliances, flooring, carpeting and kitchen/bath replacements and renovations. Ordinary repairs and maintenance, such as unit cleaning, painting and appliance repairs, are expensed when incurred.

We allocate the purchase price of acquired properties to net tangible and identified intangible assets and liabilities acquired based on their fair values. In making estimates of fair values for purposes of allocating the purchase price, we utilize a number of sources, including analysis provided by an advisor, independent appraisals that may be obtained in connection with the acquisition or financing of the respective property, our analysis of recently acquired and existing comparable properties in our portfolio and other market data. The intangible assets are amortized over the remaining lease terms, which is approximately 12 months. Due to the short term nature of residential leases, we believe that existing lease rates approximate market rates; therefore, no allocation is made for above/below market leases. The intangible assets associated with one commercial lease are being amortized over the life of the lease, which is 60 months.

For properties under development, we capitalize interest costs on funds used in construction, real estate taxes and insurance from the commencement of development activity through the time the property is substantially complete and ready for leasing. For properties under development accounted for under the equity method, we capitalize interest costs on our investment through the time the venture commences planned principal operations. We also capitalize internal costs related to our consolidated and equity method ventures, which are primarily payroll, but may also include costs such as travel, lodging and temporary construction facilities that are directly attributable to the construction of a property or asset. Certain costs associated with the lease-up of development projects, such as signs and "grand openings" are capitalized and amortized over the estimated life of average tenant relationships, which are approximately 12 months. All other internal costs associated with the lease up of development properties are expensed as incurred. Revenue from incidental operations for properties under development are recognized as reductions of capitalized project costs. Capitalized payroll costs are allocated to projects based upon time incurred by the applicable personnel. Capitalized costs related to development and construction are transferred to buildings and improvements and/or furniture and fixtures, as applicable, upon substantial completion of the project. Total capitalized interest during the three and six months ended June 30, 2014 was $1.2 million and $2.2 million, respectively. Total capitalized interest during the three and six months ended June 30, 2013 was $790,000 and $1.3 million, respectively. Total capitalized payroll costs during the three and six months ended June 30, 2014 were $860,000 and $1.6 million, respectively. Total capitalized payroll costs during the three and six months ended June 30, 2013 were $750,000 and $1.3 million, respectively.

We discontinue the depreciation of assets we have specifically identified as held for sale. There were no properties classified as held for sale at June 30, 2014 or December 31, 2013.

Classification of Fixed Asset Additions

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

Discontinued Operations

In April 2014, the Financial Accounting Standards Board ("FASB") issued ASU No. 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant and Equipment (Topic 360): Reporting of Discontinued Operations and Disclosures of Components of an Entity. This ASU states that only those disposals of components of an entity that represent a strategic shift that has (or will have) a major effect on an entity's operations and financial results should be reported as discontinued operations in the financial statements. Prior accounting guidance held that a component of an entity that is a reportable segment, an operating segment, a reporting unit, a subsidiary or an asset group was eligible for discontinued operations presentation. This led to many disposals, many of which were routine in nature and did not change an entity's strategy, to be reported as discontinued operations. The amendments in this ASU require expanded disclosure for discontinued operations, which should provide financial statement users with more information about the assets, liabilities, revenues and expenses of discontinued operations. As such, our disposition of individual properties will generally no longer meet the guidance to be classified as discontinued operations. See Note 3 for additional information related to how this ASU affects our current reporting. This updated guidance requires prospective application for all disposals of components of an entity that occur within annual periods beginning on or after December 15, 2014 and interim periods within those years, with early adoption permitted. We adopted this guidance effective January 1, 2014.

Revenue

In May 2014, the FASB issued Accounting Standards Update ("ASU") 2014-09 Revenue from Contracts with Customers (Topic 606) ("ASU 2014-09"). ASU 2014-09 is a comprehensive new revenue recognition model requiring a company to recognize revenue to depict the transfer of goods or services to a customer at an amount reflecting the consideration it expects to receive in exchange for those goods or services. In adopting ASU 2014-09, companies may use either a full retrospective or a modified retrospective approach. Additionally, this guidance requires improved disclosures regarding the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. ASU 2014-09 is effective for the first interim period within annual reporting periods beginning after December 15, 2016, and early adoption is not permitted. The Company is currently in the process of evaluating the impact the adoption of ASU 2014-09 will have on the Company's financial position or results of operations.

Reclassifications and Adjustments to Previously Issued Financial Statements

During the three months ended June 30, 2014, certain reclassifications were made to the 2014 financial statements to conform to ASC 360-10-45-5 and include gains recognized on the sale of long-lived assets that are not discontinued operations in income from continuing operations.

In connection with the preparation of the financial statements as of June 30, 2014, we identified an adjustment related to the reporting of cash expenditures for development fixed asset additions and the related non-cash investing disclosure which impacted the Consolidated Statements of Cash Flows for the Year Ended December 31, 2013, by reducing cash flow from operating activities and cash used for investing activities. To correctly present cash flows expended for development fixed asset additions, the Consolidated Statements of Cash Flows for the Year Ended December 31, 2013, will include an adjustment of $8.3 million to increase net cash flow provided by operating activities, as well as a corresponding increase to net cash flow used for investing activities. We assessed the materiality of the foregoing adjustment on the prior period financial statements by examining and assessing the pertinent quantitative and qualitative criteria, and concluded that it was not material to the prior period. However, we determined it was appropriate to revise the applicable financial statements the next time such financial statements are included in a filing with the SEC. The following are selected line items from our Consolidated Statements of Cash Flows for the Year Ended December 31, 2013 illustrating the affect of the adjustment thereon:

(in thousands)	As Reported	Adjustment	As Revised
Cash flow from operating activities:			
Net change in assets and liabilities:			
Accounts payable and accrued expenses	$(3,267)	$8,262	$4,995
Total adjustments	$12,268	$8,262	$20,530
Net cash flow provided by operating activities	$73,563	$8,262	$81,825
Cash flow from investing activities:			
Development fixed asset additions	$(77,094)	$(8,262)	$(85,356)
Net cash flow used for investing activities	$(211,176)	$(8,262)	$(219,438)
Supplemental disclosure of non-cash information:			
Net change in accounts payable related to fixed asset additions	$14,360	$(8,262)	$6,098

There is no impact on these adjustments to the Consolidated Balance Sheets, Consolidated Statement of Shareholders' Equity or Consolidated Statements of Operations and Comprehensive Income of the Company in any previously reported periods or any interim periods reported during the year ended December 31, 2013.

3. ACQUISTION, DEVELOPMENT, AND DISPOSITION ACTIVITY

Acquisition Activity

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

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

(Dollar amounts in thousands)

Property	Location	Units	Estimated Closing Period	Purchase Price Allocation
1160 Hammond	Atlanta, GA	345	Q4 2014	$80,350
Varela	Tampa, FL	350	Q1 2015	79,450
		695		$159,800

During the year ended December 31, 2012, we entered into an agreement to acquire for a purchase price of $80.2 million an apartment project that is being developed in Ft. Lauderdale, Florida. Our purchase obligation is conditioned upon the successful completion of the property in accordance with agreed upon plans and specifications and up to an 18-month period to allow for lease up of the property. Closing will not occur unless the conditions are satisfied, which is currently expected to occur in late 2015. The developer may elect to terminate our agreement to purchase by agreeing to the release of our $4.0 million earnest money deposit from escrow and paying us an $8.0 million termination fee. If we choose not to purchase the property, despite the closing conditions having been satisfied within the time period contemplated by the purchase agreement, we would forfeit our $4.0 million earnest money deposit. This earnest money deposit represents our maximum exposure to loss until the closing of the property. We consider our deposit to be a variable interest and the development entity to be a variable interest entity for which we are not the primary beneficiary as of this reporting date.

On June 10, 2014, we acquired Alpha Mill Phase I and Phase II, a combined 267 units, located in Charlotte, North Carolina, for a total purchase price of $45.1 million. We paid cash for this acquisition, which was funded from proceeds from the sale of Vista Germantown. The following table represents the purchase price allocation for the property acquired during the six months ended June 30, 2014.

(In thousands)	
Land	$8,055
Buildings and improvements	36,139
Furniture and fixtures	463
Existing leases (Other assets)	418
Total	$45,075

The following table presents actual and pro forma information related to the property acquired during the six months ended June 30, 2014. The pro forma information is presented as if the property was acquired on January 1, 2013. We recognized acquisition costs during the three and six months ended June 30, 2014, totaling $17,000 related to this property, which are included in "Costs associated with acquisitions" in the Consolidated Statements of Operations and Comprehensive Income. Additionally, we recognized acquisition costs totaling $78,000 related to this property during the last half of 2013. The pro forma presentation is presented for informational purposes only, and is not necessarily indicative of what our actual results of operations would have been had the acquisitions occurred at such time.

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands, except per share amounts)	2014	2013	2014	2013
Actual revenue from acquisitions	$161	$—	$161	$—
Actual net income from acquisitions	45	—	45	—
Pro forma revenue	48,372	44,053	98,678	87,470
Pro forma net income applicable to common shares	62,283	1,650	104,575	11,851
Pro forma earnings per common share - basic:				
Pro forma net income applicable to common shares	$1.08	$0.03	$1.82	$0.24
Pro forma earnings per common share - diluted:				
Pro forma net income applicable to common shares	$1.08	$0.03	$1.81	$0.23

Development Activity

On May 28, 2013, we acquired a 3.36-acre parcel of land in the South of Market neighborhood of San Francisco, California for $46.6 million. On February 3, 2014, we entered into a 50/50 partnership with AIG Global Real Estate ("AIG") to develop and own this site known as 350 Eighth. The partnership intends to develop a 410-unit apartment community with commercial space and underground parking. See Note 6 for additional information related to this development.

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

(Dollar amounts in thousands) Under Construction	Location	Ownership %	Total Units	Total Estimated Capital Cost [1]	Cost to Date	Total Debt	Actual Construction Start	Estimated Construction Completion
7001 Arlington at Bethesda	Bethesda, MD	97.0% [2]	140	$53,400	$33,724	$9,795	Q4 2012	Q2 2015
Cantabria	Dallas, TX	100.0%	249	$56,800	$38,621	$19,086	Q2 2013	Q1 2015
The Desmond on Wilshire	Los Angeles, CA	100.0%	175	$76,300	$35,141	$—	Q2 2013	Q4 2015
Total			564	$186,500	$107,486	$28,881		

(1) Total capital costs are calculated as if owned 100% by AEC and represent estimated costs for projects under development inclusive of all capitalized costs in accordance with GAAP.

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

The following table identifies our unconsolidated development activity that is in early stages of construction or in the planning phase:

(Dollar amounts in thousands)			Estimated		AEC
		Ownership	Number	Cost to	Investment
Name	Location	%	Total Units (1)	Date	to Date
350 Eighth	San Francisco, CA	50.0%	410	$58,725	$28,214
950 East Third	Los Angeles, CA	50.0%	472	$34,115	$4,115
Monrovia	Monrovia, CA	50.0%	154	$15,022	$7,507
Total			1,036	$107,862	$39,836

(1) Based on current projections as of July 29, 2014.

Disposition Activity

The results of operations and gains related to the sale of operating properties for the current period presented are reported in income from continuing operations in the accompanying Consolidated Statements of Operations and Comprehensive Income. Prior to adoption of ASU 2014-08, and in all prior periods presented, these results were reported in "Income from discontinued operations" in the accompanying Consolidated Statements of Operations and Comprehensive Income. Furthermore, the results of properties classified as held for sale are now reported in income from continuing operations. See Note 2 for additional information related to how this ASU affects our current reporting.

During the six months ended June 30, 2014, we completed the sale of four properties for an aggregate total sales price of $172.2 million and recognized aggregate gains of $100.9 million. Three of the properties were located in Maryland and one in Tennessee.

"Income from discontinued operations" in the accompanying Consolidated Statements of Operations and Comprehensive Income for the three and six months ended June 30, 2013 includes the operating results for four properties sold in 2013, as well as the recognized gain related to the one property sold during the six months ended June 30, 2013. The following table summarizes "Income from discontinued operations:"

	Three Months Ended	Six Months Ended
	June 30,	June 30,
(In thousands)	2013	2013
Revenue		
Property revenue	$2,179	$6,240
Expenses		
Property operating and maintenance	955	2,906
Depreciation and amortization	499	1,170
Total expenses	1,454	4,076
Operating income	725	2,164
Gain on disposition of properties	—	8,796
Income from discontinued operations	$725	$10,960

We have, on occasion, engaged Hancock Real Estate Strategies ("HRES"), a full service investment real estate brokerage and advisory firm, to provide certain real estate brokerage services. HRES is owned by Matthew E. Friedman, a son of our CEO. For the six months ended June 30, 2014, in conjunction with the sale of one property in Nashville, Tennessee for $53.3 million on April 2, 2014, HRES was paid a commission totaling $244,000. For the six months ended June 30, 2013, in conjunction with the sale of one property and our joint venture to develop the 950 East Third land, HRES received commissions totaling $574,000. The aggregate value of those transactions was $93.2 million. These transactions were approved by the Company's independent directors in compliance with Company policy.

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4. DEBT

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

(Dollar amounts in thousands)	June 30, 2014 Balance Outstanding	June 30, 2014 Weighted Average Interest Rate		December 31, 2013 Balance Outstanding	December 31, 2013 Weighted Average Interest Rate	
Fixed Rate Debt:						
Secured	$249,911	4.9	%	$271,374	4.9	%
Unsecured - notes	250,000	4.4	%	250,000	4.4	%
Total Fixed Rate Debt	499,911	4.7	%	521,374	4.7	%
Variable Rate Debt Swapped to Fixed:						
Unsecured - term loan	125,000	3.0	%	125,000	3.0	%
Total Variable Rate Debt Swapped to Fixed	125,000	3.0	%	125,000	3.0	%
Variable Rate Debt Unhedged:						
Secured	28,881	1.5	%	8,100	1.5	%
Unsecured - revolver	36,000	1.5	%	133,500	1.5	%
Unsecured - term loan	25,000	1.9	%	25,000	1.9	%
Total Variable Rate Debt Unhedged	89,881	1.6	%	166,600	1.5	%
Total Debt	$714,792	4.0	%	$812,974	3.8	%

Mortgage Notes Payable

The following table provides information on mortgage loans repaid during the six months ended June 30, 2014:

(Dollar amounts in thousands) Property	Loans Repaid Amount	Interest Rate	
Residence at White River	$9,221	5.4%	
Spring Valley	10,817	5.4%	
Total/weighted average rate	$20,038	5.4%	(1)

(1) Represents weighted average interest rate for the loans listed.

On April 25, 2014, the 350 Eighth partnership, which is accounted for under the equity method of accounting, entered into a construction loan agreement for $143.6 million with a five-year term and, based on our current credit ratings, has a per annum interest rate of LIBOR plus 160 basis points. There were no borrowings on this loan at June 30, 2014. We have guaranteed the payment of all future borrowings from this loan and the completion of construction in connection with the partnership's development. Additionally, we have drawn $19.1 million on the Cantabria construction loan and $9.8 million on the 7001 Arlington at Bethesda construction loan as of June 30, 2014. Cash paid for interest net of capitalized interest was $12.9 million and $11.0 million for the six months ended June 30, 2014 and 2013, respectively.

5. GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill

Our goodwill was allocated to our properties on a relative fair value basis. Upon disposition of properties, the goodwill allocated is included in the calculation of the gain or loss on disposal and subsequently written off. During the six months ended June 30, 2014, we wrote off $150,000 of our goodwill as a result of property dispositions. The carrying value of our goodwill as of June 30, 2014 and December 31, 2013 was $1.4 million and $1.5 million, respectively. Our annual review of goodwill impairment is completed during the first quarter of each year (and more frequently if events or changes in circumstances indicate the carrying value may not be recoverable). The review completed during the three months ended March 31, 2014 determined that goodwill was not impaired, and no other events have occurred that would require goodwill to be reevaluated. In performing this analysis, we compare the net assets of each property on which goodwill has been allocated, including the amount of allocated goodwill, to its estimated fair market value. Should the estimates used to determine the fair value of the properties change, impairment may result, which could materially impact our results of operations for the period in which it is recorded.

Intangible Assets

We allocate a portion of the total purchase price of a property acquisition to any intangible assets identified, such as existing leases. The intangible assets are amortized over the remaining lease terms, which is approximately 12 months. Due to the short-term nature of residential leases, we believe existing lease rates approximate market rates. Therefore, no allocation is made for above/below market leases. The intangible assets associated with one commercial lease are being amortized over the life of the lease, which is 60 months. See Note 13 for additional information related to this lease.

6. INVESTMENT IN UNCONSOLIDATED ENTITIES

350 Eighth

On February 3, 2014, we entered into a partnership agreement with AIG, an unrelated third-party, for the development and operation of 350 Eighth, a 410-unit apartment community with commercial space and underground parking located in San Francisco, California. See Note 3 for more information related to this development. We are a 50.01% partner in this partnership. Our partner, AIG, has contributed $27.1 million to the partnership. The land upon which the partnership is developing was purchased by us for $46.6 million on May 28, 2013. As of December 31, 2013, this land was included in our consolidated financial statements. Upon the formation of our partnership with AIG, the land and improvements to date, with a carrying value of $50.3 million, were deconsolidated. Any future equity capital needs will be funded according to the partners' percentage interests in the partnership. Both partners have equal voting rights with respect to all major decisions, and all such decisions must be unanimous, including, among other things, development planning, budgeting and operational budgets. We will perform construction management and property management services in accordance with the approved budgets for which we will receive fees. As of June 30, 2014, we have recognized $165,000 of the construction management fee. As the partnership is not sufficiently funded to finance the activities of the entity, and not all of the capital will be funded up front, the partnership is not deemed to have sufficient equity, and has therefore been determined to be a variable interest entity. It has also been determined that we do not control the decisions that most significantly affect the economics of the entity, and that we do not hold a controlling financial interest in the entity. As such, our investment in the entity is accounted for in our consolidated financial statements using the equity method. At June 30, 2014, we have a cumulative basis difference in the partnership of $510,000 due to capitalization of interest on our investment and internal payroll and overhead costs directly related to the development of this property. This excess of our investment over our equity in the underlying net assets of the joint venture is included in "Investment in unconsolidated entities" in our Consolidated Balance Sheets, and will be amortized as a reduction to earnings on a straight-line basis over the lives of the related assets. On April 25, 2014, the partnership entered into a construction loan agreement for $143.6 million with a five-year term. There were no borrowings on this loan at June 30, 2014. We have guaranteed the payment of all future borrowings from this loan and the completion of construction in connection with the partnership's development. See Note 4 for more information related to this loan and Note 13 for more information related to the guarantees. Our maximum exposure to loss, as a result of our involvement in this entity, is the carrying value of our investment, which was $28.2 million as of June 30, 2014.

950 East Third

During the year ended December 31, 2013, we entered into a partnership agreement with Legendary Investors Group No. 1 LLC ("Legendary"), an unrelated third-party, for the development and operation of 950 East Third, a 472-unit apartment community located in Los Angeles, California. We are a 50.0% partner with Legendary, who contributed the land at a value of $30.0 million to the partnership. As of June 30, 2014, we have contributed $4.1 million to the partnership. We expect to fund the remaining portion of our capital contribution during the development and construction process. Both partners have equal voting rights with respect to all major decisions, and all such decisions must be unanimous, including, among other things, development planning, budgeting and operational budgets. We will perform construction management and property management services in accordance with the approved budgets for which we will receive fees. As of June 30, 2014, we have not yet begun to receive or recognize these fees. As the partnership is not sufficiently funded to finance the activities of the entity, and not all of the capital will be funded up front, the partnership is not deemed to have sufficient equity, and has therefore been determined to be a variable interest entity. It has also been determined that we do not control the decisions that most significantly affect the economics of the entity, and that we do not hold a controlling financial interest in the entity. As such, our investment in the entity is included in our consolidated financial statements using the equity method. At June 30, 2014, we have a cumulative basis difference in the partnership of $520,000 due to the capitalization of interest on our investment and internal payroll and overhead costs directly related to the development of this property. This excess of our investment over our equity in the underlying net assets of the partnership is included in "Investment in unconsolidated entities" in our Consolidated Balance Sheets, and will be amortized as a reduction to earnings on a straight-line basis over the lives of the related assets. Our maximum exposure to loss, as a result of our involvement in this entity, is the carrying value of our investment, which was $4.1 million as of June 30, 2014. See Note 3 for more information related to this development.

Monrovia

During the year ended December 31, 2013, we entered into a partnership agreement with LPC MM Monrovia, LLC ("Lincoln"), an unrelated third-party, for the limited purpose of acquiring a property in Monrovia, California, and to produce construction drawings for improvements to the property. The land, upon which the partnership plans to develop a 154-unit multifamily apartment community, was purchased by the partnership on August 9, 2013 for $13.1 million. We are a 50.0% partner with Lincoln, who has contributed $7.3 million to the partnership. As of June 30, 2014, we have contributed $7.5 million to the partnership. Any future equity capital needs will be funded on a 50/50 basis by the partners. Both partners have equal voting rights with respect to all major decisions, and all such decisions must be unanimous, including, among other things, development planning, budgeting and operational budgets. Lincoln will perform the day-to-day activities on behalf of the partnership. As the partnership is not sufficiently funded to finance the activities of the entity, and not all of the capital will be funded up front, the partnership is not deemed to have sufficient equity, and has therefore been determined to be a variable interest entity. It has also been determined that we do not control the decisions that most significantly affect the economics of the entity, and that we do not hold a controlling financial interest in the entity. As such, our investment in the entity is included in our consolidated financial statements using the equity method. At June 30, 2014, we have a cumulative basis difference in the partnership of $280,000 due to the capitalization of interest on our investment and internal payroll and overhead costs directly related to the development of this property. This excess of our investment over our equity in the underlying net assets of the partnership is included in "Investment in unconsolidated entities" in our Consolidated Balance Sheets, and will be amortized as a reduction to earnings on a straight-line basis over the lives of the related assets. Our maximum exposure to loss, as a result of our involvement in this entity, is the carrying value of our investment, which was $7.5 million as of June 30, 2014. See Note 3 for more information related to this development.

7. NONCONTROLLING INTERESTS

Noncontrolling Redeemable Interest

In 1998, in conjunction with the acquisition of an operating partnership that owned two apartment communities, one of which was sold in October 2005, we issued a total of 522,032 operating partnership units ("OP units"). Holders of OP units were entitled to receive cumulative distributions per OP unit equal to the per share distributions on our common shares. When the OP units were presented for redemption, we were obligated to redeem those OP units for either common shares exchangeable on a one-for-one basis, or the cash equivalent amount, determined as the average closing price for our common shares over the 20-day period preceding the redemption, at our option. On October 23, 2013, we consummated a subsidiary merger transaction that had the effect of converting the remaining 74,083 OP units into a right to receive cash merger consideration, pursuant to which we paid $1.4 million on November 6, 2013. As of December 31, 2013, there were no remaining OP units as all remaining units had been redeemed for cash or canceled in the merger. No OP units were redeemed during the six months ended June 30, 2013.

Activity related to the noncontrolling redeemable interest is as follows:

(In thousands)	Three Months Ended June 30, 2013	Six Months Ended June 30, 2013
Balance at beginning of period	$1,734	$1,734
Net income attributable to noncontrolling redeemable interest	14	28
Distribution to noncontrolling redeemable interest	(14)	(28)
Balance at end of period	$1,734	$1,734

Noncontrolling Interests

On July 14, 2011, we entered into a partnership agreement with Keating Project Development, Inc., an unrelated third-party, pursuant to which we hold a 97.0% equity interest in the partnership. In March 2012, the partnership acquired a 2.5-acre parcel of land in Bethesda, Maryland for $12.2 million on which it is developing 140 apartment units and 7,000 square feet of commercial space. We have determined that this entity is not a variable interest entity and that we hold a controlling interest in the entity. As such, this entity is included in our consolidated financial statements. We have also determined that the noncontrolling interest in this entity meets the criteria to be classified as a component of permanent equity.

On September 24, 2010, we entered into a partnership agreement with Bristol Development Group, an unrelated third-party, for the development of Vista Germantown, a 242-unit apartment community located in downtown Nashville, Tennessee. We contributed $9.4 million to the partnership and held a 90.0% equity interest in the partnership. In February 2013, we funded the redemption of the interest of the minority 10.0% partner of this partnership for $4.5 million, as a result of which we owned a 100% interest in Vista Germantown as of February 2013. On April 2, 2014, we disposed of Vista Germantown for a sales price of $53.3 million.

The following table provides details of the activity related to the noncontrolling interests:

	Six Months Ended June 30,	
(In thousands)	2014	2013
Balance at beginning of period	$350	$1,344
Net income	—	3
Purchase of noncontrolling interest	—	(997)
Balance at end of period	$350	$350

The following table provides details of the activity related to changes in ownership of noncontrolling interests:

	Six Months Ended June 30,	
	2014	2013
Net income attributable to AERC	$104,621	$11,984
Decrease in equity for purchase of noncontrolling interest	—	(3,547)
Change from net income attributable to AERC and net transfers to noncontrolling interest	$104,621	$8,437

8. EQUITY

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

	Six Months Ended June 30, 2014					
(In thousands)	Common Shares (at $.10 stated value)	Paid-In Capital	Accumulated Distributions in Excess of Accumulated Net Income	Accumulated Other Comprehensive Loss	Treasury Shares (at Cost)	Noncontrolling Interest
Balance, December 31, 2013	$5,760	$754,582	$(213,275)	$(702)	$(1,915)	$ 350
Net income attributable to AERC	—	—	104,621	—	—	—
Other comprehensive income:						
Changes in fair value of hedge instruments	—	—	—	(746)	—	—
Share-based compensation	—	1,295	—	—	1,872	—
Purchase of common shares	—	—	—	—	(999)	—
Option exercises	7	706	—	—	—	—
Issuance of common shares	3	—	—	—	—	—
Common share dividends declared	—	—	(22,104)	—	—	—
Balance, June 30, 2014	$5,770	$756,583	$(130,758)	$(1,448)	$(1,042)	$ 350

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9. EARNINGS PER SHARE

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

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands, except per share amounts)	2014	2013	2014	2013
Numerator - basic and diluted:				
Income from continuing operations	$62,348	$927	$104,621	$1,055
Net income attributable to noncontrolling interests	—	(14)	—	(31)
Allocation to participating securities	(212)	—	(355)	—
Income from continuing operations applicable to common shares	$62,136	$913	$104,266	$1,024
Income from discontinued operations applicable to common shares	$—	$725	$—	$10,960
Denominator - basic:	57,475	49,864	57,419	49,749
Effect of dilutive securities [(1)]	444	719	457	682
Denominator - diluted:	57,919	50,583	57,876	50,431
Net income applicable to common shares - basic:				
Income from continuing operations applicable to common shares	$1.08	$0.02	$1.82	$0.02
Income from discontinued operations	—	0.01	—	0.22
Net income attributable to common shares - basic	$1.08	$0.03	$1.82	$0.24
Net income applicable to common shares - diluted:				
Income from continuing operations applicable to common shares	$1.07	$0.02	$1.80	$0.02
Income from discontinued operations	—	0.01	—	0.22
Net income attributable to common shares - diluted	$1.07	$0.03	$1.80	$0.24

(1) The Company has excluded 83 stock options for the three and six months ended June 30, 2013, as their inclusion would be anti-dilutive.

10. EQUITY BASED AWARD PLANS

During the three and six months ended June 30, 2014, we recognized share-based compensation cost of $840,000 and $2.2 million, respectively, in "General and administrative expense" in the Consolidated Statements of Operations and Comprehensive Income. During the three and six months ended June 30, 2013, we recognized share-based compensation cost of $1.0 million and $2.4 million, respectively, in "General and administrative expense" in the Consolidated Statements of Operations and Comprehensive Income. Additionally, during the three and six months ended June 30, 2014, we capitalized $120,000 and $220,000, respectively, of share-based compensation related to time incurred on development projects. During the three and six months ended June 30, 2013, we capitalized $100,000 and $210,000, respectively, of share-based compensation related to time incurred on development projects. See Note 2 for additional information related to capitalized payroll.

Restricted Shares. Restricted shares generally have the same rights as our common shares, except for transfer restrictions and forfeiture provisions. We have two compensation plans under which our officers and directors may elect to defer the receipt of restricted shares. Restricted share awards deferred under these plans are reflected as deferred restricted share equivalent units ("DRSUs") in an individual bookkeeping account maintained for each participant. The vesting of DRSUs occurs on the same schedule as the restricted shares made subject to the deferral election, and the valuation and attribution of cost in our consolidated financial statements are also the same as the restricted shares subject to the deferral election. DRSUs are not included in the number of issued and outstanding common shares reflected in the "Equity" section of our Consolidated Balance Sheets. DRSUs with non-forfeitable dividend rights are included in the allocation to participating securities using the two-class method. DRSUs with forfeitable dividend rights do not qualify as participating securities, and are included in the calculation of diluted earnings per share to the extent they are not anti-dilutive for the period presented.

The following table represents restricted share and DRSU activity for the six months ended June 30, 2014:

	Number of Restricted Shares	Weighted Average Grant-Date Fair Value	Number of DRSUs	Weighted Average Grant-Date Fair Value
Nonvested at beginning of period	735,184	$10.52	34,797	$17.15
Granted	161,267	$16.11	39,526	$16.14
Vested	170,264	$16.37	26,603	$17.38
Forfeited	15,946	$10.52	8,194	$16.38
Nonvested at end of period	710,241	$10.38	39,526	$16.14

The weighted average grant-date fair value of restricted shares granted during the six months ended June 30, 2013 was $10.36. The total fair value of restricted shares vested during the six months ended June 30, 2014 and 2013 was $3.2 million and $2.7 million, respectively. The total fair value of DRSUs vested during the six months ended June 30, 2014 and 2013 was $462,000 and $590,000, respectively, recognized as "Paid-in-capital." At June 30, 2014, there was a total of $6.4 million of unrecognized compensation cost related to non-vested restricted share awards and DRSUs that we expect to recognize over a weighted average period of 2.2 years.

During 2014 and 2013, we issued restricted share awards in which the number of shares that will ultimately vest is subject to market conditions over a three-year period and service conditions over a four-year period. The total estimated grant-date fair value of these awards, including the awards that were deferred, were $90,000 during 2014 and $4.3 million during 2013. We used the Monte Carlo method to estimate the fair value of these awards. The Monte Carlo method, which is similar to the binomial analysis, evaluates the award for changing stock prices over the term of vesting, and uses random situations that are averaged based on past stock characteristics. There were one million simulation paths used to estimate the fair value of these awards. The expected volatility for the awards granted in 2014 and 2013 was based upon a 50/50 blend of historical and implied volatility. The historical volatility was based upon changes in the weekly closing prices of our shares over a period equal to the expected life of the restricted shares granted. The implied volatility was the trailing month average of daily implied volatilities calculated by interpolating between the volatilities implied by stock call option contracts that were closest to both the expected life and the exercise price of the restricted shares. The risk-free interest rate used was based on a yield curve derived from U.S. Treasury zero-coupon bonds on the date of grant with a maturity equal to the market condition performance periods. The expected life used was the market condition performance period.

The following table represents the assumption ranges used in the Monte Carlo method for the multi-year restricted share awards:

	2014	2013
Expected volatility - AERC	22.3% to 24.2%	18.1% to 22.5%
Expected volatility - peer group	16.9% to 24.7%	14.7% to 29.5%
Risk-free interest rate	0.02% to 0.8%	0.08% to 0.5%
Expected life (performance period)	3 years	3 years

Stock Options. We use the Black-Scholes option pricing model to estimate the fair value of stock options awarded. There were no options awarded, 76,930 options exercised and 5,000 options forfeited during the six months ended June 30, 2014. There were no options awarded, 169,164 options exercised and no options forfeited during the six months ended June 30, 2013.

The following table represents stock option activity for the six months ended June 30, 2014:

	Number of Stock Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contract Life
Outstanding at beginning of period	510,020	$11.47	
Exercised	76,930	$9.29	
Forfeited	5,000	$14.00	
Outstanding at end of period	428,090	$11.83	3.4
Exercisable at end of period	376,424	$11.53	2.8

The aggregate intrinsic value of stock options outstanding and stock options exercisable at June 30, 2014 and 2013 was $2.4 million and $2.9 million, respectively.

11. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

We utilize interest rate swaps, from time to time, to add stability to interest risk and to manage our exposure to interest rate movements. See Note 2 for additional information related to our derivative instruments and hedging policy.

As of June 30, 2014, the Company had the following outstanding interest rate derivatives that were designated as cash flow hedges:

Interest Rate Derivative	Number of Instruments	Notional Amount
Interest Rate Swaps	2	$125.0 million

On April 2, 2013, we entered into a forward starting interest rate swap on $125.0 million of our $150.0 million unsecured term loan, fixing the rate beginning June 2, 2016 at a rate of 1.55% per annum plus the credit spread, which was 1.70% per annum as of June 30, 2014, or an all-in rate of 3.25% per annum until January 2018. The credit spread is subject to change, from time to time, from a minimum of 1.25% per annum to a maximum of 2.20% per annum over LIBOR based upon our qualified ratings as defined in the agreement. See Notes 12 and 14 for additional information.

On December 19, 2011, we entered into a forward starting interest rate swap effective June 7, 2013. This swap hedges the future cash flows of interest payments on $125.0 million of our unsecured term loan by fixing the rate until June 2016 at a rate of 1.26% per annum plus the credit spread, which was 1.70% per annum at June 30, 2014, or an all-in rate of 2.96% per annum. The credit spread is subject to change, from time to time, from a minimum of 1.25% per annum to a maximum of 2.20% per annum over LIBOR based upon our qualified ratings as defined in the agreement. See Notes 12 and 14 for additional information.

The following table presents the fair value of our derivative financial instruments as well as the classification on the Consolidated Balance Sheets (see Note 12 for additional information regarding the fair value of these derivative instruments):

Fair Value of Derivative Instruments

	Asset Derivatives			
	As of June 30, 2014		As of December 31, 2013	
(In thousands)	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments:				
Interest rate swap	Other assets, net	$547	Other assets, net	$1,573

Fair Value of Derivative Instruments

	Liability Derivatives			
	As of June 30, 2014		As of December 31, 2013	
(In thousands)	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments:				
Interest rate swap	Accounts payable and other liabilities	$1,996	Accounts payable and other liabilities	$2,275

The following table presents the effect of our derivative financial instruments on the Consolidated Statements of Operations and Comprehensive Income:

The Effect of Derivative Instruments on the Consolidated Statements of Operations and Comprehensive Income

(In thousands) Derivatives in Cash Flow Hedging Relationships (Interest Rate Swaps)	Location of Gain or (Loss) Recognized in Income on Derivative	Three Months Ended June 30, 2014	2013	Six Months Ended June 30, 2014	2013
Amount of gain/(loss) recognized in OCI on derivative		$(1,032)	$2,333	$(1,439)	$2,221
Amount of loss reclassified from accumulated OCI into interest expense	Interest expense	$(349)	$(89)	$(693)	$(89)
Amount of gain/(loss) recognized in income on derivative (ineffective portion and amount excluded from effectiveness testing)	Other expense	$—	$—	$—	$—

The following table presents the effect of offsetting financial assets and liabilities on the Consolidated Balance Sheets:
Offsetting of Derivative Assets and Liabilities

				Gross Amounts Not Offset in the Balance Sheets		
(In thousands)	Gross Amounts of Recognized Assets/Liabilities	Gross Amounts Offset in the Balance Sheets	Net Amounts of Assets/Liabilities Presented in the Balance Sheets	Financial Instruments	Cash Collateral Received	Net Amount
June 30, 2014						
Offsetting Derivative						
Assets	$547	$—	$547	$—	$—	$547
Liabilities	$1,996	$—	$1,996	$—	$—	$1,996
December 31, 2013						
Offsetting Derivative						
Assets	$1,573	$—	$1,573	$—	$—	$1,573
Liabilities	$2,275	$—	$2,275	$—	$—	$2,275

As of June 30, 2014, the fair value of the derivative in a liability position, excluding any adjustment for nonperformance risk, was $2.1 million. As of June 30, 2014, we have not posted any collateral related to this agreement. If we had breached any of the provisions in the agreement with our derivative counterparty at June 30, 2014, we could have been required to settle our obligations under the agreement at its termination value of $2.1 million, which includes accrued interest of $84,000. The expected amount of other comprehensive income to be reclassified as earnings within the next twelve months is $1.4 million.

12. FAIR VALUE

Fair value, as defined by GAAP, represents the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. The inputs used in the determination of fair value amounts and disclosures are based on the assumptions that market participants would use when pricing certain assets or liabilities. These inputs are classified in the fair value hierarchy as follows:

Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that we have the ability to access;

Level 2 inputs may include quoted prices for similar assets and liabilities in active markets, as well as interest rates and yield curves that are observable at commonly quoted intervals; and

Level 3 inputs are unobservable inputs for the asset or liability that are typically based on an entity's own assumptions as there is little, if any, related market activity.

The inputs used in the fair value measurement should be from the highest level available. In instances where the measurement is based on inputs from different levels of the fair value hierarchy, the fair value measurement will fall within the lowest level input that is significant to the fair value measurement in its entirety.

Cash, accounts and notes receivable, other assets, accounts payable, accrued expenses and other liabilities (except for the interest rate swap discussed below) are carried at amounts that reasonably approximate corresponding fair values because of their short term nature.

The interest rate swap derivatives, as discussed in detail in Note 11 under "Derivative Instruments and Hedging Activities," are carried at fair value. The fair value of the derivative was determined by using a model that applies discount rates to the expected future cash flows associated with the swap. The significant inputs used in the valuation model to estimate the discount rates and expected cash flows are observable in active markets and, therefore, are Level 2 inputs.

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We estimate the fair value of our mortgage notes payable by discounting the associated cash flows using the interest rates available to us as of the dates reported for issuance of debt with similar terms, remaining maturities and loan to value ratios, which ranged from 38% to 53% at June 30, 2014. We classify the fair value of our mortgage notes payable as Level 3.
We estimate the fair value of our unsecured debt by discounting the associated cash flows using the interest rates available to us as of the dates reported for issuance of debt with similar terms and remaining maturities. We classify the fair value of our unsecured debt as Level 2.

		Fair Value at June 30, 2014 Using		
(In thousands)	Carrying Value	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Mortgage notes payable	$278,792	$—	$—	$291,928
Unsecured debt	$436,000	$—	$444,363	$—

		Fair Value at December 31, 2013 Using		
(In thousands)	Carrying Value	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Mortgage notes payable	$279,474	$—	$—	$284,886
Unsecured debt	$533,500	$—	$530,022	$—

13. CONTINGENCIES

Legal Proceedings

In conjunction with our May 2012 acquisition of land for development of an apartment community, we acquired a commercial building in Los Angeles, California (the "Property"), and entered into a triple net master lease (the "Lease") of the Property as landlord with Art and Architecture Books of the 21st Century as tenant ("Tenant").
When Tenant failed to pay December 2012 rent when due under the Lease, we served Tenant with a notice to pay rent or vacate the premises pursuant to the California Code of Civil Procedure. On December 20, 2012, we filed an unlawful detainer action in the Superior Court for the State of California (the “Bankruptcy Court”). Tenant did not pay rent for January or February 2013.
On February 19, 2013 (the scheduled trial date for our unlawful detainer suit), Tenant filed its Chapter 11 petition with the U.S. Bankruptcy Court for the Central District of California (the "California Bankruptcy Case").

On March 29, 2013, Tenant filed a motion to assume the Lease. We opposed Tenant's lease assumption motion. On September 12, 2013, the Bankruptcy Court granted Tenant's motion to assume the Lease. We appealed the Bankruptcy Court's order granting Tenant's motion to assume the Lease to the U.S. District Court for the Central District of California (the "District Court"). On December 2, 2013, the District Court ruled in our favor and held the Bankruptcy Court had erred when it concluded the Lease had not been terminated prior to the date Tenant filed its Chapter 11 petition. The District Court remanded the case back to the Bankruptcy Court for further proceedings consistent with the District Court's determination. Tenant has filed a notice of appeal of the District Court's decision to the U.S. Court of Appeals for the Ninth Circuit.

If we conclude, based on the outcome of this proceeding, that it is unlikely Tenant will remain the master lease tenant at the Property, we will accelerate the amortization of the remaining intangible asset associated with the Lease at that time. The intangible asset is being amortized over the initial five-year term of the Lease, beginning May 2012, and had a balance of $1.1 million at June 30, 2014. In addition, we may be required to refund to Tenant the $630,000 cure payment Tenant paid to us in connection with its assumption of the lease.

In addition to the California Bankruptcy Case, we are subject to other legal proceedings, lawsuits and other claims in the ordinary course of our business (collectively, "Litigation"). Litigation is subject to uncertainties and outcomes are difficult to predict. Many of the claims in Litigation are covered by insurance, subject to deductible amounts. With respect to current Litigation, we have determined either that a loss is not reasonably possible or that the estimated loss or range of loss, if any, will not have a material adverse impact on our financial statements.

Guarantees

On April 25, 2014, the 350 Eighth partnership, in which we are a 50.01% partner and that we account for under the equity method, entered into a construction loan agreement for $143.6 million with a five-year term. We have guaranteed the payment of all future borrowings from this loan and the completion of construction in connection with the partnership's development. We have determined that the fair value of these guarantees are immaterial and thus have not recorded any liability as of June 30, 2014.

14. SUBSEQUENT EVENTS

Dividends. On August 1, 2014, we paid a dividend of $0.19 per common share to shareholders of record on July 15, 2014, which had been declared on June 20, 2014. The declaration and payment of future quarterly dividends remains subject to review by, and approval of, the Board of Directors.

Debt. On July 25, 2014, we amended and restated our $150.0 million term loan. Among other modifications the amendment extended the maturity date from January 3, 2018 to January 3, 2020, and reduced the interest rate spread across the pricing grid. The term loan currently bears interest at LIBOR plus a spread of 140 basis points. The interest rate spread over LIBOR is based on the Company's credit ratings and may range from 90 to 190 basis points for LIBOR-based loans. We also entered into an amendment to our revolver to implement corresponding financial covenant modifications to our revolver.

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

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 2014 performance that are based on certain assumptions. Accordingly, readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date of this report. 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, the overall level of economic activity, the availability of consumer credit and mortgage financing, unemployment rates and other factors;
- elimination of, or limitations on, federal government support for Fannie Mae and/or Freddie Mac that might result in significantly reduced availability of mortgage financing sources, as well as increases in interest rates for mortgage financing;
- our ability to refinance debt on favorable terms at maturity;
- risks of a lessening of demand for the multifamily units that we own;
- competition from other available multifamily units, single family units available for rental or purchase, and changes in market rental rates;
- the failure of development projects or redevelopment activities to achieve expected results due to, among other causes, construction and contracting risks, unanticipated increases in materials and/or labor, delays in project completion and/or lease-up that result in increased costs and/or reduce the profitability of a completed project, and the absence of our right to control all activities and decisions of joint venture developments where the applicable agreement allocate decision making authority to, or require the consent of, our joint venture partner;
- the failure to enter into development joint venture arrangements on acceptable terms;
- increases in property and liability insurance costs;
- unanticipated increases in real estate taxes and other operating expenses;
- weather conditions that adversely affect operating expenses;
- expenditures that cannot be anticipated such as utility rate and usage increases and unanticipated repairs;
- our inability to control operating expenses or achieve increases in revenue;
- shareholder ownership limitations that may discourage a takeover otherwise considered favorable by shareholders;
- the results of litigation involving us;
- changes in tax legislation;
- risks of personal injury and property damage claims that are not covered by our insurance;
- catastrophic property damage losses that are not covered by our insurance;
- risks associated with property acquisitions, such as failure to achieve expected results or matters not discovered in due diligence; and
- risks related to 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.

Overview.

We are engaged primarily in the ownership and operation of multifamily apartment units. Our subsidiary, Merit, is a general contractor and construction manager that acts as our in-house construction division. Our primary source of cash and revenue from operations is rental payments from the leasing of apartment units, which represented substantially all of our consolidated revenue for the six months ended June 30, 2014 and June 30, 2013.

The operating performance of our properties is affected by general economic trends including, but not limited to, household formation, job and wage growth, unemployment rates, population growth, immigration, the supply of new multifamily rental units and, in certain markets, the supply of other housing alternatives, such as condominiums, single family and multifamily rental homes and owner-occupied single family and multifamily homes. Additionally, our performance may be affected by our ability to access the capital markets and the prices we can obtain for our debt and equity securities.

Rental revenue collections are impacted by rental rates and occupancy levels. We use LRO™, a rental revenue software program that provides comprehensive submarket-based statistical data to assist in maximizing rental revenue while remaining market competitive. We combine this data with our proprietary market knowledge and experience to maximize rental revenues and maintain high occupancy levels. With LRO™, we generate long-term rent growth by adjusting rents to address market forces in real-time. We adjust our rental rates in our continuing effort to adapt to changing market conditions, and we continuously monitor physical occupancy and revenue per occupied unit to track our success in maximizing property revenue. These indicators are more fully described in the Results of Operations comparison. Additionally, we consider property net operating income ("NOI") and Funds from Operations ("FFO") to be important indicators of our overall performance. Property NOI (property revenue less property operating and maintenance expenses) is a measure of the profitability of our properties, and has the largest impact on our financial condition and operating results. FFO is used by real estate investment trusts as a supplemental measure of the operating performance of real estate companies because it excludes charges such as real estate depreciation and amortization on intangible assets that are generally considered not to be reflective of the actual value of real estate assets over time. Additionally, gains and losses from the sale of most real estate assets and certain other items are also excluded from FFO. A reconciliation of property NOI to consolidated net income attributable to AERC and a reconciliation of net income attributable to AERC to FFO is included in the Results of Operations comparison.

LIQUIDITY AND CAPITAL RESOURCES

Cash Flows and Liquidity. Significant sources and uses of cash are summarized as follows:

(In thousands)	Six Months Ended June 30, 2014	2013
Net cash provided by operations	$35,153	$37,542
Fixed assets:		
Acquisitions and development expenditures	(73,994)	(59,968)
Net property disposition proceeds	168,756	61,970
Recurring, revenue enhancing and non-recurring capital expenditures	(4,899)	(4,956)
Cash proceeds from sale of equity interest in development property	24,075	—
Contributions to joint ventures	(5,636)	(1,598)
Debt:		
Decrease in mortgage notes payable, net	(297)	(1,593)
Decrease in revolving credit facility borrowings, net	(97,500)	(157,000)
Unsecured note issuances	—	150,000
Exercise of stock options	714	1,550
Purchase of treasury shares	(999)	(697)
Purchase of noncontrolling interest	—	(4,544)
Cash dividends and operating partnership distributions paid	(22,579)	(18,775)

Our primary sources of liquidity are cash flow provided by operations, short-term borrowings on our unsecured revolving credit facility, project-specific loans and the sale of debt or equity securities. Our scheduled debt maturities for 2014 consisted of three mortgage loans totaling approximately $44.5 million. As of June 30, 2014, we have repaid two of these loans totaling approximately $20.0 million with property sale proceeds. We intend to repay the remaining loan from one or more of the following sources: borrowings on our unsecured revolving credit facility, unsecured debt financings, or proceeds from property sales. The maximum amount of borrowings available to us under the unsecured revolving credit facility is $350.0 million and, as of July 25, 2014, there were outstanding borrowings of $34.0 million on this facility.

We anticipate cash flow provided by operations for the remainder of the year will be sufficient to meet normal business operations and liquidity requirements. We believe that if net cash provided by operations is below projections, other sources, such as our unsecured revolver and/or secured and unsecured borrowings, are or can be made available and will be sufficient to meet our normal business operations and liquidity requirements. We anticipate that we will continue to pay our regular quarterly dividends in cash. Funds to be used for property acquisitions, development or other capital expenditures are expected to be provided primarily by our unsecured revolving credit facility, the sale of properties, the sale of additional common shares, the sale of additional debt securities and/or the admission of joint venture partners.

Cash flow provided by operations decreased 6.4% during the six months ended June 30, 2014, compared to the six months ended June 30, 2013, as a result of changes in accounts payable due to the timing of payments.

During the remainder of 2014, we anticipate incurring approximately $9.0 million in additional capital expenditures for replacements and improvements at our operating properties. This includes replacement of worn carpet and appliances, refurbishing parking lots and similar items in accordance with our current property expenditure plan, as well as commitments for investment/revenue enhancing and non-recurring expenditures. We expect to use cash provided by operating activities to pay for these expenditures.

The following table identifies our capital expenditures for the six months ended June 30:

(In thousands)	2014	2013	Variance
Recurring fixed asset additions	$4,203	$4,564	$(361)
Revenue enhancing/non-recurring fixed asset additions	696	392	304
Acquisition fixed asset additions [1]	46,385	731	45,654
Development fixed assets:			
Internal costs	1,600	1,300	300
Capitalized interest	2,200	1,300	900
Land and other development costs [2]	23,809	56,637	(32,828)
Total development fixed asset additions	$27,609	$59,237	$(31,628)
Total fixed asset additions	$78,893	$64,924	$13,969

(1) The increase in acquisition fixed asset additions in 2014 compared to 2013 is due to the 2014 acquisition of Alpha Mill Phase I and II.

(2) The increase in land and other development costs in 2014 compared to 2013 is due to increased construction and development costs, namely from the Cantabria and 7001 Arlington at Bethesda projects.

See Note 2, "Real Estate Capitalization Policies and Depreciation" and "Classification of Fixed Asset Additions" for additional information.

Unconsolidated Development. On February 3, 2014, we entered into a partnership agreement with AIG for the development and operation of 350 Eighth, a 410-unit apartment community with commercial space and underground parking located in San Francisco, California. We are a 50.01% partner with AIG, which has contributed $27.1 million to the partnership. The land upon which the partnership is developing was purchased by us for $46.6 million on May 28, 2013. As of December 31, 2013, this land was included in our consolidated financial statements. Upon the formation of our partnership with AIG, the land and improvements to date, with a carrying value of $50.3 million, were deconsolidated. On April 25, 2014, the partnership entered into a construction loan agreement for $143.6 million with a five-year term. We have guaranteed the payment of all future borrowings from this loan and the completion of construction in connection with the partnership's development. As this partnership is not sufficiently funded to finance the activities of the entity, and not all of the capital will be funded up front, the partnership has been deemed to not have sufficient equity, and has therefore been determined to be variable interest entity. It has also been determined that we do not control the decisions that most significantly affect the economics of the entity, and that we do not hold a controlling financial interest in the entity. As such, our investment in the entity is accounted for in our consolidated financial statements using the equity method. Our strategy with respect to this entity is to reduce the overall financial risk related to the development of the property. However, we do not believe that this investment has a materially different impact upon our liquidity, cash flows, capital resources, credit or market risk than the other consolidated development activities.

RESULTS OF OPERATIONS

Comparison of the three and six months ended June 30, 2014 to the three and six months ended June 30, 2013:

Our Same Community portfolio represents operating properties that we owned for all of the comparison periods. Development properties are added to our Same Community portfolio after they have been stabilized for all of the comparison periods. We consider a property to be stabilized when it has reached 93% occupancy. For the three and six-month comparison periods ended June 30, 2014 and 2013, the Same Community portfolio consisted of 44 owned properties containing 11,484 units. In 2014, the four properties we acquired in 2012 (The Apartments at the Arboretum, Southpoint Village, 21 Forty Medical District and The Park at Crossroads), containing 1,156 units in total, moved into the Same Community portfolio from the acquired/development properties portfolio. Properties that are sold are removed from the Same Community portfolio at that time. The properties we sold during the six months ended June 30, 2014 containing 909 units have been removed from the Same Community portfolio. Acquired and development properties for the three and six-month comparison periods ended June 30, 2014 and 2013 include one property acquired in 2014, five properties acquired in 2013 and a 99-unit expansion in Dallas, Texas, which stabilized during the first quarter of 2014.

Net income for the three months ended June 30, 2014 increased $60.7 million to $62.3 million when compared to the $1.6 million of net income recognized for the three months ended June 30, 2013. Net income recognized for the six months ended June 30, 2014 increased $92.6 million. This change was primarily due to the gains recognized on the disposition of four properties in 2014 of $100.9 million. Our positive performance was also due to an increase in property revenue and a decline in interest expense, net of increases in property operating and maintenance expenses, depreciation and amortization expense and general and administrative expenses.

The following chart reflects the amount and percentage change in line items relevant to the changes in overall operating performance:

(Dollar amounts in thousands)	Increase (Decrease) When Comparing the Three Months Ended June 30, 2014 to June 30, 2013				Increase (Decrease) When Comparing the Six Months Ended June 30, 2014 to June 30, 2013			
Property revenue	$4,022		9.3	%	$10,628		12.4	%
Property operating and maintenance expenses	1,470		8.8	%	4,643		14.1	%
Depreciation and amortization	2,028		14.6	%	4,432		16.0	%
General and administrative expenses	198		4.5	%	559		6.0	%
Interest expense	(808	)	(10.9	)%	(1,276	)	(8.6	)%
Gain on disposition of properties	59,904		100.0	%	100,870		100.0	%
Income from discontinued operations	(725	)	(100.0	)%				