

Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

MISSION WEST PROPERTIES INC  
Form 10-Q  
August 12, 2003

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

Form 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2003

COMMISSION FILE NUMBER 1-8383

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

Maryland  
-----

95-2635431  
-----

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer Identification Number)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). 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:

17,744,691 shares outstanding as of August 12, 2003

- 1 -

Mission West Properties, Inc.

FORM 10-Q  
FOR THE QUARTER ENDED JUNE 30, 2003

Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

INDEX

PART I FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited):

Consolidated Balance Sheets as of June 30, 2003  
and December 31, 2002.....

Consolidated Statements of Operations for the three  
and six months ended June 30, 2003 and 2002.....

Consolidated Statements of Cash Flows for the  
six months ended June 30, 2003 and 2002.....

Notes to Consolidated Financial Statements.....

Item 2. Management's Discussion and Analysis of Financial  
Condition and Results of Operations.....

Item 3. Quantitative and Qualitative Disclosures About Market Risk.....

Item 4. Controls and Procedures.....

PART II OTHER INFORMATION

Item 4. Submission of Matters to a Vote of Security Holders.....

Item 6. Exhibits and Reports on Form 8-K.....

SIGNATURES.....

- 2 -

PART I - FINANCIAL INFORMATION

ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS

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

June 30, 2003  
-----

ASSETS

Real estate assets, at cost  
Land

\$ 276,405

Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

Buildings and improvements	795,415
	-----
Total investments in properties	1,071,820
Less accumulated depreciation	(76,049)
	-----
Net investments in properties	995,771
Investment in unconsolidated joint venture	2,159
	-----
Net investments in real estate assets	997,930
Cash and cash equivalents	2,745
Deferred rent	17,451
Other assets	13,477
	-----
Total assets	\$1,031,603
	=====

LIABILITIES AND STOCKHOLDERS' EQUITY

Liabilities:	
Line of credit (related parties)	\$ 4,185
Revolving line of credit	18,431
Loan payable	-
Mortgage notes payable	302,352
Mortgage notes payable (related parties)	10,923
Interest payable	335
Security deposits	10,664
Prepaid rental income	14,056
Dividend/distribution payable	25,017
Accounts payable and accrued expenses	4,672
	-----
Total liabilities	390,635
Commitments and contingencies (Note 6)	
Minority interests	528,317
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, 17,739,691 and 17,487,329 shares issued and outstanding at June 30, 2003 and December 31, 2002, respectively	18
Paid-in-capital	130,429
Accumulated deficit	(17,796)
	-----
Total stockholders' equity	112,651
	-----
Total liabilities and stockholders' equity	\$1,031,603
	=====

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

- 3 -

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

Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

	Three months ended June 30,	
	2003	2002
Revenues:		
Rental revenues from real estate	\$33,194	\$32,753
Tenant reimbursements	4,990	4,875
Other income, including interest	569	278
<b>Total revenues</b>	<b>38,753</b>	<b>37,906</b>
Expenses:		
Operating expenses	1,891	1,921
Real estate taxes	3,440	3,003
Depreciation and amortization	5,397	4,455
General and administrative	322	370
Interest	4,356	2,362
Interest (related parties)	256	899
<b>Total expenses</b>	<b>15,662</b>	<b>13,010</b>
Income before equity in earnings of unconsolidated joint venture & minority interests	23,091	24,896
Equity in earnings of unconsolidated joint venture	2,023	-
Minority interests	20,958	20,823
<b>Income from continuing operations</b>	<b>4,156</b>	<b>4,073</b>
Discontinued operations, net minority interests:		
Gain from disposal of discontinued operations	-	-
Income attributable to discontinued operations	-	-
<b>Income from discontinued operations</b>	<b>-</b>	<b>-</b>
<b>Net income to common stockholders</b>	<b>\$ 4,156</b>	<b>\$ 4,073</b>
<b>Net income to minority interests</b>	<b>\$20,958</b>	<b>\$20,823</b>
Income per share from continuing operations:		
Basic	\$0.23	\$0.23
Diluted	\$0.23	\$0.23
Income per share from discontinued operations:		
Basic	-	-
Diluted	-	-
Net income per share to common stockholders:		
Basic	\$0.23	\$0.23
Diluted	\$0.23	\$0.23

Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

Weighted average number of shares of common stock outstanding (basic)	17,701,999	17,464,692	17
	=====	=====	=====
Weighted average number of shares of common stock outstanding (diluted)	17,762,773	17,902,853	17
	=====	=====	=====

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

- 4 -

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

	-----	Si
	-----	20
	-----	-----
Cash flows from operating activities:		
Net income	\$	8
Adjustments to reconcile net income to net cash provided by operating activities:		
Minority interests		41
Depreciation		9
Gain on sales of assets		
Equity in earnings of unconsolidated joint venture		(2
Distributions from unconsolidated joint venture		1
Other		
Changes in assets and liabilities:		
Deferred rent		
Other assets		
Interest payable		
Security deposits		
Prepaid rental income		4
Accounts payable and accrued expenses		
		-----
Net cash provided by operating activities		61
		-----
Cash flows from investing activities:		
Improvements to real estate assets/new equipment		
Refundable option payment		
Real estate purchase		(110
Proceeds from sales of real estate		
Restricted cash		
Proceeds from sale of joint venture real estate		1
		-----
Net cash used in investing activities		(109
		-----
Cash flows from financing activities:		

Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

Principal payments on mortgage notes payable	(2
Proceeds from mortgage note payable	180
Principal payments on mortgage notes payable (related parties)	
Net payments under line of credit (related parties)	(54
Proceeds from loan payable	
Payment on loan payable	(20
Payment on revolving line of credit	(5
Financing costs	
Proceeds from stock options exercised	
Minority interests distributions	(41
Dividends paid	(8
	-----
Net cash provided by (used in) financing activities	46
	-----
Net (decrease) increase in cash and cash equivalents	(1
Cash and cash equivalents, beginning	4
	-----
Cash and cash equivalents, ending	\$ 2
	=====
Supplemental information:	
Cash paid for interest	\$ 8
	=====
Supplemental schedule of non-cash investing and financing activities:	
Debt incurred in connection with property acquisitions (related parties)	
	=====
Assumption of other liabilities in connection with property acquisitions	\$
	=====
Issuance of operating partnership units in connection with property acquisitions	\$
	=====
Issuance of operating partnership units in connection with joint venture acquisition	\$ 1
	=====

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

- 5 -

MISSION WEST PROPERTIES, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data and per square footage)  
(Unaudited)

-----

1. PRINCIPLES OF CONSOLIDATION AND BASIS OF PRESENTATION

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

Certain prior year amounts have been reclassified to conform to the current year's presentation. There is no impact on net income or stockholders' equity.

Minority interest represents the separate private ownership of the operating partnerships by the Berg Group (defined as Carl E. Berg, his

## Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

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, 2003. 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, 2003 are not necessarily indicative of the results to be expected for the entire year.

The Company accounts for its investments in unconsolidated joint ventures under the equity method of accounting as the Company exercises some influence, but does not operate, manage or control the properties. These investments are recorded at cost and subsequently adjusted for equity in earnings and cash contributions and distributions.

The Company adopted Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long Lived Assets," effective January 1, 2002 (see note 7).

In January 2003, the FASB Interpretation No. 46, "Consolidation of Variable Interest Entities - an interpretation of ARB No. 15" ("FIN 46"). FIN 46 requires that any entity meeting certain rules and relation to a company's equity investment risk and level of financial control be considered as a variable interest entity. The statement is applicable to all variable interest entities created or acquired after January 31, 2003, and the first interim period beginning after June 15, 2003, for variable interest entities in which the Company holds a variable interest that is acquired before February 1, 2003. The Company plans on adopting FIN 46 in the time frames as required by the statement. Management expects no significant effect on the consolidated financial position, results of operations or cash flows of the Company as a result of the initial adoption of this standard in regard to existing variable interest entities; however, newly formed entities in 2003 could meet these requirements and will be recorded as appropriate.

The Company has elected to be taxed as a real estate investment trust ("REIT") 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, 2003.

## 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

## Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

purposes in the future, directly or indirectly, by certain members of the Berg Group. At present, there are approximately 250 acres of Silicon Valley land, including land under development, owned directly or under 50% joint venture entities, 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

- 6 -

cash or, at their option, operating partnership interests ("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, 2003, the Company had completed 19 acquisitions under the Berg Land Holdings Option Agreement representing approximately 1,864,000 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 \$7.50 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 members of the independent directors committee of the Company's board of directors.

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.

### INVESTMENT IN UNCONSOLIDATED JOINT VENTURE

Effective January 1, 2003, the Company acquired a 50% interest in a joint venture with TBI in Morgan Hill, California for \$1,800 from the Berg Group under the Berg Land Holdings Option Agreement. The Company financed the acquisition of its 50% interest with the issuance of 181,032 O.P. units to the Berg Group. The joint venture consists of four R&D buildings with approximately 593,000 rentable square feet, which are operated and managed by TBI, the other partner in the joint venture. The Company's investment in this joint venture is reflected as an investment in unconsolidated joint venture on the accompanying consolidated balance sheets. This investment is not consolidated because TBI has management and control over significant day-to-day operating activities.

On April 1, 2003, the Company's joint venture acquired a 60,000 rentable square foot shell building in Morgan Hill, California from the Berg Group under the Berg Land Holdings Option Agreement. The joint venture financed 100% of the cost of the building. The building was sold on April 2, 2003. The Company received a cash distribution and recognized a gain of \$1,400, its proportionate share, on the sale.

### PROPERTY ACQUISITIONS

Effective April 9, 2003, the Company acquired a 36-acre seven-building campus style office/R&D project comprised of approximately 625,000 rentable



## Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

square feet at San Tomas and Central Expressway in Santa Clara, California, also known as the San Tomas Technology Park. The project was acquired for approximately \$110,000 from an unrelated third party and financed with a combination of debt and cash reserves. The debt component is comprised of an \$80,000 short term loan from Citicorp USA, Inc., which is collateralized by the acquired properties. This loan bears interest at an annual rate equal to LIBOR plus 2% and matures in April 2004. In addition, the Company utilized approximately \$19,200 of its operating line of credit with Cupertino National Bank in connection with this acquisition. The Consolidated Statements of Operations for the three and six months ended June 30, 2003 include revenues and expenses from the acquired properties at the San Tomas Technology Park from the date of acquisition.

### 3. STOCK TRANSACTIONS

During the six months ended June 30, 2003, stock options to purchase 60,362 shares of common stock and 35,000 shares of common stock were exercised at \$4.50 and \$8.25 per share, respectively. Total proceeds to the Company were approximately \$560. Two limited partners exchanged 157,000 O.P. units for 157,000 shares of the Company's common stock under the terms of the December 1998 Exchange Rights Agreement among the Company and all limited partners of the operating partnerships.

### 4. NET INCOME PER SHARE

Basic operating net income per share is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted operating 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 using the treasury stock method.

- 7 -

The computation for weighted average shares is detailed below:

	Three Months Ended June 30,		Six
	2003	2002	2
Weighted average shares outstanding (basic)	17,701,999	17,464,692	17,6
Incremental shares from assumed option exercise	60,774	438,161	
Weighted average shares outstanding (diluted)	17,762,773	17,902,853	17,7
	17,762,773	17,902,853	17,7

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 calculation after adding the minority interests' share of income back to net income. The total number of O.P. units outstanding at June 30, 2003 and 2002 was 86,498,064 and 86,161,346, respectively.

## Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

### 5. RELATED PARTY TRANSACTIONS

As of June 30, 2003, the Berg Group owned 78,364,716 O.P. units. The Berg Group's ownership as of June 30, 2003 represented approximately 75% of the equity interests of the Company, assuming conversion of the 86,498,064 O.P. units outstanding into the Company's common stock.

Effective January 1, 2003, the Company and the Berg Group mutually agreed to reduce the Berg Group \$100,000 line of credit to \$20,000 and to reduce the number of properties securing the line of credit to five. The Berg Group line of credit bears interest at LIBOR plus 1.30%, which was 2.42% as of June 30, 2003, and matures in March 2004. 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, 2003, debt in the amount of \$4,185 was due the Berg Group under the line of credit, and debt in the amount of \$10,923 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 ten years with principal payments amortized over 20 years.

Carl E. Berg has a substantial financial interest in one company that leases space from the operating partnerships. This company occupies 5,862 square feet at \$1.00 per square foot per month. This lease was in effect prior to the Company's acquisition of its general partnership interests in July 1998. The lease expires in May 2004.

The Company currently leases office space owned by Berg & Berg Enterprises, Inc., an affiliate of Carl E. Berg and Clyde J. Berg. Rental amounts and overhead reimbursements paid to Berg & Berg Enterprises, Inc. were \$23 for each of the three-month periods ended June 30, 2003 and 2002 and \$45 for each of the six-month periods ended June 30, 2003 and 2002.

### 6. 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 is not aware of any litigation against the Company that 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 losses from the consequence of terrorism or seismic activity, although they do cover losses from fires after an earthquake.

### 7. DISCONTINUED OPERATIONS

Effective January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long Lived Assets," which addresses financial accounting and reporting for the impairment and disposal of long-lived assets. In general, income or loss attributable to the operations and sale of property, and the operations related to property held for sale, are classified as discontinued operations in the statements of operations. All periods presented in this report will likely require further reclassification in future periods if additional property sales occur.

As of June 30, 2003, there were no properties under contract to be sold or disposed of which would qualify as discontinued operations.

In March 2002, the Company sold one property for a total gain of \$6,103, including minority interest share of \$5,087. Condensed results of

Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

operations for this property for the six months ended June 30, 2002 are as follows:

- 8 -

	Six Months Ended June 30, 2002
	----- (Dollars in thousands)
Rental income from real estate	\$333
Tenant reimbursements	293
	-----
Total revenues	626
Real estate taxes	293
Depreciation	46
	-----
Total expenses	339
	-----
Income before minority interests	287
Minority interests	239
	-----
Net income	\$48
	=====

8. BUSINESS COMBINATIONS

On April 9, 2003, the Company acquired San Tomas Technology Park for \$110,000 in cash. The purchase price was allocated to long-lived assets and in-place leases, proportionate to the assets, respective fair market value. The Company recorded an intangible asset of \$11,200 in building and improvements in the accompanying balance sheet for an in-place above market lease. The intangible asset will be amortized over six years, the life of the lease. Amortization expense of \$472 was recorded for the three months ended June 30, 2003.

9. SUBSEQUENT EVENTS

On July 10, 2003, the Company paid dividends of \$0.24 per share of common stock to all common stockholders of record as of June 30, 2003. On the same date, the operating partnerships paid a distribution of \$0.24 per O.P. unit to all holders of O.P. units.

- 9 -

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

## Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

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, 2002. The results for the three and six months ended June 30, 2003 are not necessarily indicative of the results to be expected for the entire fiscal year ending December 31, 2003. The following discussion includes forward-looking statements, including but not limited to, statements with respect to the Company's future financial performance, operating results, plans and objectives. Actual results may differ materially from those currently anticipated depending upon a variety of factors, including those described below under the sub-heading, "Forward-Looking Information."

### OVERVIEW

Mission West Properties, Inc. (the "Company") acquires, markets, leases, and manages R&D and office properties, primarily located in the Silicon Valley portion of the San Francisco Bay Area. As of June 30, 2003, the Company owned and managed 108 properties totaling approximately 7.8 million rentable square feet through four limited partnerships, or operating partnerships, for which it is the sole general partner. This class of property is designed for research and development and office uses and, in some cases, includes space for light manufacturing operations with loading docks. The Company believes that it has one of the largest portfolios of R&D properties in the Silicon Valley. As of June 30, 2003, the five tenants who leased the most square footage from the Company were Microsoft Corporation, JDS Uniphase Corporation, Amdahl Corporation (a subsidiary of Fujitsu Limited), Apple Computer, Inc., and NEC Electronics America, Inc. For federal income tax purposes, the Company has operated as a self-managed, self-administered and fully integrated real estate investment trust ("REIT") since fiscal 1999.

The Company's acquisition, growth and operating strategy incorporates the following elements:

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

Effective April 9, 2003, the Company acquired seven R&D and office properties located at the San Tomas Technology Park in Santa Clara, California. The acquisition added approximately 625,000 net rentable square feet, or approximately 9%, to the Company's existing portfolio of properties.

### CRITICAL ACCOUNTING POLICIES

The Company prepares the consolidated financial statements in conformity with GAAP, which requires it to make certain estimates, judgments and assumptions that affect the reported amounts in the accompanying consolidated financial statements, disclosure of contingent assets and liabilities and related

## Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

footnotes. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that require management to make estimates, judgments and assumptions, giving due consideration to materiality, in certain circumstances that affect amounts reported in the consolidated financial statements, and potentially result in materially different results under different conditions and assumptions. The Company believes that the following best describe its critical accounting policies:

**REAL ESTATE ASSETS.** Real estate assets are stated at cost. Cost includes expenditures for improvements or replacements. Maintenance and repairs are charged to expense as incurred. Gains and losses from sales are included in income in accordance with Statement of Financial Accounting Standards ("SFAS") No. 66, "Accounting for Sales of Real Estate."

The Company reviews real estate assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If the carrying amount of the asset exceeds its estimated undiscounted net cash flow, before interest, it will recognize an impairment loss equal to the difference between the carrying amount and the estimated fair value. If impairment is recognized, the reduced carrying amount of the asset will be accounted for as its new cost. For a depreciable asset,

- 10 -

the new cost will be depreciated over the asset's remaining useful life. Generally, fair values are estimated using discounted cash flow, replacement cost or market comparison analyses. The process of evaluating for impairment requires estimates as to future events and conditions, which are subject to varying market and economic factors, however. Therefore, it is reasonably possible that a change in estimate resulting from judgments as to future events could occur which would affect the recorded amounts of the property.

**ALLOWANCE FOR DOUBTFUL ACCOUNTS AND RESERVE.** The preparation of the consolidated financial statements requires the Company to make estimates and assumptions. As such, it must make estimates of the uncollectability of its accounts receivable based on the evaluation of its tenants' financial position, analyses of accounts receivable and current economic trends. The Company also makes estimates for a straight-line adjustment reserve for existing tenants with the potential of bankruptcy or ceasing operations. Its estimates are based on the review of tenants' payment histories, publicly available financial information and such additional information about their financial condition as tenants provide them. The information available to the Company might lead it to overstate or understate these reserve amounts. The use of different estimates or assumptions could produce different results. Moreover, actual future collections of accounts receivable or reductions in future reported rental income due to tenant bankruptcies or other business failures could differ materially from the Company's estimates.

**CONSOLIDATED JOINT VENTURES.** The Company, through an operating partnership, owns three properties that are in joint ventures in which the Company holds ownership interests. The Company manages and operates all three properties. The Company's ownership of these properties and its portion of their operating results are reflected on the Company's consolidated financial statements because the Company owns a majority interest, exercises significant control over major operating decisions, and has operational and financial control of the investments. The Company makes judgments and assumptions about the estimated monthly payments to be made to its joint venture partners, which are reported with its periodic results of operations. Actual results may differ from these estimates under different assumptions or conditions.

## Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

INVESTMENTS IN UNCONSOLIDATED JOINT VENTURES. The Company, through an operating partnership, has a non-controlling limited partnership interest in one unconsolidated joint venture. This investment is not consolidated because the Company does not exercise significant control over major operating and financial decisions. The Company accounts for the joint venture using the equity method of accounting.

REVENUE RECOGNITION. The Company recognizes rental revenue on the straight-line method of accounting required by GAAP under which contractual rent payment increases are recognized evenly over the lease term, regardless of when the rent payments are received by the Company. The difference between recognized rental income and rental cash receipts is recorded as deferred rent on the balance sheet.

Certain lease agreements contain terms that provide for additional rents based on reimbursement of certain costs. These additional rents are recognized on the accrual basis.

Rental revenue is affected if existing tenants terminate or amend their leases. Thus, if a tenant lengthens its lease term, additional rental revenue is recognized. On the other hand, if a tenant terminates its lease agreement or shortens its lease term, rental revenue decreases due to reduced future cash flows and a straight-line adjustment to deferred rent, which is the difference between recognized rental income and rental cash receipts. The Company tries to identify tenants who may be likely to declare bankruptcy or cease operations. By anticipating these events in advance, the Company expects to take steps to minimize their impact on its reported results of operations through lease renegotiations, adjustments to deferred rent, and other appropriate measures. The Company's judgments and estimations about tenants' capacity to continue to meet their lease obligations will affect the rental revenue recognized. Material differences may result in the amount and timing of our rental revenue for any period if the Company made different judgments or estimations.

- 11 -

### RESULTS OF OPERATIONS

COMPARISON OF THE THREE AND SIX MONTHS ENDED JUNE 30, 2003 TO THE THREE AND SIX MONTHS ENDED JUNE 30, 2002.

As of June 30, 2003, the Company, through its controlling interests in the operating partnerships, owned 108 properties totaling approximately 7.8 million square feet compared to 100 properties totaling approximately 7.0 million square feet owned by the Company as of June 30, 2002. This represents a net increase of approximately 11% in total rentable square footage, which is primarily attributable to the Company's acquisition of seven properties at the San Tomas Technology Park in Santa Clara, California consisting of approximately 625,000 net rentable square feet in April 2003.

Rental revenues from continuing operations for the three and six months ended June 30, 2003 compared to the three and six-month periods in 2002 as follows:

Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

Three Months Ended June 30,				
	2003	2002	\$ Change	% Change by Property Gro
(Dollars in thousands)				
Same Property (1)	\$27,735	\$30,913	(\$3,178)	(10.3%)
2002 Acquisitions (2)	2,523	1,840	683	37.1%
2003 Acquisitions	2,936	-	2,936	100%
	\$33,194	\$32,753	\$ 441	1.3%

Six Months Ended June 30,				
	2003	2002	\$ Change	% Change by Property Gro
(Dollars in thousands)				
Same Property (1)	\$56,584	\$62,358	(\$5,774)	(9.3%)
2002 Acquisitions (2)	5,106	2,880	2,226	77.3%
2003 Acquisitions	2,936	-	2,936	100%
	\$64,626	\$65,238	(\$ 612)	(1.0%)

- (1) "Same Property" is defined as properties owned by the Company prior to 2002 that the Company still owned as of June 30, 2003.
- (2) Operating rental revenues for 2002 Acquisitions do not reflect a full 12 months of operations in 2002 because these properties were acquired at various times during 2002.

RENTAL REVENUE FROM CONTINUING OPERATIONS

For the quarter ended June 30, 2003, rental revenues increased by \$0.4 million, or 1.3%, from \$32.8 million for the three months ended June 30, 2002 to \$33.2 million for the same period of 2003. The net increase resulted from a decline of (\$3.2) million in the Company's "Same Property" portfolio, an increase of \$0.7 million from properties acquired in 2002, and an increase of \$2.9 million from properties acquired in 2003. Rental revenues decreased by (\$0.6) million from \$65.2 million for the six months ended June 30, 2002 to \$64.6 million for the same period of 2003. Of the (\$0.6) million decrease in rental revenues, (\$5.7) million resulted from the Company's "Same Property" portfolio, \$2.2 million were generated by properties acquired in 2002, and \$2.9 million were generated by properties acquired in 2003. The overall decline in rental revenues was a result of adverse market conditions and the loss of several tenants due to their bankruptcy or cessation of operations since June 30, 2002. The Company's occupancy rate at June 30, 2003 was approximately 80%, compared to approximately 90% at June 30, 2002.

EQUITY IN EARNINGS FROM UNCONSOLIDATED JOINT VENTURE

As of June 30, 2003, the Company had investments in four R&D buildings, totaling 593,000 rentable square feet, through an unconsolidated joint venture, in which the Company acquired a 50% interest in January 2003. The Company has a non-controlling limited partnership interest in this joint venture, which it accounts for using the equity method of accounting. For the three months ended June 30, 2003, the Company recorded equity in earnings from the unconsolidated

## Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

joint venture of approximately \$2.0 million, including \$1.4 million relating to a gain from the sale of real estate by the unconsolidated joint venture. For the six-month period ended June 30, 2003, equity in earnings from the unconsolidated joint venture was approximately \$2.8 million.

### OTHER INCOME

Other income, including interest, increased to \$0.6 million for the three months ended June 30, 2003 from \$0.3 million for the second quarter of 2002. For the six months ended June 30, 2003 and 2002, other income, including interest, was \$1.3 million and \$0.8 million, respectively. Utility rebate and security deposit forfeitures represented most of the increase. The Company does not consider these transactions to be recurring items.

### EXPENSES FROM CONTINUING OPERATIONS

Operating expenses and real estate taxes from continuing operations, on a combined basis, increased by \$0.4 million, or 8.2%, from \$4.9 million to \$5.3 million for the three months ended June 30, 2002 and 2003, respectively, due to the acquisition of the San Tomas Technology Park in April 2003. For the same reason, tenant reimbursements from continuing operations consistently increased by \$0.1 million, or 2.0%, from \$4.9 million for the three months ended June 30, 2002 to \$5.0 million for the three months ended June

- 12 -

30, 2003. The increase in tenant reimbursements was less than the increase in operating expenses and real estate taxes because of lower occupancy. Certain expenses such as property insurance, real estate taxes, and other fixed expenses are not recoverable from vacant properties.

Depreciation and amortization expense of real estate from continuing operations increased by \$0.9 million from \$4.5 million to \$5.4 million for the three months ended June 30, 2002 and 2003, respectively. Of the \$0.9 million increase in depreciation and amortization expense of real estate, approximately \$0.5 million represented amortization expense of an intangible asset resulting from an above market in-place lease at the San Tomas Technology Park (see note 8). Depreciation expense from continuing operations increased by \$1.2 million from \$8.8 million to \$10.0 million for the six months ended June 30, 2002 and 2003, respectively, primarily because of the newly acquired R&D and office properties.

Interest expense increased by \$2.0 million, or 83.3%, from \$2.4 million for the three months ended June 30, 2002 to \$4.4 million for the three months ended June 30, 2003. The increase in interest expense resulted from additional debt obtained by the Company, consisting of a new revolving line of credit from Cupertino National Bank put in place during the third quarter 2002, a new \$100 million mortgage loan from Northwestern Mutual Life Insurance Company obtained in early January 2003, and a new \$80 million mortgage loan from Citicorp USA, Inc. obtained in early April 2003. Interest expense (related parties) decreased by \$0.6 million, or 66.7%, from \$0.9 million for the three months ended June 30, 2002 to \$0.3 million for the three months ended June 30, 2003 due to lower interest rates and the repayments of the Berg Group line of credit. Total debt outstanding, including amounts due related parties, increased by \$104.5 million, or 45.2%, from \$231.4 million as of June 30, 2002 to \$335.9 million as of June 30, 2003. As a result of the new debt, interest expense, including amounts paid to related parties, for the quarter ended June 30, 2003 increased by \$1.4 million compared to the same quarter a year ago because the new debt carries a higher interest rate than the Berg Group line of credit which it mainly replaced.

Interest expense increased by \$3.2 million, or 69.6%, from \$4.6 million for the six months ended June 30, 2002 to \$7.8 million for the six months ended June 30, 2003. Interest expense (related parties) decreased by \$1.4 million, or 73.7%,



## Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

from \$1.9 million for the six months ended June 30, 2002 to \$0.5 million for the six months ended June 30, 2003. Overall interest expense for the six months ended June 30, 2003 increased by \$1.8 million compared to the six months ended June 30, 2002 with the substitution of new debt for the loan under the Berg Group line of credit. Management expects interest expense to increase as new debt is incurred in connection with property acquisitions, as the Company draws on the Cupertino National Bank revolving line of credit, and as it seeks alternative sources of credit.

### NET INCOME TO MINORITY INTEREST AND NET INCOME TO COMMON STOCKHOLDERS

The minority interest portion of income increased by \$0.1 million, or 0.5%, from \$20.8 million for the three months ended June 30, 2002 to \$20.9 million for the three months ended June 30, 2003. Net income to common stockholders increased by \$0.1 million, or 2.4%, from \$4.1 million for the three months ended June 30, 2002 to \$4.2 million for the same period in 2003. For the six months ended June 30, 2003 and 2002, the minority interest portion of income was \$41.2 million and \$46.9 million, respectively, resulting in net income to stockholders of \$8.2 million and \$9.3 million, respectively. The decline in net income was primarily due to reduced rental revenues and because net income for the prior year's comparable period included gain from a sale of discontinued operations. Minority interest represents the ownership interest of all limited partners in the operating partnerships taken as a whole, which was approximately 83% as of June 30, 2003 and 2002.

### RECENT DEVELOPMENTS

**RENTAL MARKET CONDITIONS.** 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 since 2001 after fast-paced growth in 1999 and 2000. The Silicon Valley R&D property market has historically 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 21.9% in late 2002 to 23.1% at the end of the second quarter 2003. Total vacant R&D square footage in Silicon Valley at the end of the second quarter of 2003 amounted to 35.6 million square feet, of which 37%, or 13.1 million square feet, was being offered under subleases. Total negative net absorption in 2002 amounted to approximately (10.9) million square feet. During the first six months of 2003, there was total negative net absorption of approximately (3.8) million square feet. The impact of this decline has not been uniform throughout the area, however. The Silicon Valley R&D property market has been characterized by a substantial number of submarkets, with rent and vacancy rates varying by submarket and location within each submarket.

The Company's actual occupancy rate at June 30, 2003 was 80.2%, which is a significant decline from the occupancy rate of 90.3% at June 30, 2002. The Company believes that its occupancy rate could decline further going forward if key tenants seek the protection of the bankruptcy laws or discontinue operations. In addition, leases with respect to approximately 145,000 rentable square feet are expiring in the second half of 2003. The properties subject to these leases may take anywhere from six to 12 months or longer to re-lease. The Company expects the average 2003 renewal rental rates for these properties to be approximately equal to, or perhaps, below current rents. If the Company is unable to lease a significant portion of any vacant space or space scheduled to expire; if the Company experiences significant tenant defaults as a result of the current economic downturn; or if the Company is not able to lease space at or above current market rates, its results of operations and cash flows will be adversely affected. 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

## Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

- 13 -

"Forward-Looking Information" below and in the section entitled "Risk Factors" in the Company's most recent annual report on Form 10-K.

RECENT PROPERTY ACQUISITIONS. Effective January 1, 2003, the Company acquired a 50% interest in a joint venture with TBI in Morgan Hill, California for \$1.8 million from the Berg Group under the Berg Land Holdings Option Agreement. The Company financed the acquisition of its 50% interest with the issuance of 181,032 O.P. units to the Berg Group. The joint venture consists of four R&D buildings with approximately 593,000 rentable square feet, which are operated and managed by TBI, the other partner in the joint venture. The property is subject to secured loans of approximately \$53.6 million, of which the Company's pro rata share of unconsolidated joint venture debt at June 30, 2003 was approximately \$26.6 million.

On April 1, 2003, the Company's joint venture acquired a shell building in Morgan Hill, California from the Berg Group under the Berg Land Holdings Option Agreement. The joint venture financed 100% of the cost of the shell building. The shell building was sold on April 2, 2003 for cash. The Company recognized a gain of \$1.4 million representing its share of the joint venture's profit.

On April 9, 2003, the Company acquired a 36-acre seven-building campus style office/R&D project comprised of approximately 625,000 rentable square feet at San Tomas and Central Expressway in Santa Clara, California, also known as the San Tomas Technology Park. The San Tomas Technology Park was approximately 90% leased at the date of acquisition, but one tenant, which leases approximately 98,000 rentable square feet, has filed a petition under Chapter 11 of the Bankruptcy Code subsequent to the acquisition date. The project was acquired for \$110 million from BRE/San Tomas I LLC and BRE/San Tomas II LLC and financed with a combination of approximately \$100 million of new debt and cash reserves.

- 14 -

### CHANGES IN FINANCIAL CONDITION

The most significant changes in financial condition during the three months ended June 30, 2003 resulted from the \$110 million acquisition of the San Tomas Technology Park. Stockholders' equity increased from the exercise of stock options and the exchange of O.P. units for common stock.

At June 30, 2003, real estate assets increased by approximately \$110.5 million from December 31, 2002 due to the San Tomas Technology Park acquisition and new tenant improvements. Of the \$110.5 million increase in real estate assets, approximately \$11.2 million was allocated separately to an above market rent lease. In early 2003, the Company acquired a 50% interest in a joint venture from the Berg Group under the Berg Land Holdings Option Agreement for \$1.8 million. The Company financed this acquisition by issuing 181,032 O.P. units. The joint venture consists of four buildings with approximately 593,000 square feet, which are operated and managed by TBI, the other partner in the joint venture.

At June 30, 2003, total stockholders' equity, net, increased by approximately \$1.8 million from December 31, 2002 as the Company obtained additional capital from stock option exercises and the exchange of O.P. units for the Company's common stock while incurring a deficit of (\$0.3) million. During the six months

## Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

ended June 30, 2003, stock options to purchase 60,362 shares of common stock were exercised at \$4.50 per share, and stock options to purchase 35,000 shares of common stock were exercised at \$8.25 per share. Total proceeds to the Company were approximately \$0.6 million. During the first six months of 2003, two limited partners exchanged 157,000 O.P. units for 157,000 shares of the Company's common stock under the Exchange Rights Agreement among the Company and the limited partners in the operating partnerships. The newly issued shares increased additional paid in capital by approximately \$2.1 million.

### LIQUIDITY AND CAPITAL RESOURCES

The Company expects its principal sources of liquidity for distributions to stockholders and unit holders, debt service, leasing commissions and recurring capital expenditures to come from operations and/or the Berg Group line of credit and other credit facilities that may be established by the Company with third party financial institutions. The Company expects these sources of liquidity to be adequate to meet projected distributions to stockholders and other presently anticipated liquidity requirements during the next 12 months. The Company expects to meet its long-term liquidity requirements for the funding of property development, property acquisitions and other material non-recurring capital improvements through long-term secured and unsecured indebtedness and the issuance of additional equity securities by the Company. The Company has the ability to meet short-term obligations or other liquidity needs based on the Berg Group and Cupertino National Bank revolving lines of credit. Despite the current weakness in the economy, the Company expects interest expense to increase, but not significantly, as it incurs debt through acquisitions of new properties and as interest rates increase.

On January 9, 2003, the Company obtained a \$100 million secured mortgage loan from Northwestern Mutual Life Insurance Company ("Northwestern Loan") that bears a fixed interest rate at 5.64% and matures in ten years with principal payments amortized over 20 years. The mortgage loan is secured by 11 properties. The Company paid approximately \$675,000 in loan fees and financing costs and used the proceeds to primarily pay down short-term debt and the Berg Group line of credit.

On April 9, 2003, the Company obtained an \$80 million short-term mortgage loan from Citicorp USA, Inc. ("Citicorp Loan") that bears interest at LIBOR plus 2% and matures in April 2004. The Company paid \$200,000 in financing costs and used the proceeds to acquire the San Tomas Technology Park property. The original loan term was 120 days, but the Company and Citicorp USA, Inc. agreed to a nine-month loan term extension in June 2003.

On July 10, 2003, the Company paid dividends of \$0.24 per share of common stock to all common stockholders of record as of June 30, 2003. On the same date, the operating partnerships paid a distribution of \$0.24 per O.P. unit to all holders of O.P. units.

At June 30, 2003, the Company had total indebtedness of \$335.9 million, including \$302.4 million of fixed rate mortgage debt, \$10.9 million under the Berg Group mortgage note (related parties), \$18.4 million under the Cupertino National Bank line of credit, and \$4.2 million under the Berg Group line of credit (related parties), as detailed in the table below:

- 15 -

### Mortgage Debt

The following table sets forth information regarding debt outstanding as of June

Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

30, 2003:

Debt Description	Collateral Properties	Bala
		(Dollars in
Line of Credit:		
Berg Group (related parties)	2033-2043 Samaritan Drive, San Jose, CA 2133 Samaritan Drive, San Jose, CA 2233-2243 Samaritan Drive, San Jose, CA 1310-1450 McCandless Drive, Milpitas, CA 1795-1845 McCandless Drive, Milpitas, CA	\$ 4,
Cupertino National Bank	Not Applicable	18,
Mortgage Notes Payable (related parties):	5300 & 5350 Hellyer Avenue, San Jose, CA	10,
Mortgage Notes Payable:		
Prudential Capital Group	20400 Mariani Avenue, Cupertino, CA	
Washington Mutual (Home Savings & Loan Assoc.)	10460 Bubb Road, Cupertino, CA	
Prudential Insurance Company of America (2)	10300 Bubb Road, Cupertino, CA 10500 N. De Anza Boulevard, 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 Boulevard, 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	122,
Northwestern Mutual Life Insurance Company	1750 Automation Parkway, San Jose, CA 1756 Automation Parkway, San Jose, CA 1762 Automation Parkway, San Jose, CA 6320 San Ignacio Avenue, San Jose, CA 6540-6541 Via Del Oro, San Jose, CA 6385-6387 Via Del Oro, San Jose, CA 2251 Lawson Lane, Santa Clara, CA 1325 McCandless Drive, Milpitas, CA	98,

## Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

1650-1690 McCandless Drive, Milpitas, CA  
20605-20705 Valley Green Drive, Cupertino, CA

Citicorp USA, Inc.

2001 Walsh Avenue, Santa Clara, CA 80,  
2880 Scott Boulevard, Santa Clara, CA  
2890 Scott Boulevard, Santa Clara, CA  
2770-2800 Scott Boulevard, Santa Clara, CA  
2300 Central Expressway, Santa Clara, CA  
2220 Central Expressway, Santa Clara, CA  
2330 Central Expressway, Santa Clara, CA

Mortgage Notes Payable Subtotal

-----  
302,  
-----

TOTAL

\$335,  
=====

- (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 2004. The interest rate at June 30, 2003 was 2.42%.
- (2) John Kontrabecki, one of the limited partners, has guaranteed approximately \$12,000 of this debt.
- (3) Interest rate equal to LIBOR plus 2%. The interest rates for the Cupertino National Bank line of credit and the Citicorp USA, Inc. mortgage loan at June 30, 2003 were 3.32% and 3.29%, respectively.

- 16 -

As of June 30, 2003, the Company's debt to total market capitalization ratio was approximately 22.1%, based upon a total market capitalization of approximately \$1.5 billion. The Company computed this ratio by dividing the Company's total debt outstanding as of June 30, 2003 by the sum of this debt plus the market value of common stock (based upon the closing price of \$11.37 per share on June 30, 2003) on a fully diluted basis, taking into account the conversion of all O.P. units into common stock.

### HISTORICAL CASH FLOWS

Net cash provided by operating activities for the six months ended June 30, 2003 was \$61.1 million compared to \$64.7 million for the same period in 2002. The decline resulted from the decrease in rental revenue from the Company's current portfolio of property due to tenant lease obligation defaults during 2002 and 2003.

Net cash used in investing activities was approximately (\$109.6) million and (\$19.8) million for the six months ended June 30, 2003 and 2002, respectively. Of the (\$109.6) million net cash used in investing activities, (\$110) million was used to acquire the San Tomas Technology Park property, \$1.4 million received from the sale of joint venture real estate, and (\$1) million was used for tenant improvements and new equipment.

Net cash provided by financing activities was \$46.8 million for the six months ended June 30, 2003 compared to (\$44.4) million used in financing activities for the same period in 2002. Of the \$46.8 million net cash from financing activities, (\$82.9) million was used to pay outstanding debt, (\$41.6) million for minority interest distributions, and (\$8.4) million for dividends. The Company obtained approximately \$180 million from financing activity, which

## Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

included the Northwestern Loan and Citicorp Loan and related financing costs, as well as proceeds from the exercise of stock options.

### CAPITAL EXPENDITURES

The Company's existing R&D properties require periodic investments of capital for tenant-related capital expenditures and for general capital improvements. For the years ended December 31, 1997 through December 31, 2002, 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 2003. The Company believes it will recover substantially all of these sums from the tenants under new or renewed leases through increases in rental rates. The Company expects to meet its long-term liquidity requirements for the funding of property development, property acquisitions and other material non-recurring capital improvements through long-term secured and unsecured indebtedness and the issuance of additional equity securities by the Company.

### FUNDS FROM OPERATIONS

The Company's principal performance measurements are net income to common stockholders and earnings per share computed in accordance with GAAP. Management considers Funds From Operations ("FFO") an appropriate measure of performance of an equity REIT because, along with cash flows from operating activities, financing activities and investing activities, it provides investors with an understanding of the Company's ability to incur and service debt, and make capital expenditures. FFO is a non-GAAP financial measurement used by real estate investment trusts to measure and compare operating performance. 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, amortization of commission and depreciation of non-real estate assets) and after adjustments for unconsolidated partnerships and joint ventures. 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. 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, 2003 and 2002, as reconciled to net income to common stockholders, are summarized in the tables below:

## Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

	Three Months Ended June 30,		
	2003	2002	
	(Dollars in thousands)		
Net income to common stockholders	\$ 4,156	\$ 4,073	\$
Add:			
Minority interests (1)	20,799	20,671	4
Depreciation and amortization (2)	5,397	4,455	
Less:			
Gain on sale of JV assets / assets	(1,400)	-	(
Funds From Operations	\$28,952	\$29,199	\$5

(1) Excludes minority interest for unrelated parties.

(2) Includes depreciation of real estate from discontinued operations and amortization expense of costs allocated to above market leases in property acquisitions.

### DISTRIBUTION POLICY

The Company's board of directors will determine the amount and timing of distributions to our stockholders. The board of directors will consider many factors prior to making any distributions, including the following:

- the amount of cash available for distribution;
- the Company's financial condition;
- whether to reinvest funds rather than to distribute such funds;
- the Company's committed and projected capital expenditures;
- the amount of cash required for new property acquisitions, including acquisitions under existing agreements with the Berg Group;
- prospects of tenant renewals and re-leases of properties subject to expiring leases;
- cash required for re-leasing activities;
- the annual distribution requirements under the REIT provisions of the federal income tax laws; and
- such other factors as the board of directors deems relevant.

The Company cannot assure you that it will be able to meet or maintain management's cash distribution objectives.

- 18 -

### IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

The Company does not believe recently issued accounting standards will materially impact its financial statements.

## Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

In January 2003, the FASB Interpretation No. 46, "Consolidation of Variable Interest Entities - an interpretation of ARB No. 15" ("FIN 46"). FIN 46 requires that any entity meeting certain rules and relation to a company's equity investment risk and level of financial control be considered as a variable interest entity. The statement is applicable to all variable interest entities created or acquired after January 31, 2003, and the first interim period beginning after June 15, 2003, for variable interest entities in which the Company holds a variable interest that is acquired before February 1, 2003. The Company plans on adopting FIN 46 in the time frames as required by the statement. Management expects no significant effect on the consolidated financial position, results of operations or cash flows of the Company as a result of the initial adoption of this standard in regard to existing variable interest entities; however, newly formed entities in 2003 could meet these requirements and will be recorded as appropriate.

### FORWARD-LOOKING INFORMATION

This quarterly report contains forward-looking statements within the meaning of the federal securities laws. The Company intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Reform Act of 1995, and is including this statement for purposes of complying with these safe harbor provisions. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies and expectations of the Company, are generally identifiable by use of the words "believe," "expect," "intend," "anticipate," "estimate," "project" or similar expressions. Additionally, all disclosures under Part I., Item 3 constitute forward-looking statements. The Company's ability to predict results or the actual effect of future plans or strategies is inherently uncertain.

Factors that could have a material adverse effect on the operations and future prospects of the Company include, but are not limited to, the following:

- 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,
- lease term expirations and renewals, and
- general accounting principles, policies and guidelines applicable to REITs.

In addition, the actual timing of development, construction, and leasing on any 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. 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.

- 19 -



## Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

### QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not generally hold market risk sensitive instruments for trading purposes. We use fixed and variable rate debt to finance our operations. Our exposure to market risk for changes in interest rates relates primarily to our current and future debt obligations. We are vulnerable to significant fluctuations of interest rates on our floating rate debt and pricing on our future debt. We manage our market risk by monitoring interest rates where we try to recognize the unpredictability of the financial markets and seek to reduce potentially adverse effect on the results of our operations. This takes frequent evaluation of available lending rates and examination of opportunities to reduce interest expense through new sources of debt financing. Several factors affecting the interest rate risk include governmental monetary and tax policies, domestic and international economics and other factors that are beyond our control. The following table provides information about the principal cash flows, weighted average interest rates, and expected maturity dates for debt outstanding as of June 30, 2003. The current terms of this debt are described in Item 2., "Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources."

For variable rate debt, the table presents the assumption that the outstanding principal balance at June 30, 2003 will be paid upon maturity.

For fixed rate debt, the table presents the assumption that the outstanding principal balance at June 30, 2003 will be paid according to scheduled principal payments and that we will not prepay any of the outstanding principal balance.

	2003 ----	2004 ----	2005 ----	2006 ----	2007 ----
VARIABLE RATE DEBT: <span style="float: right;">(dollars in thousands)</span>					
Secured debt		\$102,616			
Weighted average interest rate		3.27%			
FIXED RATE DEBT:					
Secured notes payable	\$2,656	\$5,612	\$5,977	\$6,245	\$6,350
Weighted average interest rate	6.23%	6.23%	6.23%	6.23%	6.23%

The primary market risk we face is the risk of interest rate fluctuations. Principal amounts outstanding under the Berg Group line of credit, the Cupertino National Bank line of credit and the Citicorp USA, Inc. mortgage loan, which are tied to a LIBOR based interest rate, were approximately \$4.2 million, \$18.4 million, and \$80.0 million, or 1.3%, 5.5% and 23.8%, respectively, of the total \$335.9 million of outstanding debt as of June 30, 2003. As a result, we pay lower rates of interest in periods of decreasing interest rates and higher rates of interest in periods of increasing interest rates. All of the debt is denominated in United States dollars. We had no interest rate caps or interest rate swap contracts at June 30, 2003.

The following discussion of market risk is based solely on a possible hypothetical change in future market conditions related to our variable-rate debt. It includes "forward-looking statements" regarding market risk, but we are not forecasting the occurrence of these market changes.

Based on the amount of variable debt outstanding as of June 30, 2003, a 1% increase or decrease in interest rates on our \$102.6 million of floating rate debt would decrease or increase, respectively, six months earnings and cash flows by approximately \$0.5 million, as a result of the increased or decreased

Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

interest expense associated with the change in rate, and would not have an impact on the fair value of the floating rate debt. This amount is determined by considering the impact of hypothetical interest rates on our borrowing cost. Due to the uncertainty of fluctuations in interest rates and the specific actions that might be taken by us to mitigate of such fluctuations and their possible effects, the foregoing sensitivity analysis assumes no changes to our financial structure.

ITEM 4  
CONTROLS AND PROCEDURES

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES. The Company has conducted an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer, President and Vice President of Finance, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-14c. Base upon that evaluation, the Chief Executive Officer, President and Vice President of Finance concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its subsidiaries) required to be included in the Company's periodic SEC filings.

CHANGES IN INTERNAL CONTROLS. There were no significant changes in our internal controls or to our knowledge, in other factors that could significantly affect such internal controls subsequent to the date of their evaluation.

- 20 -

=====  
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 21, 2003 in which proxies representing 14,717,323 shares of common stocks, or 83.4% of the total outstanding shares, voted.
- b) At the annual meeting of stockholders, Carl E. Berg, John C. Bolger, William A. Hasler, Lawrence B. Helzel, and Raymond V. Marino were elected as directors for the ensuing year, all of whom were serving on the board of directors at the time of the meeting.
- c) The following proposals were voted upon at the meeting:  
  
Proposal No. 1: Election of Directors

Directors	Total Vote for Each Director	Total Vote Against or Withheld from Each Director	Total Abs
Carl E. Berg	12,865,431	1,688,937	162,
John C. Bolger	14,553,529	839	162,

Edgar Filing: MISSION WEST PROPERTIES INC - Form 10-Q

William A. Hasler	14,553,195	1,173	162,
Lawrence B. Helzel	14,554,029	339	162,
Raymond V. Marino	12,865,965	1,688,403	162,

Proposal No. 2: Ratification of the selection of PricewaterhouseCoopers, LLP as independent public accountants for the Company for the year ending December 31, 2003. There were 14,629,481 votes in favor of the proposal, 56,049 votes against the proposal, and 31,793 abstentions.

ITEM 6  
EXHIBITS AND REPORTS ON FORM 8-K

a. Exhibits

- 10.27.1 Amendment to Berg Group \$100,000,000 Line of Credit
- 10.45.1 Citicorp USA, Inc. Promissory Note Extension
- 31.1 Section 1350 Certificate of CEO
- 31.2 Section 1350 Certificate of principal financial officer
- 32 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

b. Reports on Form 8-K

The Company filed an amendment to Current Report on Form 8-K on June 20, 2003, regarding its acquisition of the San Tomas Technology Park. On April 23, 2003, the Company filed a Current Report on Form 8-K, regarding its acquisition of the San Tomas Technology Park on April 9, 2003 and its results of operations and financial condition for the first quarter of 2003.

- 21 -

=====  
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 12, 2003

By: /s/ Carl E. Berg

-----  
Carl E. Berg  
Chief Executive Officer

Date: August 12, 2003

By: /s/ Wayne N. Pham

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

