KILROY REALTY CORP
Form 10-Q
July 30, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2008

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _______ to _______

Commission File Number: 1-12675

KILROY REALTY CORPORATION

(Exact name of registrant as specified in its charter)

Maryland	**95-4598246**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**
12200 W. Olympic Boulevard,	**90064**
Suite 200,	

Los Angeles, California
(Address of principal executive offices) **(Zip Code)**
(310) 481-8400

(Registrant s telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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 þ No ¨

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

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

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

As of July 29, 2008, 32,652,346 shares of common stock, par value $.01 per share, were outstanding.

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KILROY REALTY CORPORATION

QUARTERLY REPORT FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2008

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Unless otherwise indicated or unless the context requires otherwise, all references in this report to we, us, our or the Company mean Kilroy Realty Corporation, including our consolidated subsidiaries.

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

KILROY REALTY CORPORATION

CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	June 30, 2008 (unaudited)	December 31, 2007
ASSETS		
REAL ESTATE ASSETS:		
Land and improvements	$ 324,779	$ 324,779
Buildings and improvements	1,739,874	1,719,700
Undeveloped land and construction in progress	365,106	324,077
Total real estate held for investment	2,429,759	2,368,556
Accumulated depreciation and amortization	(497,697)	(463,932)
Total real estate assets, net	1,932,062	1,904,624
CASH AND CASH EQUIVALENTS	4,367	11,732
RESTRICTED CASH	756	546
MARKETABLE SECURITIES (Note 7)	2,406	707
CURRENT RECEIVABLES, NET	3,843	4,891
DEFERRED RENT RECEIVABLES, NET	66,554	67,283
NOTES RECEIVABLE	10,904	10,970
DEFERRED LEASING COSTS AND ACQUISITION-RELATED INTANGIBLES, NET	52,282	54,418
DEFERRED FINANCING COSTS, NET	7,341	8,492
PREPAID EXPENSES AND OTHER ASSETS, NET	7,210	5,057
TOTAL ASSETS	$ 2,087,725	$ 2,068,720
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES:		
Secured debt (Note 2)	$ 392,511	$ 395,912
Exchangeable senior notes, net (Note 2)	456,550	456,090
Unsecured senior notes	144,000	144,000
Unsecured line of credit (Note 2)	159,000	111,000
Accounts payable, accrued expenses and other liabilities (Note 7)	44,893	58,249
Accrued distributions (Note 13)	21,422	20,610
Deferred revenue and acquisition-related liabilities (Note 3)	75,421	59,187
Rents received in advance and tenant security deposits	20,386	18,433
Total liabilities	1,314,183	1,263,481
COMMITMENTS AND CONTINGENCIES (NOTE 8)		
MINORITY INTERESTS:		
7.45% Series A cumulative redeemable preferred units of the Operating Partnership	73,638	73,638
Common units of the Operating Partnership (Note 4)	36,608	38,309
Total minority interests	110,246	111,947
STOCKHOLDERS EQUITY (Notes 5 and 6):		

Preferred stock, $.01 par value, 30,000,000 shares authorized:		
7.45% Series A cumulative redeemable preferred stock, $.01 par value, 1,500,000 shares authorized, none issued and outstanding		
Series B junior participating preferred stock, $.01 par value, 400,000 shares authorized, none issued and outstanding		
9.25% Series D cumulative redeemable preferred stock, $.01 par value, 900,000 shares authorized, none issued and outstanding		
7.80% Series E cumulative redeemable preferred stock, $.01 par value, 1,610,000 shares authorized, issued and outstanding ($40,250 liquidation preference)	38,425	38,425
7.50% Series F cumulative redeemable preferred stock, $.01 par value, 3,450,000 shares authorized, issued and outstanding ($86,250 liquidation preference)	83,157	83,157
Common stock, $.01 par value, 150,000,000 shares authorized, 32,652,346 and 32,765,893 shares issued and outstanding, respectively	327	328
Additional paid-in capital	651,386	658,894
Distributions in excess of earnings	(109,999)	(87,512)
Total stockholders equity	663,296	693,292
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 2,087,725	$ 2,068,720

See accompanying notes to consolidated financial statements.

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KILROY REALTY CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited, in thousands, except share and per share data)

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
REVENUES:				
Rental income	$ 61,486	$ 54,518	$ 123,791	$ 108,951
Tenant reimbursements	7,686	5,712	15,879	11,610
Other property income	457	1,950	761	3,053
Total revenues	69,629	62,180	140,431	123,614
EXPENSES:				
Property expenses	11,873	10,604	23,361	20,570
Real estate taxes	4,843	4,668	10,322	9,220
Provision for bad debts (Note 9)	3,204	(26)	3,659	(199)
Ground leases	400	389	795	792
General and administrative expenses	9,187	9,460	18,423	18,508
Interest expense	9,448	8,072	19,161	17,728
Depreciation and amortization	21,536	17,378	41,402	34,223
Total expenses	60,491	50,545	117,123	100,842
OTHER INCOME:				
Interest and other investment income	184	371	341	990
INCOME FROM CONTINUING OPERATIONS BEFORE MINORITY INTERESTS	9,322	12,006	23,649	23,762
MINORITY INTERESTS:				
Distributions on cumulative redeemable preferred units	(1,397)	(1,397)	(2,794)	(2,794)
Minority interest in earnings of Operating Partnership attributable to continuing operations	(348)	(531)	(1,012)	(1,044)
Total minority interests	(1,745)	(1,928)	(3,806)	(3,838)
INCOME FROM CONTINUING OPERATIONS	7,577	10,078	19,843	19,924
DISCONTINUED OPERATIONS (Note 11):				
Revenues from discontinued operations	199	2,450	199	5,095
Expenses from discontinued operations		(1,509)		(3,112)
Net gain on dispositions of discontinued operations	234	4,848	234	13,474
Minority interest in earnings of Operating Partnership attributable to discontinued operations	(27)	(375)	(27)	(1,005)
Total income from discontinued operations	406	5,414	406	14,452
NET INCOME	7,983	15,492	20,249	34,376
PREFERRED DIVIDENDS	(2,402)	(2,402)	(4,804)	(4,804)

NET INCOME AVAILABLE FOR COMMON STOCKHOLDERS	$ 5,581	$ 13,090	$ 15,445	$ 29,572
Income from continuing operations per common share basic (Note 12)	$ 0.16	$ 0.23	$ 0.47	$ 0.47
Income from continuing operations per common share diluted (Note 12)	$ 0.16	$ 0.23	$ 0.47	$ 0.47
Net income per common share basic (Note 12)	$ 0.17	$ 0.40	$ 0.48	$ 0.91
Net income per common share diluted (Note 12)	$ 0.17	$ 0.40	$ 0.48	$ 0.91
Weighted average shares outstanding basic (Note 12)	32,351,044	32,371,183	32,403,829	32,359,999
Weighted average shares outstanding diluted (Note 12)	32,509,817	32,486,171	32,532,424	32,485,566
Dividends declared per common share	$ 0.580	$ 0.555	$ 1.160	$ 1.110

See accompanying notes to consolidated financial statements.

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KILROY REALTY CORPORATION

CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

(unaudited, in thousands, except share and per share data)

	Preferred Stock	Common Stock Number of Shares	Common Stock Common Stock	Additional Paid-in Capital	Distributions in Excess of Earnings	Total
BALANCE AT DECEMBER 31, 2007	$ 121,582	32,765,893	$ 328	$ 658,894	$ (87,512)	$ 693,292
Net income					20,249	20,249
Repurchase of common stock (Note 5)		(299,777)	(3)	(14,767)		(14,770)
Issuance of nonvested shares of common stock (Note 6)		184,245	2	2,165		2,167
Non-cash amortization of share-based compensation				4,867		4,867
Exercise of stock options		1,000		21		21
Exchange of common units of the Operating Partnership (Note 5)		985		28		28
Adjustment for minority interest				178		178
Preferred dividends					(4,804)	(4,804)
Dividends declared per common share ($1.16 per share)					(37,932)	(37,932)
BALANCE AT JUNE 30, 2008	$ 121,582	32,652,346	$ 327	$ 651,386	$ (109,999)	$ 663,296

See accompanying notes to consolidated financial statements.

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KILROY REALTY CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited, in thousands)

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 20,249	$ 34,376
Adjustments to reconcile net income to net cash provided by operating activities (including discontinued operations):		
Depreciation and amortization of building and improvements and leasing costs	41,010	34,551
Increase (decrease) in provision for uncollectible tenant receivables	283	(199)
Increase in provision for uncollectible deferred rent receivables	3,376	
Distributions on cumulative redeemable preferred units	2,794	2,794
Minority interests in earnings of Operating Partnership	1,039	2,049
Depreciation of furniture, fixtures and equipment	392	431
Non-cash amortization of share-based compensation awards	7,229	7,387
Non-cash amortization of deferred financing costs and debt discount	1,587	1,176
Non-cash amortization of above/below market rents, net	(335)	(691)
Net gain on dispositions of operating properties (Note 11)	(234)	(13,474)
Non-cash amortization of deferred revenue related to tenant improvements (Note 3)	(3,782)	(1,453)
Insurance proceeds received for a property casualty loss	(531)	
Changes in assets and liabilities:		
Marketable securities	(1,699)	
Current receivables	765	1,374
Deferred rent receivables	(2,647)	(1,326)
Deferred leasing costs	(669)	(968)
Prepaid expenses and other assets	(2,595)	(1,663)
Accounts payable, accrued expenses and other liabilities	(5,935)	4,181
Deferred revenue	1,870	5,655
Rents received in advance and tenant security deposits	1,953	417
Net cash provided by operating activities	64,120	74,617
CASH FLOWS FROM INVESTING ACTIVITIES:		
Expenditures for operating properties	(13,714)	(19,834)
Expenditures for development and redevelopment properties	(37,726)	(109,134)
Acquisition of redevelopment property and undeveloped land		(68,970)
Proceeds received from 1031 exchange completion		43,794
Net proceeds received from dispositions of operating properties (Note 11)	275	14,473
Insurance proceeds received for a property casualty loss	531	
Proceeds from termination of profit participation agreement		4,848
Decrease in escrow deposits		3,000
Increase in restricted cash	(210)	(125)
Receipt of principal payments on note receivable	66	62
Net cash used in investing activities	(50,778)	(131,886)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of exchangeable senior notes, net of discount		455,400
Cost of capped call options on common stock		(29,050)
Net borrowings (repayments) on unsecured line of credit	48,000	(258,000)

Principal payments on secured debt	(6,182)	(58,581)
Repurchase of common stock (Note 5)	(14,770)	(2,631)
Financing costs	(523)	(5,289)
Proceeds from exercise of stock options	21	
Dividends and distributions paid to common stockholders and common unitholders	(39,655)	(37,796)
Dividends and distributions paid to preferred stockholders and preferred unitholders	(7,598)	(7,598)
Net cash (used in) provided by financing activities	(20,707)	56,455
Net decrease in cash and cash equivalents	(7,365)	(814)
Cash and cash equivalents, beginning of period	11,732	11,948
Cash and cash equivalents, end of period	$ 4,367	$ 11,134

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KILROY REALTY CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(unaudited, in thousands)

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash paid for interest, net of capitalized interest of $8,388 and $9,191 at June 30, 2008 and 2007, respectively	$ 17,858	$ 13,801
NON-CASH INVESTING AND FINANCING TRANSACTIONS:		
Tenant improvements funded directly by tenants to third parties	$ 18,493	$ 23,210
Accrual for expenditures for operating properties and development and redevelopment properties	$ 4,896	$ 14,908
Accrual of dividends and distributions payable to common stockholders and common unitholders	$ 20,212	$ 19,400
Accrual of dividends and distributions payable to preferred stockholders and preferred unitholders	$ 1,909	$ 1,909
Accrual of public facility bond obligation (Note 2)	$ 2,781	
Issuance of share-based compensation awards (Note 6)	$ 10,050	$ 23,633
Exchange of common units of the Operating Partnership into shares of the Company s common stock	$ 28	$ 1,837
Accrued costs for issuance of exchangeable senior notes		$ 760

See accompanying notes to consolidated financial statements.

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KILROY REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Three and Six Months Ended June 30, 2008 and 2007

(unaudited)

1. Organization and Basis of Presentation

Organization

Kilroy Realty Corporation (the Company) owns, operates, develops and acquires office and industrial real estate located in Southern California. The Company qualifies and operates as a self-administered real estate investment trust (REIT) under the Internal Revenue Code of 1986, as amended.

As of June 30, 2008, the Company s stabilized portfolio of operating properties was comprised of 86 office buildings (the Office Properties) and 43 industrial buildings (the Industrial Properties), which encompassed an aggregate of approximately 8.1 million and 3.9 million rentable square feet, respectively. As of June 30, 2008, the Office Properties were approximately 93.8% leased to 304 tenants, and the Industrial Properties were approximately 90.7% leased to 62 tenants. All of the Company s properties are located in Southern California.

The Company s stabilized portfolio excludes development and redevelopment properties currently under construction and lease-up properties (collectively, the in-process development and redevelopment properties). The Company defines lease-up properties as properties recently developed or redeveloped by the Company that have not yet reached 95% occupancy and are within one year following cessation of major construction activities. As of June 30, 2008, the in-process development and redevelopment properties included three buildings that were under construction and three lease-up properties, which will encompass an aggregate of approximately 611,000 rentable square feet of new office space when completed. All of the in-process development and redevelopment properties are in the San Diego region of Southern California, except for one redevelopment property, which is in El Segundo, California.

The Company owns its interests in all of its Office Properties and Industrial Properties through Kilroy Realty, L.P. (the Operating Partnership) and Kilroy Realty Finance Partnership, L.P. (the Finance Partnership). The Company conducts substantially all of its operations through the Operating Partnership, in which it owned a 93.7% general partnership interest as of June 30, 2008. The remaining 6.3% common limited partnership interest in the Operating Partnership as of June 30, 2008, was owned by certain of the Company s executive officers and directors, certain of their affiliates, and other outside investors (see Note 4). Kilroy Realty Finance, Inc., a wholly-owned subsidiary of the Company, is the sole general partner of the Finance Partnership and owns a 1.0% general partnership interest. The Operating Partnership owns the remaining 99.0% limited partnership interest. The Company conducts substantially all of its development activities through Kilroy Services, LLC (KSLLC), which is a wholly-owned subsidiary of the Operating Partnership. Unless otherwise indicated, all references to the Company include the Operating Partnership, the Finance Partnership, KSLLC and all wholly-owned subsidiaries of the Company. With the exception of the Operating Partnership, all of the Company s subsidiaries are wholly-owned.

Basis of Presentation

The consolidated financial statements of the Company include the consolidated financial position and results of operations of the Company, the Operating Partnership, the Finance Partnership, KSLLC and all wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in the consolidated financial statements. The Company also consolidates all variable interest entities (VIEs) in which it is deemed to be the primary beneficiary in accordance with Financial Accounting Standards Board (FASB) Interpretation No. 46R, *Consolidation of Variable Interest Entities*. The Company had no VIEs at June 30, 2008 or December 31, 2007.

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KILROY REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The accompanying interim financial statements have been prepared by the Company s management in accordance with accounting principles generally accepted in the United States of America (GAAP) and in conjunction with the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures required for annual financial statements have been condensed or excluded pursuant to SEC rules and regulations. Accordingly, the interim financial statements do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, the accompanying interim financial statements reflect all adjustments of a normal and recurring nature that are considered necessary for a fair presentation of the results for the interim periods presented. However, the results of operations for the interim periods are not necessarily indicative of the results that may be expected for the year ending December 31, 2008. These financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2007.

Accounting Pronouncements Adopted January 1, 2008

Effective January 1, 2008, the Company adopted, on a prospective basis, Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157), as amended by FASB Staff Position SFAS 157-1, *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13* (FSP FAS 157-1) and FASB Staff Position SFAS 157-2, *Effective Date of FASB Statement No. 157* (FSP FAS 157-2). SFAS 157 defines fair value, establishes a framework for measuring fair value in GAAP and provides for expanded disclosure about fair value measurements. SFAS 157 applies prospectively to all other accounting pronouncements that require or permit fair value measurements. FSP FAS 157-1 amends SFAS 157 to exclude from the scope of SFAS 157 certain leasing transactions accounted for under Statement of Financial Accounting Standards No. 13, *Accounting for Leases*. FSP FAS 157-2 amends SFAS 157 to defer the effective date of SFAS 157 for all non-financial assets and non-financial liabilities except those that are recognized or disclosed at fair value in the financial statements on a recurring basis to fiscal years beginning after November 15, 2008.

The adoption of SFAS 157 did not have a material impact on the Company s consolidated financial statements. Management is currently evaluating the impact that SFAS 157 will have on its non-financial assets and non-financial liabilities since the application of SFAS 157 for such items was deferred to January 1, 2009. The Company currently believes that the application of SFAS 157 to its non-financial assets and non-financial liabilities will not be material to its consolidated financial statements. Assets and liabilities typically recorded at fair value on a non-recurring basis to which the Company has not yet applied SFAS 157 due to the deferral of SFAS 157 for such items include:

- Non-financial assets and liabilities initially measured at fair value in an acquisition or business combination;

- Long-lived assets measured at fair value due to an impairment assessment under Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*; and

- Asset retirement obligations initially measured under Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations*.

Effective January 1, 2008, the Company adopted, on a prospective basis, Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective of the guidance is to improve financial reporting by providing entities with the opportunity to mitigate

KILROY REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The adoption of SFAS 159 did not have a material impact on the Company s consolidated financial statements since the Company has not elected to apply the fair value option for any of its eligible financial instruments or other items.

Recent Accounting Pronouncements to be Adopted in Future Reporting Periods

In May 2008, the FASB issued FASB Staff Position APB 14-1 *Accounting for Convertible Debt Instruments That May Be Settled Upon Conversion (Including Partial Cash Settlement)* (FSP APB 14-1). This new standard requires the initial proceeds from convertible debt that may be settled in cash to be bifurcated between a liability component and an equity component. The objective of the guidance is to require the liability and equity components of convertible debt to be separately accounted for in a manner such that the interest expense recorded on the convertible debt would not equal the contractual rate of interest on the convertible debt, but instead would be recorded at a rate that would reflect the issuer s conventional debt borrowing rate. This is accomplished through the creation of a discount on the debt that would be accreted using the effective interest method as additional non-cash interest expense over the period the debt is expected to remain outstanding. The provisions of FSP APB 14-1 will be applied retrospectively to all periods presented for fiscal years beginning after December 31, 2008. Management believes that FSP APB 14-1 will impact the accounting for the Company s 3.25% Exchangeable Senior Notes (the Notes) and will have a material impact on the Company s consolidated financial statements and results of operations.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R) *Business Combinations* (SFAS 141(R)) and Statement of Financial Accounting Standards No. 160 *Noncontrolling Interests in Consolidated Financial Statements An Amendment of ARB No. 51* (SFAS 160). SFAS 141(R) requires an acquiring entity to recognize acquired assets and assumed liabilities in a transaction at fair value as of the acquisition date and changes the accounting treatment for certain items, including acquisition costs, which will be required to be expensed as incurred. SFAS 160 requires that noncontrolling interests be presented as a component of consolidated stockholders equity and eliminates minority interest accounting such that the amount of net income attributable to the noncontrolling interests will be presented as part of consolidated net income on the consolidated statement of operations. SFAS 141(R) and SFAS 160 require concurrent adoption and are to be applied prospectively for the first annual reporting period beginning on or after December 15, 2008. Early adoption of either standard is prohibited. Management is currently evaluating the impact of these statements on the Company s consolidated financial statements.

In June 2008, the FASB issued FASB Staff Position EITF No. 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (FSP EITF 03-6-1). This new standard requires that nonvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents be treated as participating securities in the computation of earnings per share pursuant to the two-class method. The Company believes that FSP EITF 03-6-1 will require the Company to include the impact of its nonvested shares of common stock and restricted stock units in earnings per share using this more dilutive methodology. However, the Company currently believes that FSP EITF 03-6-1 will not have a material impact on the Company s consolidated financial statements and results of operations for the share-based payment programs currently in place. FSP EITF 03-6-1 will be applied retrospectively to all periods presented for fiscal years beginning after December 15, 2008.

In June 2008, the FASB ratified EITF Issue 07-5, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity s Own Stock* (EITF 07-5). Paragraph 11(a) of Statement of Financial Accounting Standard No 133 *Accounting for Derivatives and Hedging Activities* (SFAS 133) specifies that a contract that would otherwise meet the definition of a derivative but is both (a) indexed to the Company s own stock

KILROY REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and (b) classified in stockholders equity in the statement of financial position would not be considered a derivative financial instrument. EITF 07-5 provides a new two-step model to be applied in determining whether a financial instrument or an embedded feature is indexed to an issuer s own stock and thus able to qualify for the SFAS 133 paragraph 11(a) scope exception. Management is currently evaluating whether the adoption of EITF 07-5 will have an impact on the accounting for the Notes and related capped call option transactions. EITF 07-5 will be effective for the first annual reporting period beginning after December 15, 2008, and early adoption is prohibited.

In April 2008, the FASB issued FASB Staff Position 142-3, *Determination of the Useful Life of Intangible Assets* (FSP 142-3). FSP 142-3 is to be applied prospectively for fiscal years beginning after December 15, 2008. Management is currently evaluating the impact of FSP 142-3 on the Company s consolidated financial position, results of operations and cash flows but currently does not believe it will have a material impact on the Company s consolidated financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS 161). SFAS 161 is to be applied prospectively for the first annual reporting period beginning on or after November 15, 2008. The Company believes that the adoption of SFAS 161 will not have a material impact on the Company s financial statement disclosures since the Company does not currently have any derivative instruments.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, *The Hierarchy of Generally Accepted Accounting Principles* (SFAS 162). This new standard identifies a hierarchical framework of accounting principles for the purpose of selecting the principles to be used in the preparation of financial statements of nongovernmental entities. The Company believes that the adoption of SFAS 162 will not have a material impact on the Company s consolidated financial position, results of operations and cash flows.

2. Unsecured and Secured Debt

Unsecured Line of Credit

The Company has a $550 million unsecured line of credit (the Credit Facility), under which the Company may elect to borrow up to an additional $100 million under an increase option. As of June 30, 2008, the Company had borrowings of $159 million outstanding under the Credit Facility and borrowing capacity of approximately $391 million. The Credit Facility bears interest at an annual rate between LIBOR plus 0.85% and LIBOR plus 1.35% depending upon the Company s leverage ratio at the time of borrowing (3.5% at June 30, 2008). The Credit Facility matures in April 2010 with an option to extend the maturity for one year. The fee for unused funds under the Credit Facility ranges from an annual rate of 0.15% to 0.20% depending on the Company s leverage ratio. The Company expects to use the Credit Facility to finance development and redevelopment expenditures, to fund potential acquisitions and for other general corporate uses.

Exchangeable Senior Notes

In March 2008, the exchange rate for the Notes was adjusted by 0.05% for the 4.5% increase in the Company s dividend per common share approved by the Company s Board of Directors in February 2008. This adjustment was made pursuant to the original terms of the Notes since the exchange rate for the Notes is subject to adjustment under certain circumstances, including increases in the Company s common dividends. The Notes had an initial exchange rate of 11.3580 common shares per $1,000 principal amount of the Notes, which was equivalent to an exchange price of $88.04 per common share and a conversion premium of approximately 20.0% based on a price of $73.37 per share of the Company s common stock on March 27, 2007. The exchange rate was adjusted to 11.3636 common shares per $1,000 principal amount of the Notes, which is equivalent to an

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KILROY REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

exchange price of $88.00 per common share and a conversion premium of approximately 19.94% based on a price of $73.37 per share of the Company s common stock on March 27, 2007.

Secured Debt

In February 2008, the City of Carlsbad issued public facility bonds (the Bonds), the proceeds from which were used to finance infrastructure improvements on one of the Company s undeveloped land parcels. Of the Company s $3.5 million maximum obligation under the Bonds, $2.8 million was assessed to the Company and is reported as secured debt on the consolidated balance sheet at June 30, 2008 since the Company s obligation was fixed and determinable. Principal and interest payments for the Bonds will be charged to the Company through the assessment of special property taxes.

Debt Covenants and Restrictions

The Credit Facility, the unsecured senior notes and certain other secured debt arrangements contain covenants and restrictions requiring the Company to meet certain financial ratios and reporting requirements. Some of the more restrictive financial covenants include a maximum ratio of total debt to total assets, a maximum ratio of total secured debt to total assets, a fixed charge coverage ratio, a minimum consolidated tangible net worth and a limit of the ratio of development activities to total assets. In addition, one of the Company s loan covenants prohibits the Company from paying dividends in excess of 95% of funds from operations (FFO). Noncompliance with one or more of the covenants and restrictions could result in the full or partial principal balance of the associated debt becoming immediately due and payable. The Company was in compliance with all of its debt covenants at June 30, 2008.

Capitalized Interest and Loan Fees

The following table sets forth the Company s gross interest expense and loan cost amortization from continuing operations net of capitalized interest and loan cost amortization for the three and six months ended June 30, 2008 and 2007. The interest and loan cost amortization are capitalized as a cost of development and increase the carrying value of undeveloped land and construction in progress.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(in thousands)			
Gross interest expense and loan cost amortization	$ 14,030	$ 13,166	$ 28,241	$ 27,580
Capitalized interest and loan cost amortization	(4,582)	(5,094)	(9,080)	(9,852)
Interest expense	$ 9,448	$ 8,072	$ 19,161	$ 17,728

3. Deferred Revenue and Acquisition-Related Liabilities

Deferred revenue and acquisition-related liabilities consisted of the following at June 30, 2008 and December 31, 2007:

	June 30, 2008	December 31, 2007
	(in thousands)	
Deferred revenue related to tenant-funded tenant improvements	$ 72,474	$ 55,779
Acquisition-related liabilities below-market leases	1,452	1,801

Other deferred revenue	1,495	1,607
Total	$ 75,421	$ 59,187

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Deferred revenue related to tenant-funded tenant improvements

During the six months ended June 30, 2008, the Company recorded an additional $20.5 million of deferred revenue related to tenant-funded tenant improvements. This amount primarily represents the cost of the tenant improvements paid for or reimbursed by the tenant in connection with three significant leases. The deferred revenue related to these tenant-funded tenant improvements will be amortized as additional rental income over the term of the related lease beginning upon the substantial completion of the respective properties.

During the three months ended June 30, 2008 and 2007, $2.0 million and $0.8 million, respectively, of deferred revenue related to tenant-funded tenant improvements was amortized and recognized as rental income. During the six months ended June 30, 2008 and 2007, $3.8 million and $1.5 million, respectively, of deferred revenue related to tenant-funded tenant improvements was amortized and recognized as rental income. The following is the estimated amortization of deferred revenue related to tenant-funded tenant improvements at June 30, 2008 for the remainder of 2008, the next five years and thereafter:

Year	(in thousands)
Remaining 2008	$ 4,130
2009	8,346
2010	8,019
2011	7,564
2012	6,905
2013	6,464
Thereafter	31,046
Total	$ 72,474

4. Minority Interests

Common Limited Partnership Unitholders

The Company owned a 93.7%, 93.7% and 93.5% common general partnership interest in the Operating Partnership as of June 30, 2008, December 31, 2007 and June 30, 2007, respectively. The remaining 6.3%, 6.3% and 6.5% common limited partnership interest as of June 30, 2008, December 31, 2007 and June 30, 2007, respectively, was owned by certain of the Company s executive officers and directors, certain of their affiliates, and other outside investors in the form of common limited partnership units. The common limited partnership units may be redeemed by unitholders for cash. The Company may, at its option, satisfy the cash redemption obligation with shares of the Company s common stock. The redemption value for each common limited partnership unit of the Operating Partnership as of any balance sheet date is the amount equal to the average of the closing quoted price per share of the Company s common stock, par value $.01 per share, as reported on the New York Stock Exchange (NYSE) for the ten trading days immediately preceding the respective balance sheet date. Accordingly, as of June 30, 2008 and December 31, 2007, the aggregate redemption value of the then-outstanding common limited partnership units of the Operating Partnership was $107.7 million and $119.2 million, respectively.

5. Stockholders Equity

Share Repurchases

During the six months ended June 30, 2008, the Company repurchased 239,475 shares of its common stock in open market transactions for an aggregate price of approximately $11.5 million, or $48.23 per share. These repurchases were made pursuant to a share repurchase program approved by the Company s Board of Directors

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KILROY REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and were funded through borrowings on the Company s Credit Facility. As of June 30, 2008, an aggregate of 988,025 shares remained eligible for repurchase under this share repurchase program.

During the six months ended June 30, 2008, the Company accepted the return, at the current quoted market price, of 60,302 shares of its common stock from certain key employees in accordance with the provisions of its incentive stock plan to satisfy minimum statutory tax-withholding requirements related to shares that vested during this period.

Exchange of Common Limited Partnership Units

During the six months ended June 30, 2008, an aggregate 985 common limited partnership units of the Operating Partnership were exchanged into shares of the Company s common stock. Neither the Company nor the Operating Partnership received any proceeds from the issuance of the common stock to the common limited partnership unitholders.

6. Share-Based Compensation

Share-Based Incentive Plan

At June 30, 2008, the Company had one share-based incentive compensation plan, the Kilroy Realty 2006 Incentive Award Plan (the 2006 Plan), under which awards were available to be granted. At June 30, 2008, there were 1,118,206 shares and share-based awards available to be granted under the 2006 Plan. Under the Company s Stock Award Deferral Program, participants may defer receipt of awards of nonvested shares of common stock that may be granted under the 2006 Plan by electing to receive an equivalent number of restricted stock units (RSUs) in lieu of such awards of nonvested shares of common stock.

The following summarizes the share-based compensation programs approved and the share-based awards granted during the six months ended June 30, 2008 and the 2007 program for the executive officers that was still in the performance period as of June 30, 2008.

Executive Officer Share-Based Compensation Programs

In January 2008, the Executive Compensation Committee approved the 2008 Annual Long-Term Incentive Program, which allows the executive officers to receive bonus compensation in the event certain specified corporate performance measures are achieved for the fiscal year ending December 31, 2008. It is anticipated that such awards will be paid in nonvested shares of common stock or, if available and at the applicable employee s option, in other equity-based instruments that, subject to vesting and other conditions, may become exchangeable on a one-for-one basis for shares of the Company s common stock or cash, at the election of the Company. The Company anticipates that any nonvested shares of common stock or other equity-based instruments earned under this program would be issued during the first quarter of 2009. Individual awards earned under the 2008 Annual Long-Term Incentive Program would vest in two equal installments on December 31, 2009 and December 31, 2010. Vesting will be based on continued employment through the applicable vesting dates.

As of June 30, 2008, the Company was still in the performance period for the Development Performance Program (DPP), which was approved by the Company s Executive Compensation Committee in 2007. The incentive award that may be earned under the DPP will be based on whether certain future specified development completion and leasing targets are achieved for development and redevelopment properties on which the Company commenced construction during 2007. During the DPP performance period, the Company records compensation expense at the end of each reporting period by evaluating the likelihood of achieving the specified

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

targets and estimating the timeframe in which the targets could potentially be achieved and then recording compensation cost on the applicable portion of the estimated performance period that has elapsed before the end of the period. Performance is measured independently for the development completion and development leasing components of the DPP. If the development completion and development leasing targets individually are not achieved, no award would be earned under that component of the DPP. The Company currently estimates that any nonvested shares of common stock or other equity-based instruments that could potentially be earned under the development completion component of the DPP would be granted in the second half of 2008, and any nonvested shares of common stock or other equity-based instruments that could potentially be earned under the development leasing component of the DPP would be granted in the first half of 2009.

Key Employee Share-Based Compensation Program

In February 2008, the Executive Compensation Committee granted an aggregate of 82,303 nonvested shares of common stock to certain key employees. The total compensation cost for the grants of nonvested shares of common stock was calculated based on the quoted closing share price of the Company s common stock on the NYSE of $49.21 on the grant date of February 5, 2008. These shares vest in equal annual installments on December 31st of each year over a five-year period.

Non-employee Board Member Share-Based Compensation Program

In May 2008, the Executive Compensation Committee granted an aggregate of 1,867 nonvested shares of common stock and 7,468 nonvested RSUs to non-employee board members as part of the board members annual compensation in accordance with the Company s Board of Directors compensation program. The total compensation cost for these awards was calculated based on the quoted closing share price of the Company s common stock on the NYSE of $53.58 on the grant date of May 15, 2008. These awards vest in equal annual installments on May 15th of each year over a two-year period.

Summary of nonvested shares of common stock

A summary of the status of the Company s nonvested shares of common stock as of January 1, 2008 and changes during the six months ended June 30, 2008, is presented below:

Nonvested Shares of Common Stock	Shares	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2008	237,833	$ 80.35
Granted[1]	184,245	52.38
Vested	(51,840)	59.20
Nonvested at June 30, 2008	370,238	$ 68.94

(1) Includes 100,075 nonvested shares of common stock awarded to the executive officers on December 31, 2007 under the 2007 Annual Long-Term Incentive Program, which were issued and outstanding on January 1, 2008.

The total fair value of shares that vested during the six months ended June 30, 2008 and 2007 was $2.6 million and $6.7 million, respectively, which was calculated based on the quoted closing share price of the Company s common stock on the NYSE on the applicable date of vesting.

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KILROY REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Summary of nonvested RSUs

A summary of the status of the Company s nonvested RSUs as of January 1, 2008 and changes during the six months ended June 30, 2008, is presented below:

Restricted Stock Units	Restricted Stock Units	Weighted-Average Grant-Date Fair Value
Outstanding at January 1, 2008		$
Granted	7,468	53.58
Outstanding and nonvested at June 30, 2008	7,468	$ 53.58

Each RSU represents the right to receive one share of the Company s common stock in the future and will be subject to the same vesting conditions as would have applied to the award of nonvested shares of common stock in lieu of which such RSU is issued. RSUs carry with them the right to receive dividend equivalents that credit participants, upon the Company s payment of dividends with respect to the shares underlying the participant s RSUs, with additional, fully-vested RSUs equal to the value of the dividend paid in respect of such shares. Shares issued in settlement of RSUs will, to the extent vested, be distributed in a single lump sum distribution upon the earliest to occur of: (i) termination of the participant s employment or directorship; (ii) the occurrence of a change of control event; (iii) the date specified by the participant upon making the election, which must be at least two years after the start of the year in which the underlying award is earned; or (iv) the participant s death or disability.

Compensation cost recorded during the period

The total compensation cost for all share-based compensation programs was $4.0 million and $4.1 million for the three months ended June 30, 2008 and 2007, respectively, and $7.8 million for both the six months ended June 30, 2008 and 2007. Of the total share-based compensation cost, $0.3 million and $0.2 million were capitalized as part of real estate assets for the three months ended June 30, 2008 and 2007, respectively, and $0.5 million and $0.4 million were capitalized as part of real estate assets for the six months ended June 30, 2008 and 2007, respectively. As of June 30, 2008, there was approximately $14.4 million of total unrecognized compensation cost related to nonvested incentive awards granted under share-based compensation arrangements that is expected to be recognized over a weighted-average period of 1.7 years. The remaining compensation cost related to these nonvested incentive awards had been recognized in periods prior to June 30, 2008. The $14.4 million of unrecognized compensation cost does not reflect the potential future compensation cost for the 2008 Annual Long-Term Incentive Program or the DPP discussed above since share-based awards have not been granted under these programs as of June 30, 2008. The compensation cost that will be recorded in future periods related to these programs will be based on the amounts ultimately earned under these programs.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Financial Instruments Recorded at Fair Value

The assets held in connection with the Company s 2007 Deferred Compensation Plan (the Plan) and the corresponding liability to the participants are measured at fair value on a recurring basis on the Company s consolidated balance sheet. The assets are treated as trading securities for accounting purposes and reported as marketable securities on the Company s consolidated balance sheet. The liability is adjusted to fair value at the end of each accounting period based on the performance of the benchmark funds selected by each participant in the Plan and reported in accounts payable, accrued expenses and other liabilities on the Company s consolidated balance sheet.

Description	Fair Value Measurement at June 30, 2008 (Level I Inputs)(1) (in thousands)
Assets:	
Marketable Securities	$ 2,406
Liabilities:	
Deferred Compensation Plan Liability	$ (2,404)

(1) Based on quoted prices in active markets for identical securities.

8. Commitments and Contingencies

In March 2008, Newgen Results Corporation (Newgen) attempted to surrender the leased premises at one of the Company s Office Properties and ceased paying rent prior to the end of the lease term. Newgen signed the original lease for the property in 2000 and was subsequently acquired by Teletech Holdings Inc. (Teletech). The Company refused to accept a surrender of the premises and has initiated legal action against Teletech and Newgen for past due rent and future rent as it becomes due and owing. In the event there is ultimately an unfavorable result to the Company, the Company believes that there could potentially be a negative non-cash impact to the Company s results of operations ranging between $0 and approximately $3.5 million, primarily related to the deferred rent receivable balance for this tenant at June 30, 2008. The Company did not recognize any revenue associated with this lease during the three months ended June 30, 2008.

The Company leases the land at Kilroy Airport Center, Phase IV in Long Beach, California for future development opportunities. This land is adjacent to the Company s Office Properties at Kilroy Airport Center, Long Beach. The lease expires in July 2084, subject to the Company s option to terminate the lease early upon written notice to the landlord. This option to terminate was scheduled to expire in July 2008. However, in July 2008, the Company and the landlord agreed to extend this option until April 2009. Should the Company elect not to terminate the lease, the ground lease obligation will be subject to fair market rental adjustments in April 2009 and at scheduled dates thereafter.

9. Significant Lease Termination

In the second quarter of 2008, Favrille, Inc. (Favrille), the Company s seventh largest tenant at June 30, 2008 based on annualized base rental revenues, notified the Company of its intention to cease its business operations and to not pay any future rental payments under its lease beyond June 2008. In July 2008, the Company and Favrille entered into an agreement to terminate the lease as of August 31, 2008. The Company drew $3.6 million under a letter of credit and the $0.3 million cash security deposit that were held as credit support under the terms of the lease, which will be applied to July and August rent and the deferred rent receivable balance related to the lease.

KILROY REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

At June 30, 2008, the Company increased its provision for bad debts by approximately $3.1 million to reserve for the portion of the deferred rent receivable balance related to the Favrille lease at June 30, 2008 that it estimated would not be recoverable after the application of all the remaining letter of credit proceeds as of the August 2008 lease termination date. In addition, the Company will recognize approximately $2.7 million of additional non-cash rental revenue in the third quarter of 2008, primarily due to the acceleration of the amortization of the deferred revenue balance related to tenant-funded tenant improvements associated with the Favrille lease.

10. Segment Disclosure

The Company s reportable segments consist of the two types of commercial real estate properties for which the Company s chief operating decision-makers internally evaluate operating performance and financial results: Office Properties and Industrial Properties. The Company also has certain corporate level activities including legal administration, accounting, finance and management information systems, which are not considered separate operating segments.

The Company evaluates the performance of its segments based upon net operating income. Net Operating Income is defined as operating revenues (rental income, tenant reimbursements and other property income) less property and related expenses (property expenses, real estate taxes, ground leases and provisions for bad debts) and excludes other non-property income and expenses, interest expense, depreciation and amortization and corporate general and administrative expenses. There is no intersegment activity.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
	(in thousands)			
Office Properties:				
Operating revenues[1]	$ 61,309	$ 54,577	$ 123,784	$ 108,356
Property and related expenses	19,222	14,145	35,423	27,702
Net Operating Income	42,087	40,432	88,361	80,654
Industrial Properties:				
Operating revenues[1]	8,320	7,603	16,647	15,258
Property and related expenses	1,098	1,490	2,714	2,681
Net Operating Income	7,222	6,113	13,933	12,577
Total Reportable Segments:				
Operating revenues[1]	69,629	62,180	140,431	123,614
Property and related expenses	20,320	15,635	38,137	30,383
Net Operating Income	49,309	46,545	102,294	93,231
Reconciliation to Consolidated Net Income Available for Common Stockholders:				
Total Net Operating Income for reportable segments	49,309	46,545	102,294	93,231
Unallocated other income:				
Total other income	184	371	341	990
Other unallocated expenses:				
General and administrative expenses	9,187	9,460	18,423	18,508
Interest expense	9,448	8,072	19,161	17,728
Depreciation and amortization	21,536	17,378	41,402	34,223
Income from continuing operations before minority interests	9,322	12,006	23,649	23,762
Minority interests attributable to continuing operations	(1,745)	(1,928)	(3,806)	(3,838)
Income from discontinued operations	406	5,414	406	14,452
Net income	7,983	15,492	20,249	34,376
Preferred dividends	(2,402)	(2,402)	(4,804)	(4,804)
Net income available for common stockholders	$ 5,581	$ 13,090	$ 15,445	$ 29,572

(1) All operating revenues are comprised of amounts received from third-party tenants.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. Discontinued Operations

The following table summarizes the components that comprise income from discontinued operations for the three and six months ended June 30, 2008 and 2007.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(in thousands)			
REVENUES:				
Rental income	$	$ 1,937	$	$ 3,914
Tenant reimbursements		512		1,177
Other property income[(1)]	199	1	199	4
Total revenues	199	2,450	199	5,095
EXPENSES:				
Property expenses		837		1,743
Real estate taxes		192		384
Provision for bad debts				
Ground leases		113		226
Depreciation and amortization		367		759
Total expenses		1,509		3,112
Net gain on dispositions of discontinued operations[(2)]	234	4,848	234	13,474
Minority interest in earnings of Operating Partnership attributable to discontinued operations	(27)	(375)	(27)	(1,005)
Total income from discontinued operations	$ 406	$ 5,414	$ 406	$ 14,452

(1) Other property income for the three and six months ended June 30, 2008 represents the receipt of a cash bankruptcy settlement payment related to a property that was sold in 2005.

(2) During the three and six months ended June 30, 2008, the Company recognized an additional $0.2 million net gain on the December 2007 disposition of Kilroy Airport Center Sea-Tac in connection with the resolution of a gain contingency related to the completion of certain capital improvements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. Earnings Per Share

The following table reconciles the numerator and denominator of the basic and diluted per-share computations for net income available for common stockholders for the three and six months ended June 30, 2008 and 2007:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(in thousands, except share and per share amounts)			
Numerator:				
Income from continuing operations	$ 7,577	$ 10,078	$ 19,843	$ 19,924
Preferred dividends	(2,402)	(2,402)	(4,804)	(4,804)
Income from continuing operations available for common stockholders	5,175	7,676	15,039	15,120
Discontinued operations	406	5,414	406	14,452
Net income available for common stockholders numerator for basic and diluted earnings per share	$ 5,581	$ 13,090	$ 15,445	$ 29,572
Denominator:				
Basic weighted average shares outstanding	32,351,044	32,371,183	32,403,829	32,359,999
Effect of dilutive securities nonvested shares of common stock, RSUs and stock options	158,773	114,988	128,595	125,567
Diluted weighted average shares and common share equivalents outstanding	32,509,817	32,486,171	32,532,424	32,485,566
Basic earnings per share:				
Income from continuing operations available for common stockholders	$ 0.16	$ 0.23	$ 0.47	$ 0.47
Discontinued operations	0.01	0.17	0.01	0.44