

PRICE LEGACY CORP  
Form 10-Q  
August 09, 2004

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

**For the quarter ended June 30, 2004**

**Commission File Number 0-20449**

**PRICE LEGACY CORPORATION**

(Exact name of registrant as specified in its charter)

**Maryland**  
(State or other jurisdiction of  
incorporation or organization)

**33-0628740**  
(I.R.S. Employer  
Identification No.)

**17140 Bernardo Center Drive, Suite 300, San Diego, California 92128**

(Address of principal executive offices) (Zip Code)

**(858) 675-9400**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes  No

The registrant had 36,919,539 shares of common stock, par value \$.0004 per share, outstanding at August 6, 2004.

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**PRICE LEGACY CORPORATION**

**INDEX TO FORM 10-Q**

**PART I - FINANCIAL INFORMATION**

**ITEM 1 - FINANCIAL STATEMENTS**

CONSOLIDATED BALANCE SHEETS

CONSOLIDATED STATEMENTS OF OPERATIONS

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

CONSOLIDATED STATEMENTS OF CASH FLOWS

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 1 - LEGAL PROCEEDINGS**

**ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K**

**PART I - FINANCIAL INFORMATION****ITEM 1 - FINANCIAL STATEMENTS**

**PRICE LEGACY CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share data)

**ASSETS**

|  | June 30<br>2004<br>(unaudited) | December 31<br>2003 |
|--|--------------------------------|---------------------|
| Real estate assets   |                                |                     |
| Land and land improvements                                 | \$ 385,569                     | \$ 410,207          |
| Building and improvements                                  | 677,668                        | 670,050             |
| Construction in progress                                   | 2,919                          | 582                 |
|  | <b>1,066,156</b>               | <b>1,080,839</b>    |
| Property held for sale                                     | 50,474                         | 70,988              |
| Less accumulated depreciation                              | (62,339)                       | (54,836)            |
|  | <b>1,054,291</b>               | <b>1,096,991</b>    |
| Investment in unconsolidated real estate joint ventures    |                                | 4,113               |
| Cash and cash equivalents                                  | 29,226                         | 7,631               |
| Restricted cash  | 9,742                          | 11,288              |
| Accounts receivable, net of allowance of \$843 and \$1,415 | 8,857                          | 7,440               |
| Notes receivable   | 9,086                          | 10,311              |
| Deferred rents   | 11,702                         | 11,161              |
| Other assets   | 19,468                         | 21,953              |
| Total assets   | <b>\$ 1,142,372</b>            | <b>\$ 1,170,888</b> |

*See accompanying notes.*

**PRICE LEGACY CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**

(in thousands, except share data)

**LIABILITIES AND STOCKHOLDERS' EQUITY**

|  | June 30<br>2004<br>(unaudited) | December 31<br>2003 |
|--|--------------------------------|---------------------|
| <b>Liabilities</b>   |                                |                     |
| Mortgages and notes payable  | \$ 541,673                     | \$ 483,675          |
| Capital lease payable on property held for sale  |                                | 11,706              |
| Revolving line of credit   |                                | 69,100              |
|  | <b>541,673</b>                 | <b>564,481</b>      |
| Accounts payable and other liabilities   | <b>24,711</b>                  | 29,945              |
| Total liabilities  | <b>566,384</b>                 | 594,426             |
| <b>Commitments and contingencies</b>   |                                |                     |
| Minority interests   | <b>595</b>                     | 1,608               |
| <b>Stockholders' equity</b>  |                                |                     |
| Series A Preferred Stock, cumulative, redeemable, \$0.0001 par value, 27,849,771 shares authorized, 5,486,994 and 27,434,166 shares issued and outstanding   | <b>79,981</b>                  | 399,615             |
| Series 1 Preferred Stock, cumulative, redeemable, \$0.0001 par value, 15,218,506 shares authorized, 2,942,463 shares issued and outstanding at June 30, 2004   | <b>47,227</b>                  |                     |
| Series B Preferred Stock, junior, convertible, redeemable, \$0.0001 par value, 27,458,855 shares authorized, 24,125,208 shares issued and outstanding at December 31, 2003   |                                | 131,023             |
| Common stock, \$0.0004 par value, 106,931,723 shares authorized, 36,919,539 issued and outstanding at June 30, 2004; \$0.0001 par value, 94,691,374 shares authorized, 8,690,414 issued and outstanding at December 31, 2003 | <b>15</b>                      | 3                   |
| Additional paid-in capital   | <b>648,999</b>                 | 176,431             |
| Accumulated comprehensive loss   | <b>(2,433)</b>                 | (1,479)             |
| Retained deficit   | <b>(198,396)</b>               | (130,739)           |
| Total stockholders' equity   | <b>575,393</b>                 | 574,854             |
| Total liabilities and stockholders' equity   | <b>\$ 1,142,372</b>            | \$ 1,170,888        |

*See accompanying notes.*

## PRICE LEGACY CORPORATION

## CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited - amounts in thousands, except per share data)

|   | Second Quarter<br>Three Months Ended<br>June 30 |            | Year-to-Date<br>Six Months Ended<br>June 30 |            |
|---|---|------------|---|------------|
|   | 2004  | 2003       | 2004  | 2003       |
| Rental revenues   | \$ 33,121                                       | \$ 31,313  | \$ 65,016                                   | \$ 62,245  |
| Expenses  |   |            |   |            |
| Operating and maintenance                                     | 5,758   | 6,637      | 11,596                                      | 12,639     |
| Property taxes  | 4,097   | 3,829      | 8,122                                       | 7,493      |
| Depreciation and amortization                                 | 5,547   | 5,617      | 11,160                                      | 9,759      |
| General and administrative                                    | 1,377   | 1,827      | 2,862                                       | 3,809      |
| Provision for asset impairment                                | 1,225   |            | 1,225                                       |            |
| Total expenses  | 18,004  | 17,910     | 34,965                                      | 33,700     |
| Operating income  | 15,117  | 13,403     | 30,051                                      | 28,545     |
| Interest and other  |   |            |   |            |
| Interest expense  | (7,054)   | (6,514)    | (13,965)                                    | (12,980)   |
| Interest income   | 63  | 113        | 108   | 925        |
| Equity in earnings of joint ventures                          |   | 1,014      | 62  | 1,164      |
| Total interest and other                                      | (6,991)   | (5,387)    | (13,795)                                    | (10,891)   |
| Income from continuing operations                             | 8,126   | 8,016      | 16,256                                      | 17,654     |
| Discontinued operations:                                      |   |            |   |            |
| Income from operations  | 241   | 442        | 460   | 713        |
| Net gain (loss) on sale of real estate                        | 2,193   | (2,314)    | 2,193                                       | (2,521)    |
| Gain (loss) on discontinued operations                        | 2,434   | (1,872)    | 2,653                                       | (1,808)    |
| Net income before gain on sale of real estate and investments | 10,560  | 6,144      | 18,909                                      | 15,846     |
| Net gain on sale of real estate and investments               | 12,666  |            | 12,622                                      | 687        |
| Net income  | 23,226  | 6,144      | 31,531                                      | 16,533     |
| Dividends to preferred stockholders                           | (2,886)   | (12,423)   | (14,700)                                    | (24,783)   |
| Preferred stock conversion and redemption                     | (1,423)   |            | (74,235)                                    |            |
| Net income (loss) applicable to common stockholders           | \$ 18,917                                       | \$ (6,279) | \$ (57,404)                                 | \$ (8,250) |
| Net income (loss) per common share                            |   |            |   |            |
| Basic   | \$ .52  | \$ (.68)   | \$ (2.29)                                   | \$ (.89)   |
| Diluted   | .51   | (.68)      | (2.29)                                      | (.89)      |
| Weighted average common shares outstanding                    |   |            |   |            |
| Basic   | 36,567  | 9,250      | 25,118                                      | 9,253      |

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|  |    |               |    |       |    |               |    |       |
|--|----|---------------|----|-------|----|---------------|----|-------|
| Diluted  |    | <b>36,987</b> |    | 9,250 |    | <b>25,118</b> |    | 9,253 |
| Cash dividends paid per Series A preferred share | \$ | <b>.35</b>    | \$ | .35   | \$ | <b>.70</b>    | \$ | .70   |
| Cash dividends paid per Series I preferred share |    | <b>.16</b>    |    |       |    | <b>.16</b>    |    |       |
| Cash dividends paid per common share             |    | <b>.28</b>    |    |       |    | <b>.28</b>    |    |       |

*See accompanying notes.*

## PRICE LEGACY CORPORATION

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(unaudited amounts in thousands)

|   | Preferred Stock<br>Series A |                  | Preferred Stock<br>Series 1 |                  | Preferred Stock<br>Series B |            | Common Stock  |              |
|---|-----------------------------|------------------|-----------------------------|------------------|-----------------------------|------------|---------------|--------------|
|   | Shares                      | Amount           | Shares                      | Amount           | Shares                      | Amount     | Shares*       | Amount       |
| <b>Balance at December 31, 2003</b>   | 27,434                      | \$ 399,615       |                             |                  | 24,125                      | \$ 131,023 | 8,690         | \$ 3         |
| Comprehensive income:   |                             |                  |                             |                  |                             |            |               |              |
| Net income  |                             |                  |                             |                  |                             |            |               |              |
| Unrealized loss on marketable securities  |                             |                  |                             |                  |                             |            |               |              |
| Unrealized loss on interest rate caps   |                             |                  |                             |                  |                             |            |               |              |
| Total comprehensive income  |                             |                  |                             |                  |                             |            |               |              |
| Dividends on Series A Preferred Stock   |                             |                  |                             |                  |                             |            |               |              |
| Dividends on Series B Preferred Stock   |                             |                  |                             |                  | 398                         | 2,212      |               |              |
| Dividends on Series 1 Preferred Stock   |                             |                  |                             |                  |                             |            |               |              |
| Dividends on common stock   |                             |                  |                             |                  |                             |            |               |              |
| Common stock issued in legal settlement   |                             |                  |                             |                  |                             |            | 160           |              |
| Common stock and Series 1 Preferred Stock issued in exchange for Series A Preferred Stock | (20,947)                    | (305,058)        | 2,942                       | 47,227           |                             |            | 18,900        | 8            |
| Common stock issued in exchange for Series B Preferred Stock                              |                             |                  |                             |                  | (24,523)                    | (133,235)  | 8,522         | 4            |
| Issuance costs associated with Recapitalization Transaction                               |                             |                  |                             |                  |                             |            |               |              |
| Common stock options exercised  |                             |                  |                             |                  |                             |            | 648           |              |
| Redemption of Series A Preferred Stock  | (1,000)                     | (14,576)         |                             |                  |                             |            |               |              |
| <b>Balance at June 30, 2004</b>   | <b>5,487</b>                | <b>\$ 79,981</b> | <b>2,942</b>                | <b>\$ 47,227</b> |                             |            | <b>36,920</b> | <b>\$ 15</b> |

|                                     | Additional Paid-In Capital | Accumulated Comprehensive Loss | Retained Earnings (Deficit) | Total      |
|-------------------------------------|----------------------------|--------------------------------|-----------------------------|------------|
| <b>Balance at December 31, 2003</b> | \$ 176,431                 | \$ (1,479)                     | \$ (130,739)                | \$ 574,854 |
| Comprehensive income:               |                            |                                |                             |            |
| Net income                          |                            |                                | 31,531                      | 31,531     |



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|  |                   |                   |                     |                   |
|--|-------------------|-------------------|---------------------|-------------------|
| Unrealized loss on marketable securities   |                   | (15)              |                     | (15)              |
| Unrealized loss on interest rate caps  |                   | (939)             |                     | (939)             |
| Total comprehensive income   |                   |                   |                     | 30,577            |
| Dividends on Series A Preferred Stock  |                   |                   | (12,017)            | (12,017)          |
| Dividends on Series B Preferred Stock  |                   |                   | (2,212)             |                   |
| Dividends on Series 1 Preferred Stock  |                   |                   | (471)               | (471)             |
| Dividends on common stock  |                   |                   | (10,252)            | (10,252)          |
| Common stock issued in legal settlement  | 2,099             |                   |                     | 2,099             |
| Common stock and Series 1 Preferred Stock issued<br>in exchange for Series A Preferred Stock | 293,337           |                   | (35,519)            | (5)               |
| Common stock issued in exchange for Series B<br>Preferred Stock                              | 170,524           |                   | (37,293)            |                   |
| Issuance costs associated with Recapitalization<br>Transaction                               | (1,500)           |                   |                     | (1,500)           |
| Common stock options exercised   | 8,108             |                   |                     | 8,108             |
| Redemption of Series A Preferred Stock   |                   |                   | (1,424)             | (16,000)          |
| <b>Balance at June 30, 2004</b>  | <b>\$ 648,999</b> | <b>\$ (2,433)</b> | <b>\$ (198,396)</b> | <b>\$ 575,393</b> |

*\*Retroactively restated for 1-for-4 reverse stock split*

*See accompanying notes.*

**PRICE LEGACY CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(unaudited - amounts in thousands)

|   | Year to Date<br>Six Months Ended<br>June 30 |           |
|---|---|-----------|
|   | 2004  | 2003      |
| Operating activities  |   |           |
| Net income  | \$ 31,531                                   | \$ 16,533 |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |           |
| Depreciation and amortization   | 11,191                                      | 10,259    |
| Deferred rents  | (803)                                       | (438)     |
| Equity in earnings of joint ventures  | (62)  | (1,164)   |
| Net (gain) loss on sale of real estate and investments                            | (14,815)                                    | 1,834     |
| Provision for asset impairment  | 1,225                                       |           |
| Changes in operating assets and liabilities:                                      |   |           |
| Accounts receivable and other assets  | (1,471)                                     | 1,139     |
| Accounts payable and other liabilities  | (2,259)                                     | (6,054)   |
| Net cash provided by operating activities   | 24,537                                      | 22,109    |
| Investing activities  |   |           |
| Refund of (deposits to) restricted cash   | 1,546                                       | (2,502)   |
| Additions to real estate assets   | (4,699)                                     | (16,178)  |
| Proceeds from the sale of real estate assets and investments                      | 51,571                                      | 15,855    |
| Contributions to real estate joint ventures                                       |   | (6)       |
| Distributions from real estate joint ventures                                     | 119   | 200       |
| Advances on notes receivable  |   | (14,466)  |
| Repayments on notes receivable  |   | 17,585    |
| Net cash provided by investing activities   | 48,537                                      | 488       |
| Financing activities  |   |           |
| Advances from revolving line of credit and notes payable                          | 269,647                                     | 68,713    |
| Repayments of revolving line of credit and notes payable                          | (290,494)                                   | (65,868)  |
| Dividends paid to stockholders  | (22,740)                                    | (19,204)  |
| Redemption of Series A Preferred Stock  | (16,000)                                    |           |
| Proceeds from exercise of stock options   | 8,108                                       |           |
| Net cash used in financing activities   | (51,479)                                    | (16,359)  |
| Net increase in cash and cash equivalents   | 21,595                                      | 6,238     |
| Cash and cash equivalents at beginning of period                                  | 7,631                                       | 11,471    |
| Cash and cash equivalents at end of period  | \$ 29,226                                   | \$ 17,709 |
| Supplemental cash flow information:   |   |           |
| Cash paid for interest  | \$ 13,349                                   | \$ 13,937 |
| Supplemental schedule of noncash investing and financing activities:              |   |           |
| Pay down of capital lease in exchange for property                                | 11,706                                      |           |
| Reduction in joint ventures in connection with purchase of real estate            | 4,012                                       |           |
| Assumption of mortgage in connection with purchase of real estate                 | 9,745                                       |           |
| Preferred stock conversion  | 72,812                                      |           |
| Increase to treasury stock for reduction in notes receivable                      |   | 779       |

*See accompanying notes.*

**PRICE LEGACY CORPORATION**

***NOTES TO CONSOLIDATED FINANCIAL STATEMENTS***

**(UNAUDITED)**

**June 30, 2004**

**Note 1 Organization and Significant Accounting Policies**

***Organization***

Price Legacy Corporation (Price Legacy) operates as a real estate investment trust (REIT) incorporated in the state of Maryland. Our principal business is to acquire, operate, and develop real property, primarily open-air shopping centers.

Our subsidiaries include Excel Legacy Holdings, Inc., which has elected to be treated as a taxable REIT subsidiary (TRS). Other than some activities related to lodging and health care facilities, a TRS may generally engage in any business. A TRS is subject to federal income tax and state and local income tax, where applicable, as a regular C corporation.

***Accounting Principles***

We prepared the financial statements following the requirements of the Securities and Exchange Commission (SEC) for interim reporting. As permitted under those rules, certain footnotes or other financial information that are normally required by accounting principles generally accepted in the United States of America (GAAP) have been omitted. However, except as disclosed below, there have been no material changes to the information disclosed in the consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2003. Certain prior year data have been reclassified to conform to the 2004 presentation.

We are responsible for the financial statements included in this document. The financial statements include all normal and recurring adjustments that are considered necessary for the fair presentation of our financial position and operating results. The information in this Quarterly Report on Form 10-Q should be read in conjunction with the consolidated financial statements and accompanying notes included in our latest Annual Report on Form 10-K.

Revenues, expenses, assets and liabilities can vary during each quarter of the year. Therefore, the results and trends in these interim financial statements may not be the same as those for the full year.

***Real Estate Assets and Depreciation***

We capitalize interest incurred during the construction period of certain assets and this interest is depreciated over the lives of those assets. The following table shows interest expense and the amount capitalized (amounts in thousands):

|                      | Three Months Ended<br>June 30 |       |      |       | Six Months Ended<br>June 30 |        |      |         |
|----------------------|-------------------------------|-------|------|-------|-----------------------------|--------|------|---------|
|                      | 2004                          |       | 2003 |       | 2004                        |        | 2003 |         |
| Interest incurred    | \$                            | 7,054 | \$   | 7,137 | \$                          | 13,983 | \$   | 14,272  |
| Interest capitalized |                               |       |      | (478) |                             | (18)   |      | (1,003) |

***Cash and Cash Equivalents***

We are required to maintain reserves with certain lenders for property taxes, insurance and capital expenditures. The aggregate amounts of these reserves held by lenders were approximately \$9.7 million at June 30, 2004 and \$11.3 million at December 31, 2003. These amounts are reflected as restricted cash on the Consolidated Balance Sheets.

Our restricted cash balances at June 30, 2004 and December 31, 2003 include \$2.4 million of restricted funds which represent the proceeds from the sale of vacant land at our property in Hollywood/Oakwood Plaza, FL. The funds will be held by the lender until the debt is repaid in 2009.

***Investment in Securities***

In April 2004, our TRS sold approximately 1.9 million shares of common stock of Mace Security International for \$10.7 million. We recognized a gain on the sale of approximately \$9.2 million.

***Stock-Based Compensation***

In December 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure - an amendment of SFAS No. 123. SFAS 148 addresses transition provisions for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123. This statement has not had a significant impact on our consolidated financial statements.

We do not record compensation expense for stock options. The following table summarizes results as if we had recorded compensation expense under the provisions of SFAS 123, as amended by SFAS 148, for our option grants (amounts in thousands, except per share data).

|   | Three Months Ended<br>June 30 |            | Six Months Ended<br>June 30 |            |
|---|-------------------------------|------------|-----------------------------|------------|
|   | 2004                          | 2003       | 2004                        | 2003       |
| Net income (loss) applicable to common stockholders:                        |                               |            |                             |            |
| As reported   | \$ 18,917                     | \$ (6,279) | \$ (57,404)                 | \$ (8,250) |
| Deduct: stock based compensation expense determined under fair value method | (56)                          | (154)      | (116)                       | (308)      |
| Pro forma   | \$ 18,861                     | \$ (6,433) | \$ (57,520)                 | \$ (8,558) |
| Net income (loss) per share basic:  |                               |            |                             |            |
| As reported   | \$ .52                        | \$ (.68)   | \$ (2.29)                   | \$ (.89)   |
| Pro forma   | \$ .51                        | \$ (.70)   | \$ (2.29)                   | \$ (.92)   |
| Net income (loss) per share diluted:  |                               |            |                             |            |
| As reported   | \$ .52                        | \$ (.68)   | \$ (2.29)                   | \$ (.89)   |
| Pro forma   | \$ .51                        | \$ (.70)   | \$ (2.29)                   | \$ (.92)   |
| Weighted average fair value of options granted during the period            | \$ 4.35                       |            | \$ 3.20                     |            |

The FASB is currently considering amending SFAS 123 and APB Opinion No. 25, Accounting for Stock Issued to Employees. The proposed standard will require us to record compensation expense for all share based compensation plans. If adopted, this proposed standard would have a negative impact on our earnings in future periods. We discuss our stock option plan further in Note 11.

## Note 2 Recapitalization Transaction

On September 22, 2003, we issued a press release announcing that we were pursuing a series of transactions intended to result in a significant simplification of our capital structure. On or about February 11, 2004, we mailed to our stockholders definitive proxy materials and to our Series A Preferred stockholders exchange offer materials related to our previously announced recapitalization transaction (the Recapitalization Transaction).

The Recapitalization Transaction consisted of:

an exchange offer in which we offered to exchange, at the option of the holder, either shares of our common stock or shares of our newly designated Series 1 Preferred Stock for all outstanding shares of our Series A Preferred Stock

exchange transactions with the holders of all of our outstanding Series B Preferred Stock in which we exchanged 8,521,746 shares of our common stock (after giving effect to the reverse stock split described below) for all of our outstanding shares of Series B Preferred Stock

an amendment and restatement of our charter to, among other things,

effect a 1-for-4 reverse stock split of our common stock

designate and establish the terms of our Series 1 Preferred Stock

eliminate the Series B Preferred Stock following its exchange for common stock

change the manner in which our directors are elected so that the holders of common stock and Series A Preferred Stock, but not the holders of Series 1 Preferred Stock, voting together as a single class, are entitled to elect all of our directors

change our authorized capital stock to provide sufficient shares to complete the Recapitalization Transaction

Our stockholders approved the Recapitalization Transaction at a special meeting of stockholders held on March 11, 2004, and the Recapitalization Transaction was completed on March 12, 2004. As a result of the Recapitalization Transaction, we issued a total of 27,421,965 shares of common stock (on a post 1-for-4 reverse stock split basis) and 2,942,463 shares of Series 1 Preferred Stock and we retired 20,947,172 shares of Series A Preferred Stock and 24,523,015 shares of Series B Preferred Stock. After giving effect to the Recapitalization Transaction, we had outstanding 36,283,973 shares of common stock, 6,486,994 shares of Series A Preferred Stock, and 2,942,463 shares of Series 1 Preferred Stock.

On March 12, 2004, we filed Articles of Amendment and Restatement in the State Department of Assessments and Taxation of Maryland effecting the 1-for-4 reverse stock split of our common stock and the other amendments to our charter contemplated by the Recapitalization Transaction.

For accounting purposes, Emerging Issue Task Force (EITF) topic D-42 governs the effect on the calculation of earnings per share for the redemption or induced conversion of preferred stock. The exchange of the Series A Preferred Stock for either common stock or Series 1 Preferred Stock is being treated as a redemption and, accordingly, the excess of the fair value of the consideration transferred to the holders of the preferred stock over the carrying amount of the preferred stock on the balance sheet was subtracted from net income to arrive at net loss applicable to common stockholders in the calculation of earnings per share. Approximately 10.7% of the Series A Preferred Stock was exchanged for Series 1 Preferred Stock and 65.6% of the Series A Preferred Stock was exchanged for common stock, requiring a deduction of



approximately \$35.5 million from net income to arrive at net loss applicable to common stockholders with the Series 1 Preferred Stock valued at \$16.05 per share.

The exchange of the Series B Preferred Stock for common stock is being treated as an induced conversion in accordance with EITF D-42. The exchange of the Series B Preferred Stock for common stock at a ratio of 1.39 shares of common stock for each share of Series B Preferred Stock resulted in a deduction of approximately \$37.3 million from net income to arrive at net loss applicable to common stockholders.

On June 7, 2004, we redeemed 1.0 million shares of our Series A Preferred Stock at the redemption price of \$16.00 per share, along with a dividend of \$0.145 per share which represented a quarterly dividend of \$0.35 per share pro-rated for the period of May 1, 2004 to June 7, 2004. The redemption price of \$16.00 per share was in excess of the carrying value of the stock which resulted in a reduction of \$1.4 million from net income to arrive at net income applicable to common stockholders in accordance with EITF topic D-42.

**Note 3 Net Income Per Share**

SFAS No. 128, Earnings per Share, requires presentation of two calculations of earnings per common share. Basic earnings per common share equals net income applicable to common stockholders divided by weighted average common shares outstanding during the period. Diluted earnings per common share equals net income applicable to common stockholders divided by the sum of weighted average common shares outstanding during the period plus dilutive potential shares. Dilutive potential shares are shares assumed to be issued if outstanding stock options were exercised. All earnings per share amounts have been presented, and where appropriate, restated to reflect these calculations. The effect of common stock equivalents for the six months ended June 30, 2004 and the three months ended June 30, 2003 was antidilutive.

|   | Three Months Ended June |           | Six Months Ended June |           |
|---|-------------------------|-----------|-----------------------|-----------|
|   | 2004                    | 2003      | 2004                  | 2003      |
| Weighted average shares outstanding                   | 36,567,169              | 9,249,799 | 25,117,700            | 9,253,478 |
| Effect of dilutive securities:                        |                         |           |                       |           |
| Employee stock options                                | 419,991                 | 2,123     | 296,626               |           |
| Weighted average shares outstanding assuming dilution | 36,987,160              | 9,251,922 | 25,414,326            | 9,253,478 |

**Note 3 Net Income Per Share**

In following the provisions of SFAS 128, we adjusted the computations of basic and diluted earnings per share and the number of common shares outstanding retroactively for all periods presented to reflect our change in capital structure. The earnings per share for the three months and six months ended June 30, 2004 and 2003 have been restated to reflect the 1-for-4 reverse stock split of our common stock in the first quarter of 2004 as if it occurred at the beginning of the period.

**Note 4 Real Estate Assets**

Our real estate properties are generally leased under noncancelable leases with remaining terms ranging from 1 to 26 years. Rental revenues include the following (amounts in thousands):

|                                      | Three Months Ended June 30 |           | Six Months Ended June 30 |           |
|--------------------------------------|----------------------------|-----------|--------------------------|-----------|
|                                      | 2004                       | 2003      | 2004                     | 2003      |
| Minimum rent                         | \$ 23,953                  | \$ 22,361 | \$ 47,090                | \$ 44,754 |
| Straight-line accrual of future rent | 388                        | 689       | 915                      | 1,176     |
| Expense reimbursements               | 6,299                      | 6,002     | 13,055                   | 12,721    |
| Percentage rent                      | 386                        | 255       | 674                      | 574       |
| Other revenues                       | 2,095                      | 2,006     | 3,282                    | 3,020     |
| Rental revenues                      | \$ 33,121                  | \$ 31,313 | \$ 65,016                | \$ 62,245 |

**Acquisitions**

During the first six months of 2004, we acquired our joint venture partners' 50% interest in a property in Fresno, CA for \$2.8 million. We assumed the outstanding mortgage of \$9.7 million.

We did not acquire any properties during the first six months of 2003.

**Dispositions**

During the first six months of 2004, we sold the following properties:

| Location                          | Description          | Date Sold | Sales Price<br>(000 s) |
|-----------------------------------|----------------------|-----------|------------------------|
| Hampton, VA                       | Retail Building/Bank | 4/1/04    | \$ 4,850               |
| San Diego/Rancho Bernardo, CA (1) | Office Building      | 5/12/04   | 14,655                 |
| Tempe, AZ (2)                     | Land, Building       | 5/13/04   | 1,724                  |
| Tucson/Marana, AZ (2)             | Land                 | 6/16/04   | 408                    |
| Orlando, FL (3)                   | Land                 | 6/23/04   | 41,500                 |
| San Diego/Morena, CA (2)          | Office Building      | 6/28/04   | 4,125                  |

(1) We subleased our interest in this property to former members of our senior management in October 2003. During the second quarter of 2004, they exercised their right to purchase all of our rights and interest in the building

(2) Partial sale

(3) This was a joint venture investment classified as land on our Consolidated Balance Sheet in accordance with FIN 46R

During the first six months of 2003, we sold the following properties:

| Location        | Description        | Date Sold | Sales Price<br>(000 s) |
|-----------------|--------------------|-----------|------------------------|
| Scottsdale, AZ  | Land, Restaurant   | 3/31/03   | \$ 3,000               |
| Inglewood, CA   | Warehouse Building | 4/29/03   | 4,000                  |
| New Britain, CT | Warehouse Building | 5/15/03   | 3,529                  |
| Northridge, CA  | Shopping Center    | 6/27/03   | 5,850                  |

Also during 2003, we received payment on three notes receivable related to the sale of our self storage development properties in 2002. We deferred the gain of \$0.7 million on the sales until 2003, when we received payment on the notes.

#### **Variable Interest Entities**

On July 1, 2003, we adopted FASB Interpretation No. 46R, Consolidation of Variable Interest Entities an interpretation of ARB No. 51 (FIN 46R). This interpretation addresses the consolidation of business enterprises (variable interest entities) to which the usual condition (ownership of a majority voting interest) of consolidation does not apply. This interpretation focuses on financial interests that indicate control. It concludes that in the absence of clear control through voting interests, a company's exposure (variable interest) to the economic risks and potential reward from the variable interest entity's assets and activities are the best evidence of control. Variable interests are rights and obligations that convey economic gains or losses from changes in the values of the variable interest entity's assets and liabilities. Variable interests may arise from financial instruments, service contracts, nonvoting ownership interests and other arrangements.

If an enterprise holds a majority of the variable interests of an entity, it would be considered the primary beneficiary. The primary beneficiary is required to include assets, liabilities and the results of operations of the variable interest entity in its financial statements. As of June 30, 2004, our analysis related to FIN 46R indicates we are the primary beneficiary of the following variable interest entity which requires consolidation in our financial statements (amounts in thousands):

|                            | Assets    | Liabilities | Minority Interest |
|----------------------------|-----------|-------------|-------------------|
| Los Arcos Development, LLC | \$ 22,000 |             |                   |

Los Arcos Development, LLC (an affiliate of Ellman Companies) owns 42 acres of land in Scottsdale, AZ. Commencing in 1996, non-recourse loans were made by one of our affiliates to Los Arcos Development, LLC to acquire the Scottsdale property. These loans were previously classified as notes receivable on our balance sheet. As of January 13, 2004, we entered into loan amendments with Los Arcos Development, LLC to confirm a second priority lien on the Scottsdale property to collateralize the loans and to establish a new maturity date of December 31, 2004.

A separate note receivable from Los Arcos Development, LLC in the aggregate principal amount of \$13.0 million was acquired by another affiliate in February 2003. This note receivable is non-recourse and collateralized by a first priority lien on the Scottsdale property.

The first and second lien loans were further amended in July 2004 to require certain payments on the notes in the total amount of \$30.3 million by July 15, August 2, August 10, and August 16, 2004, subject to certain extension options through August 31, 2004. If such payments are timely made, the borrower and its affiliates will receive releases from further liability under these loans and the related loans described in Note 7, and the liens will be released. The required July 15 and August 2 payments have been received. In addition, we granted Ellman Investments, Inc. certain rights to purchase the loans in lieu of making the required payments (with the purchase price in such event approximately equal to the amount of the required payments).

For accounting purposes, the cumulative balance of the notes receivable at June 30, 2004 was \$22.0 million, which is net of a \$29.5 million impairment recorded in the fourth quarter of 2003. This treatment does not affect the amount which Los Arcos Development, LLC owes to us pursuant to the terms of the loan documents. This balance is classified as land on our Consolidated Balance Sheets. Although interest continues to accrue per the terms of the loan documents, we did not accrue interest on the notes for accounting purposes in 2004 and 2003.

Orlando Business Park, LLC, previously classified as a joint venture on our balance sheet, owned land in Orlando, FL. This land was sold in the second quarter of 2004 and we recognized a gain of \$2.6 million on the sale.

***Property Held for Sale***

Included in the Consolidated Balance Sheets at June 30, 2004 and December 31, 2003 are the following properties held for sale, which are carried at fair value less costs to sell (amounts in thousands):

| Location                           | Description     | June 30<br>2004 | December 31<br>2003 |
|------------------------------------|-----------------|-----------------|---------------------|
| Anaheim, CA                        | Land            | \$ 36,598       | \$ 37,000           |
| Farmington, UT                     | Land            | 5,880           | 5,880               |
| Phoenix/One North First Street, AZ | Office Building | 5,539           | 5,551               |
| Tucson/Marana, AZ                  | Land            | 2,457           | 2,787               |
| San Diego/Rancho Bernardo, CA      | Office Building |                 | 15,141              |
| Hampton, VA                        | Retail Building |                 | 4,629               |
| Total                              |                 | \$ 50,474       | \$ 70,988           |

**Note 5 Discontinued Operations**

We report discontinued operations for our properties in Anaheim, CA, Farmington, UT, Phoenix/One North First Street, AZ, and Tucson/Marana, AZ which are classified as held for sale.

We also report discontinued operations for our properties in San Diego/Rancho Bernardo, CA, Hampton, VA, and San Diego, CA which were sold during the second quarter ended June 30, 2004. Also included in the Consolidated Statements of Operations for the three and six months ended June 30, 2003 are the discontinued operations of our properties at Scottsdale, AZ, Inglewood, CA, New Britain, CT, and Northridge, CA which were sold in 2003. Discontinued operations are summarized as follows (amounts in thousands, except per share data):

|  | Three Months Ended<br>June 30 |            | Six Months Ended<br>June 30 |            |
|--|-------------------------------|------------|-----------------------------|------------|
|  | 2004                          | 2003       | 2004                        | 2003       |
| Rental revenue                         | \$ 570                        | \$ 1,124   | \$ 1,128                    | \$ 2,169   |
| Expenses                               |                               |            |                             |            |
| Operating and maintenance              | 164                           | 189        | 323                         | 402        |
| Property taxes                         | 149                           | 110        | 314                         | 265        |
| Depreciation and amortization          | 16                            | 238        | 31                          | 500        |
| Interest expense                       |                               | 145        |                             | 289        |
|  | 329                           | 682        | 668                         | 1,456      |
| Income from operations                 | 241                           | 442        | 460                         | 713        |
| Net gain (loss) on sale of real estate | 2,193                         | (2,314)    | 2,193                       | (2,521)    |
| Net income (loss)                      | \$ 2,434                      | \$ (1,872) | \$ 2,653                    | \$ (1,808) |
| Earnings (loss) per common share       |                               |            |                             |            |
| Basic and diluted                      | \$ 0.07                       | \$ (0.20)  | \$ 0.11                     | \$ (0.20)  |

#### Note 6 Investments in Unconsolidated Real Estate Joint Ventures

As of June 30, 2004 and December 31, 2003, we had the following investments in unconsolidated joint ventures which we accounted for under the equity method of accounting (amounts in thousands):

| Joint Venture               | Ownership % | June 30<br>2004 | December 31<br>2003 |
|-----------------------------|-------------|-----------------|---------------------|
| Blackstone Ventures I       | 50%         | \$              | 2,469               |
| 3017977 Nova Scotia Company | 55%         |                 | 1,600               |
| Other                       | Various     |                 | 44                  |
| Total                       |             | \$              | 4,113               |

In March 2004, we paid \$2.8 million to purchase our partners' 50% share of Blackstone Ventures I and we assumed the outstanding mortgage of \$9.7 million.

During the first quarter of 2004, we sold our investment in 3017977 Nova Scotia Company to affiliates associated with the Ellman Companies. In consideration, we added \$1.6 million to an existing note receivable due from Los Arcos Development, LLC. This note receivable is consolidated and recorded as land on our Consolidated Balance Sheet in accordance with FIN 46R.

Also in the first quarter of 2004, we disposed of a joint venture investment in an apartment complex and recognized a loss on the disposal of \$44,100.

**Note 7 Notes Receivable**

As of June 30, 2004 and December 31, 2003, we had the following notes receivable outstanding related to various real estate developments and related businesses (amounts in thousands):

| Note Receivable                           | June 30<br>2004 |              | December 31<br>2003 |               |
|---|-----------------|--------------|---------------------|---------------|
| Arizona Hockey Management/Ellman Holdings | \$              | 8,275        | \$                  | 9,500         |
| Other                                     |                 | 811          |                     | 811           |
| <b>Total</b>                              | <b>\$</b>       | <b>9,086</b> | <b>\$</b>           | <b>10,311</b> |

The notes generally do not require cash payments of interest until specified future dates, typically when developments are completed or sold.

Of the \$9.1 million outstanding, the notes receivable from companies owned by or affiliated with Steven Ellman (the Ellman Affiliates) represented an aggregate outstanding principal balance, for accounting purposes, of approximately \$8.3 million. The outstanding balance is net of a \$12.9 million impairment recorded in the fourth quarter of 2003 to reflect the fair value of the notes in connection with management's plan to sell our non-core assets and an additional \$1.2 million impairment recorded in the second quarter of 2004 to reflect Ellman Affiliates' exercise of its option to purchase the loans pursuant to the terms specified below. These notes receivable from the Ellman Affiliates are collateralized by a pledge of certain Ellman Affiliates' distributions from a holding company that owns the Phoenix Coyotes hockey team and other related assets. These loans were made at a time when the Ellman Affiliates intended to relocate the hockey team to an arena that was to be constructed on the Scottsdale property owned by Los Arcos Development, LLC.

As a result of delays at the Scottsdale property, the Ellman Affiliates elected to pursue an alternative site for the hockey arena in Glendale, AZ. In December 2002, the Ellman Affiliates and the other investors involved in the ownership of the Phoenix Coyotes entered into a series of transactions in which the Phoenix Coyotes hockey team and related real estate development assets were consolidated for the purpose of assisting in obtaining additional financing. The sale of equity interests in the holding company could generate proceeds to help repay our notes. However, it is unclear at this time the impact the structure will have on the repayment of our loans made to the Ellman Affiliates in connection with their acquisition of the Phoenix Coyotes. Although interest continues to accrue per the terms of the notes, we stopped accruing interest on the loans for accounting purposes when the development projects were consolidated into the holding company.

As of January 13, 2004, we entered into loan amendments with the Ellman Affiliates to, among other things, incorporate the pledge of certain Ellman Affiliates' distributions from the holding company collateralizing the loans and set forth the new maturity date of the loans as December 31, 2004.

In August 2004, Ellman Investments, Inc. exercised its right to purchase the loans, provided that certain other obligations of the Ellman Affiliates owed to us, including the obligations to make the payments arising with respect to the notes receivable described in Note 4 have been satisfied, and provided further that the Ellman Affiliates deliver documents satisfactory to us releasing and indemnifying us from liabilities with respect to our various transactions with the Ellman Affiliates.

**Note 8 Debt**

We had the following debt outstanding at June 30, 2004 and December 31, 2003 (amounts in thousands):

|   | June 30<br>2004 | December 31<br>2003 |
|---|-----------------|---------------------|
| Mortgages on five properties in Florida bearing interest at fixed rates ranging from 8.18% to 9.00%. The loans are collateralized by the properties and mature February 2009 and January 2010                                 | \$ 157,896      | \$ 158,668          |
| Mortgage payable with a bank, bearing interest at LIBOR plus 90 basis points (2.27% at June 30, 2004). The mortgage is collateralized by four of our properties and matures July 2005   | 121,375         |                     |
| Mortgage on a property in Pentagon City, VA bearing interest at LIBOR plus 145 basis points (2.82% at June 30, 2004). The loan is collateralized by the property and matures January 2009                                     | 60,000          |                     |
| Mortgages and notes payable on four properties bearing interest at fixed rates ranging from 5.88% to 8.45%. The loans are collateralized by the properties and mature on various dates between October 2011 and February 2017 | 56,828          | 57,271              |



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|  | June 30<br>2004 | December 31<br>2003 |
|--|-----------------|---------------------|
| Mortgages on two properties bearing interest at LIBOR plus 205 basis points (3.42% at June 30, 2004). The loans are collateralized by the properties and mature December 2006                          | 29,506          | 31,508              |
| Mortgage on a property in Temecula, CA bearing interest at 5.20%. The loan is collateralized by the property and matures May 2014.   | 28,937          |                     |
| Construction loan outstanding bearing interest at LIBOR plus 310 basis points (4.47% at June 30, 2004). The loan is due March 2005 and is collateralized by a retail center in Newport, KY (see below) | 28,500          | 28,500              |
| Mortgage on a property in Orlando, FL bearing interest at LIBOR plus 130 basis points (2.67% at June 30, 2004). The loan is collateralized by the property and matures June 2008                       | 22,099          | 22,100              |
| Mortgage on a property in Greensburg, IN bearing interest at LIBOR plus 155 basis points (2.92% at June 30, 2004). The loan is collateralized by the property and matures May 2009                     | 14,200          |                     |
| Construction loan payable to a bank bearing interest at LIBOR plus 185 basis points (3.22% at June 30, 2004). The loan matures in March 2005 and is collateralized by the project in Orlando, FL       | 12,638          | 10,466              |
| Mortgage on a property in Fresno, CA bearing interest at LIBOR plus 175 basis points (3.12% at June 30, 2004). The loan is collateralized by the property and matures October 2004                     | 9,694           |                     |
| Revolving \$50.0 million credit facility bearing interest at LIBOR plus 118 to 170 basis points (2.92% at June 30, 2004), maturing March 2007 (see below)  |                 |                     |
| Mortgage payable with GMAC Commercial Mortgage Corporation, bearing interest at LIBOR plus 98 basis points. The mortgage matured in July 2004 and was refinanced                                       |                 | 121,375             |
| Revolving \$100.0 million credit facility bearing interest at LIBOR plus 150 to 200 basis points. In February 2004, we repaid \$60.0 million and amended our credit facility (see below)               |                 | 69,100              |

|  | June 30<br>2004 | December 31<br>2003 |
|--|-----------------|---------------------|
| Capital lease arrangements with an individual on two properties. The capital leases had effective interest rates of 4.43% and 7.36%. Both leases were repaid in 2004 |                 | 31,006              |
| Construction loan payable to a bank bearing interest at LIBOR plus 150 basis points. This loan was refinanced with a new lender in April 2004                        |                 | 20,929              |
| Note payable to a bank bearing interest at LIBOR plus 375 basis points. This loan was paid in full in June 2004  |                 | 8,821               |
| Note payable outstanding on a \$4.7 million facility related to Newport, KY. This loan was paid in full in March 2004  |                 | 4,737               |
| Total  | \$ 541,673      | \$ 564,481          |

We were in compliance with all covenants on our credit facility at June 30, 2004. In 2004, we plan to use cash flow from operations to fund our recurring debt service obligations.

In February 2004, we amended our credit facility, repaid \$60.0 million and Wells Fargo Bank assumed the amended facility. The amended facility provided for a maximum borrowing of \$25.0 million. This amendment was intended to provide financing through the completion of the Recapitalization Transaction (see Note 2). In April 2004, we entered into a new \$50.0 million credit facility with Wells Fargo Bank. The new facility has a 3-year term and has a current interest rate of LIBOR plus 155 basis points. The LIBOR rate add-on may vary between 118 and 170 basis points based on our leverage and other financial ratios. The new facility also can be increased by \$25.0 million to allow up to \$75.0 million of borrowings.

We have a 65% interest in Newport on the Levee, LLC (Newport) that owns a retail project in Newport, KY. In addition to the \$28.5 million construction loan in the above table, the City of Newport has issued two series of public improvement bonds. The Series 2000a tax exempt bonds total \$44.2 million and are broken down as follows: (a) \$18.7 million maturing 2018 with interest at 8.375%; (b) \$20.5 million maturing 2027 with interest at 8.5%; and (c) \$5.0 million maturing 2027 with interest at 8.375%. The Series 2000b bonds are taxable and have a par amount of \$11.6 million with interest at 11% due 2009. The bonds are guaranteed by us, by

Newport, and the third party co-developers of the project. Newport has drawn on \$46.8 million of the bonds at June 30, 2004 (See Note 12).

**Note 9 Financial Instruments: Derivatives and Hedging**

In the normal course of business, we are exposed to the effect of changes in interest rates. We limit these risks by following established risk management policies and procedures including the use of derivatives. For interest rate exposures, derivatives are used primarily to manage the cost of borrowing obligations.

We have a policy of only entering into derivative contracts with major financial institutions based upon their credit ratings and other factors. When viewed in conjunction with the underlying and offsetting exposure that the derivatives are designed to hedge, we have not sustained a material loss from those instruments nor do we anticipate any material adverse effect on our net income, financial position, or cash flows in the future from the use of derivatives.

To manage interest rate risk, we may employ options, forwards, swaps, caps and floors, or a combination thereof, depending on the underlying exposure. We undertake a variety of borrowings from lines of credit to medium and long-term financings. To manage overall costs, we currently use derivative instruments to cap our exposure to variability in interest rates or to convert a portion of our variable-rate debt to fixed-rate debt. In July 2002, we paid \$3.4 million for forward-starting, LIBOR-based interest rate caps with a combined notional value of \$152 million and a strike of 7.0% to cap our exposure to interest rate variability on anticipated floating-rate debt. The interest rate caps are effective July 1, 2004, and continue through 2009 to 2010. The interest rate caps are included with other assets on the Consolidated Balance Sheets. We also use derivatives to protect the fair value of existing or anticipated fixed-rate debt. During 2002, we had five amortizing swaps with approximately \$161 million current notional value protecting the fair value of approximately \$161 million fixed-rate debt from changes in value attributable to interest rate movement. In October 2002, we sold our five Interest Rate Swap Agreements back to the counter party for a \$13.8 million gain and will amortize the gain over the fixed-rate debt's remaining life through 2009 to 2010. The remaining deferred gain of \$10.9 million is included with accounts payable and other liabilities on the Consolidated Balance Sheets.

Hedges that are designated as fair value hedges mitigate risk on changes in the fair value of fixed-rate debt. The unrealized gains/losses in the fair value of these hedges are reported in earnings with an offsetting adjustment through earnings to the carrying value of the hedged debt. Adjustments to the carrying value of the hedged debt are amortized to earnings beginning no later than when the hedged debt ceases to be adjusted for changes in its fair value attributable to the interest rate risk being hedged.

Cash flow hedges hedge the future cash outflows of current or forecasted debt. The interest rate caps described above protect against variability in interest cash outflows above the cap strike rate. The changes in the fair value of these hedges are reported on the Consolidated Balance Sheets with a corresponding adjustment to either Accumulated Comprehensive Income or in earnings, depending on the hedging relationship. Unrealized gains and losses held in Accumulated Comprehensive Income will be reclassified to earnings in the same period or periods that the hedged cash flows affect earnings. As of June 30, 2004, the balance in Accumulated Comprehensive Loss relating to derivatives was \$2.4 million. Within the next twelve months, we estimate that approximately \$0.2 million will be reclassified from Accumulated Comprehensive Loss to earnings as additional interest expense.

We hedge our exposure to the variability in future cash flows for forecasted transactions other than interest-related cash flows over a maximum period of 12 months. During the forecasted period, unrealized gains and losses in the hedging instrument will be reported in Accumulated Comprehensive Income. Once the hedged transaction takes place, the hedge gains and losses will be reported in earnings during the same period in which the hedged item is recognized in earnings. We are not currently hedging exposure to variability in future cash flows for forecasted transactions other than interest-related cash flows on future anticipated debt.

#### **Note 10 Related Party Transaction**

During the first quarter of 2004, Mr. Mark Burton, a former member of our senior management, resigned his position with us effective February 1, 2004. In connection with his resignation, we entered into a consulting and office services agreement whereby Mr. Burton and other employees formerly with our company provide various acquisition and disposition services and related due diligence. The term of the agreement is for one year ending January 31, 2005. In connection with this agreement, we paid approximately \$50,000 in consulting services for the quarter ended June 30, 2004 and \$83,000 for the six months ended June 30, 2004.

**Note 11 Stock Option Plan**

During the first six months of 2004, we granted 85,000 stock options (on a post 1-for-4 reverse stock split basis) under our 2001 Stock Option and Incentive Plan (the Plan). As of June 30, 2004, we had reserved 998,250 shares for issuance under the Plan. We issued no stock options during the first six months of 2003.

As we stated in Note 1, we follow the provisions of APB No. 25, Accounting for Stock Issued to Employees. In 1997 and 2002, we implemented the disclosure provisions required by SFAS No. 123, Accounting for Stock-Based Compensation and SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an amendment of SFAS No.123, respectively, for our stock option plans. SFAS 123 requires pro forma net income and earnings per share information, which is calculated assuming we had accounted for our stock option plans under the fair value method described in that statement. We estimated the fair value using the Black-Scholes option pricing model, modified for dividends and using the following assumptions:

|  | Six Months Ended June 30 |      |
|--|--------------------------|------|
|  | 2004                     | 2003 |
| Risk free interest rate                | 4.21-4.49%               |      |
| Annual dividend rate                   | 6.06-6.59%               |      |
| Volatility factor of the stock price   | 38.67-40.98%             |      |
| Weighted average expected life (years) | 10                       |      |

We do not record compensation expense for stock option grants. The table in Note 1 summarizes results as if we had recorded compensation expense for options granted in 2004.

**Note 12 Subsequent Event**

On August 2, 2004, we purchased all of the Newport, KY Series 2000b taxable bonds (see Note 8) for \$10.2 million (including accrued interest).

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

**Introduction**

This report on Form 10-Q contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 which provides a safe harbor for these types of statements. You can identify these forward-looking statements by forward-looking words such as believe, may, could, will, estimate, continue, anticipate, intend, seek, plan, expect, should, would and similar on Form 10-Q. These forward-looking statements are subject to a number of risks, uncertainties and assumptions about Price Legacy, including, among other things:

the effect of economic, credit and capital market conditions in general and on real estate companies in particular, including changes in interest rates

our ability to compete effectively

developments in the retail industry

the financial stability of Price Legacy's tenants, including our reliance on major tenants

our ability to successfully complete real estate acquisitions, developments and dispositions

the financial performance of our properties, joint ventures and investments

government approvals, actions and initiatives, including the need for compliance with environmental requirements

our ability to continue to qualify as a real estate investment trust, or REIT

our ability to realize the value of various assets through negotiated transactions

The factors identified above are believed to be some, but not all, of the important factors that could cause actual events and results to be significantly different from those that may be expressed or implied in any forward-looking statements. Any forward-looking statements should also be considered in light of the information provided in Factors That May Affect Future Performance located in our Form 10-K filing for the 2003 fiscal year. We assume no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

In Management's Discussion and Analysis we explain our general financial condition and results of operations including:

why revenues, costs and earnings changed from the prior period

funds from operations (FFO)

how we used cash for capital projects and dividends and how we expect to use cash for the remainder of 2004

where we plan on obtaining cash for future dividend payments and future capital expenditures

**Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). Preparation of our financial statements in accordance with GAAP requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and the related notes. Refer to our 2003 Annual Report on Form 10-K for a discussion of our critical accounting policies which include revenue recognition, valuation of real estate assets and depreciation, and the disposal or impairment of long-lived assets. There have been no material changes to these policies in 2004. We believe that our estimates and assumptions are reasonable based upon historical experience, however, actual results may differ from these estimates under different assumptions or conditions. For a detailed discussion on the application of these and other accounting policies, see Note 1 in the Notes to the Consolidated Financial Statements in Item 8 of our Annual Report on Form 10-K for the 2003 fiscal year.

**Overview**

We receive income primarily from rental revenue from open-air shopping center properties, including recoveries from tenants, offset by operating and general and administrative expenses. During the fourth quarter of 2003, we segregated a number of our non-core assets for disposal. During the first six months of 2004, we have continued our efforts to sell our non-core assets. We sold our properties in Hampton, VA and San Diego/Rancho Bernardo, CA. We also sold land in Tucson, AZ and our joint venture investment which owned land in Orlando, FL. We completed partial sales of properties in San Diego/Morena, CA and Tempe, AZ. Finally, we sold our investment in Mace Security International stock and recognized a gain of \$9.2 million. We intend to redeploy the proceeds from the disposition of these assets into the redemption of our Series A Preferred Stock, the reduction of debt, or the acquisition of income-generating properties. During the first six months of 2004, we redeemed 1.0 million shares of Series A Preferred Stock for the redemption price of \$16 per share. During the first six months of 2004, we acquired our joint venture partners' 50% share of a property in Fresno, CA.

During the first six months of 2004, we completed a Recapitalization Transaction that resulted in a significant simplification of our capital structure. In accordance with Emerging Issues Task Force (EITF) topic D-42 which governed this transaction, approximately \$72.8 million was deducted from net income to arrive at net loss applicable to common stockholders in the calculation of earnings per share.

**Rental Revenues**

|                   | Amount<br>(000 s) | Change<br>(000 s) | Percent<br>Change |
|-------------------|-------------------|-------------------|-------------------|
| 2nd Quarter 2004  | \$ 33,121         | 1,808             | 6%                |
| 2nd Quarter 2003  | 31,313            |                   |                   |
| Year-to-Date 2004 | 65,016            | 2,771             | 4%                |
| Year-to-Date 2003 | 62,245            |                   |                   |



Rental revenues increased \$1.8 million to \$33.1 million in the second quarter of 2004 compared to the same period in 2003 primarily because:

properties we owned both years generated \$1.4 million of additional revenues, primarily due to additional leasing activity at our Miami, FL property and the opening of our Temecula, CA and Orlando/Millenia II, FL properties, partially offset by vacancies at our Wayne, NJ property due to Today's Man and The Wiz bankruptcies

we acquired our joint venture partners' 50% share of a property in Fresno, CA in March 2004 which generated \$0.5 million of additional revenues

Rental revenues increased \$2.8 million to \$65.0 million in the six month year-to-date period of 2004 compared to the same period in 2003 primarily because:

properties we owned both years generated \$2.3 million of additional revenues, primarily due to additional leasing activity at our Miami, FL property, the opening of our Temecula, CA and Orlando/Millenia II, FL properties, and additional revenue at our Tusayan, AZ hotel property, partially offset by vacancies at our Wayne, NJ property due to Today's Man and The Wiz bankruptcies and Westbury, NY due to Kmart's bankruptcy

we acquired our joint venture partners' 50% share of a property in Fresno, CA in March 2004 which generated \$0.6 million of additional revenues

**Expenses**

|                   | Amount<br>(000 s) | Change<br>(000 s) | Percent<br>Change |
|-------------------|-------------------|-------------------|-------------------|
| 2nd Quarter 2004  | \$ 18,004         | \$ 94             | 1%                |
| 2nd Quarter 2003  | 17,910            |                   |                   |
| Year-to-Date 2004 | 34,965            | 1,265             | 4%                |
| Year-to-Date 2003 | 33,700            |                   |                   |

Expenses increased \$0.1 million to \$18.0 million in the second quarter of 2004 compared to 2003 primarily because:

we recorded a provision for asset impairment of \$1.2 million related to our notes receivable with the Ellman Affiliates when they exercised their right to purchase the notes

an increase in expenses of \$0.2 million due to the acquisition of our joint venture partners' 50% share of a property in Fresno, CA

these increases to expenses were offset by

expenses from properties we owned in both years decreased \$0.8 million, primarily due to higher bad debt expense in 2003 at our Wayne, NJ property pertaining to the bankruptcies of Today's Man and The Wiz

general and administrative expenses decreased \$0.5 million mainly due to a decrease in salaries and legal expense

Expenses increased \$1.3 million to \$35.0 million for the six month year-to-date period of 2004 compared to 2003 primarily because:

we recorded a provision for asset impairment of \$1.2 million related to our notes receivable with the Ellman Affiliates when they exercised their right to purchase the notes

expenses from properties we owned in both years increased \$1.0 million, primarily due to additional operating expenses due to the openings of our properties in

Temecula, CA and Orlando/Millenia II, FL and increased depreciation expense at our Newport, KY property

an increase in expenses of \$0.2 million due to the acquisition of our joint venture partners 50% share of a property in Fresno, CA

these increases to expenses were offset by

a decrease in general and administrative expenses of \$0.9 million, primarily due to lower salary expense and legal expense

a decrease to bad debt expense of \$0.1 million

### **Operating Income**

|                   | Amount<br>(000 s) | Change<br>(000 s) | Percent<br>Change |
|-------------------|-------------------|-------------------|-------------------|
| 2nd Quarter 2004  | \$ 15,117         | \$ 1,714          | 13%               |
| 2nd Quarter 2003  | 13,403            |                   |                   |
| Year-to-Date 2004 | \$ 30,051         | 1,506             | 5%                |
| Year-to-Date 2003 | 28,545            |                   |                   |

Operating income increased for the second quarter and year-to-date periods of 2004 compared to the same periods in the prior year primarily because of the changes in Rental Revenues and Expenses discussed above.

### **Interest Expense**

|                   | Amount<br>(000 s) | Change<br>(000 s) | Percent<br>Change |
|-------------------|-------------------|-------------------|-------------------|
| 2nd Quarter 2004  | \$ 7,054          | \$ 540            | 8%                |
| 2nd Quarter 2003  | 6,514             |                   |                   |
| Year-to-Date 2004 | \$ 13,965         | 985               | 8%                |
| Year-to-Date 2003 | 12,980            |                   |                   |

Interest expense increased \$0.5 million in the second quarter of 2004 compared to 2003 because during the second quarter of 2004 we had an average of \$559.8 million of debt outstanding compared to \$558.2 million in the second quarter of 2003. Our outstanding debt increased mainly due to borrowings on our construction loans. Interest expense increased \$1.0 million in the six month year-to-date period of 2004 compared to 2003 because we had an average of \$570.0 million of debt outstanding compared to \$558.8 million for the same period of 2003.

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The weighted average interest rate on our variable rate debt also increased to 2.8% on June 30, 2004 from 2.6% on June 30, 2003. We discuss our outstanding debt further in [Liquidity and Capital Resources](#) located elsewhere in this Form 10-Q.

**Interest Income**

|                   | Amount<br>(000 s) |    | Change<br>(000 s) | Percent<br>Change |
|-------------------|-------------------|----|-------------------|-------------------|
| 2nd Quarter 2004  | \$ 63             | \$ | (50)              | -44%              |
| 2nd Quarter 2003  | 113               |    |                   |                   |
| Year-to-Date 2004 | 108               |    | (817)             | -88%              |
| Year-to-Date 2003 | 925               |    |                   |                   |

Interest income decreased \$0.1 million in the second quarter of 2004 compared to 2003 primarily because we had notes receivable outstanding with other real estate developers which earned \$0.1 million in interest income in 2003. These notes are no longer outstanding.

Interest income decreased \$0.8 million in the six month year-to-date period of 2004 compared to 2003 primarily because we had notes receivable outstanding with other real estate developers which earned \$0.8 million in interest income in 2003. These notes are no longer outstanding.

**Discontinued Operations**

We report discontinued operations for our properties in Anaheim, CA, Farmington, UT, Phoenix/One North First Street, AZ, and Tucson/Marana, AZ which are classified as held for sale. We also report discontinued operations for our properties in San Diego/Rancho Bernardo, CA, San Diego, CA and Hampton, VA which were sold in 2004. Also included in the 2003 Consolidated Statements of Operations are the discontinued operations of our properties at Scottsdale, AZ, Inglewood, CA, New Britain, CT, and Northridge, CA which were sold in 2003.

During the first six months of 2004, we sold the following properties and recognized a net gain of \$2.2 million. This gain is recorded as discontinued operations in accordance with Statement of Financial Accounting Standards No. 144.

| Location                      | Description          | Date Sold | Sales Price<br>(000 s) |
|-------------------------------|----------------------|-----------|------------------------|
| Hampton, VA                   | Retail Building/Bank | 4/1/04    | \$ 4,850               |
| San Diego/Rancho Bernardo, CA | Office Building      | 5/12/04   | 14,655                 |
| Tucson/Marana, AZ             | Land                 | 6/16/04   | 408                    |
| San Diego/Morena, CA          | Office Building      | 6/28/04   | 4,125                  |

During the first six months of 2003 we sold the following properties and recognized a net loss of \$2.5 million. This loss is recorded as discontinued operations in the Consolidated Statement of Operations in accordance with Statement of Financial Accounting Standards No. 144.

| Location | Description | Date Sold | Sales Price<br>(000 s) |
|----------|-------------|-----------|------------------------|
|----------|-------------|-----------|------------------------|

**Expenses**

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|                 |                    |         |    |       |
|-----------------|--------------------|---------|----|-------|
| Scottsdale, AZ  | Land, Restaurant   | 3/31/03 | \$ | 3,000 |
| Inglewood, CA   | Warehouse Building | 4/29/03 |    | 4,000 |
| New Britain, CT | Warehouse Building | 5/15/03 |    | 3,529 |
| Northridge, CA  | Shopping Center    | 6/27/03 |    | 5,850 |

**Gain/Loss on Sale of Real Estate and Investments**

During the first six months of 2004 we disposed of a joint venture investment, sold our investment in Mace stock, sold a parcel of land at our property in Tempe, AZ and sold our joint venture investment which owned land in Orlando, FL. We recognized a net gain of \$12.7 million on the sale of these investments.

During the first six months of 2003, we received payment on the notes receivable related to the sale of our development self storage properties and recognized additional gains on the sales of \$0.7 million.

**Funds From Operations (amounts in thousands)**

|  | Three Months<br>Ended June 30 |          | Six Months<br>Ended June 30 |           |
|--|-------------------------------|----------|-----------------------------|-----------|
|  | 2004                          | 2003     | 2004                        | 2003      |
| Net income   | \$ 23,226                     | \$ 6,144 | \$ 31,531                   | \$ 16,533 |
| Depreciation and amortization                            | 5,547                         | 5,617    | 11,160                      | 9,759     |
| Depreciation and amortization of discontinued operations | 16                            | 238      | 31                          | 500       |
| Price Legacy's share of joint venture depreciation       |                               | 338      | 26                          | 517       |
| Depreciation of non-real estate assets                   | (47)                          | (31)     | (74)                        | (62)      |
| Net (gain) loss on sale of discontinued operations       | (2,193)                       | 2,314    | (2,193)                     | 2,521     |
| Net gain on sale of real estate and investments          | (12,666)                      |          | (12,622)                    | (687)     |
| FFO before preferred dividends                           | 13,883                        | 14,620   | 27,859                      | 29,081    |
| Preferred dividends                                      | (2,886)                       | (12,423) | (14,700)                    | (24,783)  |
| Preferred stock conversion and redemption                | (1,423)                       |          | (74,235)                    |           |
| FFO  | \$ 9,574                      | \$ 2,197 | \$ (61,076)                 | \$ 4,298  |
| Net cash provided by (used in):                          |                               |          |                             |           |
| Operating activities                                     | \$ 10,458                     | \$ 7,449 | \$ 24,537                   | \$ 22,109 |
| Investing activities                                     | 57,888                        | 10,036   | 48,537                      | 488       |
| Financing activities                                     | (44,324)                      | (12,094) | (51,479)                    | (16,359)  |
| Significant non-cash items:                              |                               |          |                             |           |
| Provision for asset impairment                           | 1,225                         |          | 1,225                       |           |
| Preferred stock conversion                               |                               |          | 72,812                      |           |
| Series B preferred dividends                             |                               | 2,821    | 2,212                       | 5,579     |
| Deferred rents   | 391                           | 690      | 922                         | 1,199     |

Our Company, as well as real estate industry analysts, generally considers FFO as another measurement of economic profitability for real estate-oriented companies. The Board of Governors of the National Association for Real Estate Investment Trusts (NAREIT) defines FFO as net income in accordance with GAAP, excluding gains (or losses) from sales of property, plus depreciation and amortization. We calculate FFO in accordance with the NAREIT definition which also excludes gains (losses) from the sale of investments, and adjusts for preferred dividends. We believe that FFO is helpful to investors as a measure of our financial performance because, along with cash flow from operating activities, financing activities and investing activities, FFO provides investors with an indication of the ability of a REIT to incur and service debt, to make capital expenditures and to fund other cash needs. In addition, we believe that FFO provides useful information about our performance when compared to other REITs since FFO is generally recognized as the industry standard for reporting the operations of REITs. FFO





does not represent the cash flows from operations defined by GAAP, may not be comparable to similarly titled measures of other companies and should not be considered as an alternative to net income as an indicator of our operating performance or to cash flows as a measure of liquidity. Excluded from FFO are significant components in understanding our financial performance.

FFO before preferred dividends and preferred redemption during the second quarter of 2004 decreased \$0.7 million or 5.0% to \$13.9 million compared to the second quarter of 2003 primarily because:

joint venture investments contributed \$1.3 million to FFO in the prior year

we recorded a provision for asset impairment of \$1.2 million related to our notes receivable during the second quarter of 2004

properties sold or held for sale contributed \$0.7 million to FFO in the prior year

additional interest expense reduced FFO \$0.5 million

decreased interest income reduced FFO \$0.1 million

these decreases to FFO were partially offset by:

properties we owned in both years increased FFO \$2.1 million

reduced general and administrative expenses increased FFO \$0.5 million

we acquired our joint venture partners 50% share of a property in Fresno, CA which contributed \$0.4 million to FFO

FFO before preferred dividends and preferred stock conversion and redemption during the six month year-to-date period of 2004 decreased \$1.2 million or 4.2% to \$27.9 million compared to the same period of 2003 primarily because:

joint venture investments contributed an additional \$1.6 million to FFO in the prior year

we recorded a provision for asset impairment of \$1.2 million related to our notes receivable during the second quarter of 2004

properties sold or held for sale contributed \$1.0 million to FFO in the prior year

additional interest expense reduced FFO \$1.0 million

decreased interest income reduced FFO \$0.8 million

these decreases to FFO were partially offset by:

properties we owned in both years increased FFO \$2.8 million

reduced general and administrative expenses increased FFO \$0.9 million

we acquired our joint venture partners' 50% share of a property in Fresno, CA which contributed \$0.5 million to FFO

### **Liquidity and Capital Resources**

Liquidity refers to our ability to generate sufficient cash flows to meet the short and long-term cash requirements of our business operations. Capital resources represent those funds used or available to be used to support our business operations and consist of stockholders' equity and debt.

Cash flow from operations has been the principal source of capital to fund our ongoing operations and dividend payments, while asset sales and use of our credit facilities and mortgage financing have been the principal sources of capital required to fund our growth. While we are positioned to finance our business activities through a variety of sources, we expect to satisfy

short-term liquidity requirements through net cash provided by operations and through borrowings.

***Dividends***

As a REIT, we are required to distribute 90% of our taxable income, excluding capital gains, in dividends. Our Series A Preferred Stock required a quarterly dividend payment of \$9.6 million during the first quarter of 2004 and \$2.4 million during the second quarter of 2004. Our Series 1 Preferred Stock required a dividend of \$0.5 million during the second quarter of 2004. Also during 2004, we declared and issued a dividend of 397,807 additional shares of Series B Preferred Stock. As of June 30, 2004, we had a federal net operating loss (NOL) carry-forward of approximately \$17.1 million, which could be used to offset future taxable income.

As a result of our Recapitalization Transaction, our Series B Preferred Stock was exchanged for shares of common stock. In addition, based on a final report from the exchange agent in the Series A Exchange Offer, 20,942,672 shares of our Series A Preferred Stock were tendered for exchange in the Series A Exchange Offer for a total of 2,942,463 shares of our Series 1 Preferred Stock and 18,900,219 shares of our common stock (on a post 1-for-4 reverse stock split basis). If the dividends we pay to holders of our Series A and Series 1 Preferred Stock are less than 90% of our taxable income (after applying any applicable NOLs), we can declare a dividend to our common stockholders. Because the Recapitalization Transaction reduced the amount of dividends payable to preferred holders, it is more likely that we will be required to pay a dividend to our common stockholders in order to distribute 90% of our taxable income.

On May 14, 2004, we paid a dividend to our common stockholders of \$0.28 per share and we also paid dividends of \$0.35 per share on our Series A Preferred Stock. We also paid a dividend of \$0.16 per share on the Series 1 Preferred Stock, which represents a quarterly dividend of \$0.29 per share prorated for the period of March 12, 2004 through April 30, 2004 for a total of \$0.5 million. On July 15, 2004, we announced that our board of directors declared a dividend to our common stockholders of \$0.28 per share, a dividend of \$0.35 per share on our Series A Preferred Stock and a dividend of \$0.29 per share on the Series 1 Preferred Stock, for a total of approximately \$13.1 million. We expect to pay such dividends on or about August 16, 2004.

If our taxable income is less than the dividends we pay to holders of our Series A and Series 1 Preferred Stock, we are still obligated to pay them. If we are unable to pay these dividends when due, they accumulate until paid.

On June 7, 2004, we redeemed 1.0 million shares of our Series A Preferred Stock for the redemption price of \$16.00 per share.

***Debt***

In April 2004, we entered into a new \$50.0 million unsecured credit facility with Wells Fargo Bank. Prior to this new facility we had a \$100 million unsecured credit facility with Fleet Bank as agent, which was amended in February 2004 when we repaid \$60.0 million and Wells Fargo

assumed the facility. The new facility has a 3-year term and an interest rate as of June 30, 2004, of LIBOR plus 155 basis points and the rate will be variable, between 118 and 170 basis points based on our leverage and other financial ratios. We will be able to increase the new facility by \$25.0 million to allow up to \$75.0 million of borrowings. As of June 30, 2004 we had no amount outstanding on the new facility.

Our current credit facility requires us to comply with specified financial covenants, the most restrictive of which relate to fixed charge coverage and leverage. Covenants in some of our construction loans are also tied to our credit facility. We were in compliance with all covenants in our credit facility at June 30, 2004. To the extent that we violate any of these covenants in the future, we would need to obtain waivers from our lenders to maintain compliance. We cannot assure that any such waivers would be forthcoming.

In 2004 we had or will have the following significant debt financing and maturities:

In January 2004, we obtained a \$60.0 million loan secured by our property in Pentagon City, VA. We used the proceeds to reduce the amount outstanding on our credit facility

In February 2004, we repaid a \$4.7 million loan related to our property in Newport, KY. We repaid the loan through borrowing on our credit facility

In March 2004, a \$28.5 million construction loan related to our property in Newport, KY matured. We extended this loan for one year at the same terms

In April 2004, we refinanced a construction loan related to our property in Temecula, CA with a new lender for \$29.0 million

In April 2004, we repaid a \$19.3 million capital lease obligation on our Greensburg, IN property with proceeds from the sale of our property in Hampton, VA (approximately \$4.6 million) with the balance through a borrowing on our credit facility.

In May 2004, we obtained a \$14.2 million loan secured by our property in Greensburg, IN. We used the proceeds to reduce the amount outstanding on our credit facility

In May 2004, an \$11.7 million capital lease related to our office building in San Diego/Rancho Bernardo, CA was repaid by former member of our senior management. We subleased our interest and granted them the right to purchase the property. This right to purchase was exercised and closed in May 2004

In June 2004, a \$4.6 million loan related to land we owned in Orlando, FL matured. This loan was guaranteed by us and by our partner. We paid this loan in full and subsequently sold the land

In July 2004, a \$121.4 million loan related to five properties matured. We refinanced this loan with another lender for the same amount with four of the properties

In October 2004, a \$9.6 million loan related to our property in Fresno, CA matures. We plan to refinance this

loan

We may also refinance additional debt outstanding to obtain more favorable terms.

The following table summarizes all of our long-term contractual obligations, excluding interest, to pay third parties as of June 30, 2004 (amounts in thousands):

## Contractual Cash Obligations

|                          | Total      | Less than<br>1 year | 1-3<br>years | 3-5<br>Years | More<br>than 5<br>years |
|--------------------------|------------|---------------------|--------------|--------------|-------------------------|
| Debt                     | \$ 541,673 | \$ 11,671           | \$ 198,327   | \$ 29,926    | \$ 301,749              |
| Ground lease obligations | 23,305     | 498                 | 1,993        | 1,994        | 18,820                  |
| Total                    | \$ 564,978 | \$ 12,169           | \$ 200,320   | \$ 31,920    | \$ 320,569              |

In 2004 we plan to use cash flow from operations to fund our recurring debt service obligations.

**Off-Balance Sheet Financing Matters**

The City of Newport, KY in 1999 issued two series of public improvement bonds related to our project in Newport, KY. The Series 2000a tax exempt bonds total \$44.2 million and are broken down as follows: (a) \$18.7 million maturing 2018 with interest at 8.375%; (b) \$20.5 million maturing 2027 with interest at 8.5%; and (c) \$5.0 million maturing 2027 with interest at 8.375%. The Series 2000b bonds are taxable and have a par amount of \$11.6 million with interest at 11% due 2009. The bonds are guaranteed by the Newport project, Excel Legacy, and the project's third party developer. As of June 30, 2004, Newport had drawn on \$46.8 million of the bonds for construction incurred prior to that date.

On August 2, 2004, we purchased all of the Newport, KY Series 2000b taxable bonds for \$10.2 million (including accrued interest).

**Growth**

We continue to evaluate various properties for acquisition or development and continue to evaluate other investment opportunities in a very competitive real estate market. We anticipate borrowing available amounts on our credit facility or mortgages to fund any acquisition and development opportunities. We also anticipate obtaining construction loans to fund our development activities. During the first quarter of 2004, we paid \$2.8 million to purchase our joint venture partners' 50% interest in a property in Fresno, CA and assumed a mortgage of \$9.7 million.

**Development**

We have a significant retail project in Newport, KY. The majority of the construction was completed in October 2001, with all of the primary buildings completed except for one out parcel yet to be leased. The project opened in October 2001. At June 30, 2004, the project was approximately 75% occupied, excluding ground leases. As the project becomes fully leased, there may be capital required to fund the remaining tenant improvements. We spent \$0.8 million on tenant improvements during the first six months of 2004 and estimate spending an additional \$0.5 million through the remainder of 2004.

We also have retail development projects in which construction will continue through 2004. The Temecula, CA project is an open-air retail shopping center with Wal-Mart, Kohls and other tenants. At June 30, 2004, the project was 100% leased. We plan to develop an historical parcel within this project for approximately \$5.0 million. We spent approximately \$200,000 on this

development during the first six months of 2004 and estimate spending an additional \$250,000 through the remainder of 2004. We expect to fund these costs through available cash.

In November 2002, we purchased land adjacent to our retail property in Orlando, FL to develop an open-air retail center. At June 30, 2004, the project was approximately 66% occupied. We estimate the total cost of this development to be approximately \$19.7 million with an estimated \$0.6 million remaining to complete construction, which we will fund through an existing construction loan.

Los Arcos Development, LLC (an affiliate of the Ellman Companies) owns land in Scottsdale, AZ. Commencing in 1996 loans were made to Los Arcos Development, LLC to acquire this real estate, and we also acquired an additional senior loan secured by the Scottsdale property in 2003 (see Note 4). At December 31, 2003, we wrote down the value of these notes receivable and recognized an impairment of \$29.5 million. As of June 30, 2004, the outstanding principal balance on the note receivable relating to the Scottsdale property, net of the impairment write down, was approximately \$22.0 million and is classified as land on our Consolidated Balance Sheets in accordance with FIN 46R. We contributed \$0.9 million in the first six months of 2004 for pre-development expenses related to this project, and this sum is included within the indebtedness under the loans.

Orlando Business Park, LLC owned approximately 2,400 acres of land in Orlando, FL. During the second quarter of 2004 we sold this land and recognized a gain of \$2.6 million.

#### *Properties Held for Sale*

From time to time we will consider selling properties to better align our portfolio with our geographic and tenant composition strategies. We may also participate in tax-deferred exchange transactions, which allow us to dispose of properties and reinvest the proceeds in a tax efficient manner. During the second quarter of 2004, we sold a property in Hampton, VA for \$4.8 million. We also sold an office building at our property in San Diego/Morena, CA for \$4.1 million and a portion of our property in Tempe, AZ for \$1.7 million. When we sell an operating property, we anticipate a temporary reduction in operating income due to the time lag between selling a property and reinvesting the proceeds.

The Anaheim GardenWalk project in Anaheim, CA, located adjacent to Disney's two theme parks on Harbor Boulevard and Disney's new proposed theme park on Katella Avenue, is expected to consist of a 626,000 square foot open-air retail center and four hotels. During the fourth quarter of 2003, we decided to sell the property rather than develop it and wrote down the value by \$43.4 million to its estimated fair market value.

We own approximately 40 acres of land in Farmington, UT. During the fourth quarter of 2003, we decided to sell the property rather than develop it and wrote down the value by \$3.6 million to its estimated fair market value. We also own some land in Tucson/Marana, AZ. We sold a portion of this land during the second quarter of 2004 and continue our efforts to sell the remaining parcels.

We are contemplating purchasing various properties and selling certain other properties. As we sell properties, our cash flows from operations may decrease until the proceeds are reinvested, either into new properties, used to reduce debt, or used for the redemption of our Series A Preferred Stock.

***Notes Receivable***

We had \$9.1 million in principal amount of third party notes receivable outstanding as of June 30, 2004 related to various real estate developments and related businesses. The notes generally do not require cash payments of interest until specified future dates, typically when developments are completed or sold. Of the \$9.1 million outstanding, notes receivable from companies owned by or affiliated with Steven Ellman (the Ellman Affiliates) represent an aggregate outstanding principal balance, for accounting purposes, of approximately \$8.3 million. The outstanding balance is net of a \$12.9 million impairment recorded in the fourth quarter of 2003 to reflect the fair value of the notes in connection with management's plan to sell our non-core assets and an additional \$1.2 million impairment recorded in the second quarter of 2004 to reflect Ellman Affiliates' exercise of its option to purchase the loans pursuant to the terms specified below. These notes receivable from the Ellman Affiliates are collateralized by a pledge of certain Ellman Affiliates' distributions from a holding company that owns the Phoenix Coyotes hockey team and other related assets. These loans were made at a time when the Ellman Affiliates intended to relocate the hockey team to an arena that was to be constructed on the Scottsdale property owned by Los Arcos Development, LLC.

As a result of delays at the Scottsdale property, the Ellman Affiliates elected to pursue an alternative site for the hockey arena in Glendale, AZ. In December 2002, the Ellman Affiliates and the other investors involved in the ownership of the Phoenix Coyotes entered into a series of transactions in which the Phoenix Coyotes hockey team and related real estate development assets were consolidated for the purpose of assisting in obtaining additional financing. The sale of equity interests in the holding company could generate proceeds to help repay our notes. However, it is unclear at this time the impact the structure will have on the repayment of our loans made to the Ellman Affiliates in connection with their acquisition of the Phoenix Coyotes. Although interest continues to accrue per the terms of the notes, we stopped accruing interest on the loans for accounting purposes when the development projects were consolidated into the holding company.

As of January 13, 2004, we entered into loan amendments with the Ellman Affiliates to, among other things, incorporate the pledge of certain Ellman Affiliates' distributions from the holding company collateralizing the three loans and set forth the new maturity date of the loans as December 31, 2004.

In August 2004, Ellman Investments, Inc. exercised its right to purchase the loans, provided that certain other obligations of the Ellman Affiliates owed to us, including the obligations to make the payments arising with respect to the notes receivable described in Note 4 have been satisfied, and provided further that the Ellman Affiliates deliver documents satisfactory to us releasing and indemnifying us from liabilities with respect to our various transactions with the Ellman Affiliates.



*Other*

In April 2004, we sold our investment in Mace Security International Stock and recognized a gain on the sale of \$9.2 million.

In April 2002, we entered into five Interest Rate Swap Agreements with Fleet Bank that are accounted for under SFAS No. 133. The combined notional amount was approximately \$161 million and the maturities ranged from 2009 to 2010. We paid monthly interest of LIBOR plus 3.08% to 3.77% and Fleet Bank assumed our fixed rates of 8.18% to 9.00%. These swaps hedged the fair value of fixed-rate debt. In October 2002, we sold the five swaps back to the counter party for \$13.8 million and will amortize the gain over the fixed-rate debt's remaining life through 2009 to 2010.

In July 2002, we paid \$3.4 million for four Interest Rate Cap Agreements with Wells Fargo Bank and Fleet Bank that are also accounted for under SFAS No. 133. The combined notional amount is \$152.0 million and the maturities range from 2009 to 2010. The agreements cap our variable rate risk on one month LIBOR interest at 7%.

**Inflation**

Because a substantial number of our leases contain provisions for rent increases based on changes in various consumer price indices, based on fixed rate increases, or based on percentage rent if tenant sales exceed certain base amounts, we do not expect inflation to have a material impact on future net income or cash flow from developed and operating properties. In addition, substantially all retail leases are triple net, which means specific operating expenses and property taxes are passed through to the tenant.

**ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risks relating to our operations result primarily from changes in short-term LIBOR interest rates. We do not have any significant foreign exchange or other material market risk.

Our exposure to market risk for changes in interest rates relates primarily to our variable interest rate debt. We enter into variable rate debt obligations to support general corporate purposes, including acquisitions, capital expenditures and working capital needs. We continuously evaluate our level of variable rate debt with respect to total debt and other factors, including our assessment of the current and future economic environment.

We had \$298.0 million in variable rate debt outstanding at June 30, 2004. Based upon these year-end debt levels, a hypothetical increase in interest rates by 100 basis points would increase interest expense by approximately \$3.0 million on an annual basis, and likewise decrease our earnings and cash flows. We cannot predict market fluctuations in interest rates and their impact on our variable rate debt, nor can there be any assurance that fixed rate long-term debt will be



available to us at favorable rates, if at all. Consequently, future results may differ materially from the estimated adverse changes discussed above.

In July 2002, in order to mitigate our variable interest rate exposure, we acquired four interest rate caps, which hedge our exposure on \$152 million of variable rate debt. The hedges limit our exposure to the one-month LIBOR index associated with certain of our outstanding debt at 7%. To the extent the one-month LIBOR index exceeds 7%, the counter parties on the hedges will pay us the difference between the actual index and 7%.

The following table presents the scheduled principal payments on notes receivable and the scheduled principal payments on mortgages payable over the next five years and thereafter. The table also includes the average interest rates of the financial instruments during each respective year and the fair value of the notes receivable and mortgages payable. We determine the fair value of financial instruments through the use of discounted cash flow analysis using current interest rates for notes receivable with terms and credit characteristics similar to our existing portfolio and borrowings under terms similar to our existing mortgages payable.

|   | Expected Maturity Date as of June 30, 2004<br>(dollar amounts in thousands) |            |           |          |           |            |            | Total      | Fair Value |
|---|---|------------|-----------|----------|-----------|------------|------------|------------|------------|
|   | 2004  | 2005       | 2006      | 2007     | 2008      | Thereafter |            |            |            |
| Notes receivable, including notes from affiliates | \$ 10,311   |            |           |          |           |            |            | \$ 10,311  | \$ 10,311  |
| Average interest rate                             | 12%   |            |           |          |           |            |            | 12%        |            |
| Debt  | \$ 11,671   | \$ 166,745 | \$ 31,582 | \$ 3,791 | \$ 26,135 | \$ 301,749 | \$ 541,673 | \$ 547,734 |            |
| Average interest rate                             | 3%  | 3%         | 4%        | 7%       | 3%        | 6%         | 5%         |            |            |

#### ITEM 4 CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Securities and Exchange Commission Rule 13a-15(b), under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, we carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level.



There have been no changes in our internal controls over financial reporting during the quarter covered by this report that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

## **PART II - OTHER INFORMATION**

### **ITEM 1 LEGAL PROCEEDINGS**

We are not a party to any legal proceedings other than various claims and lawsuits arising in the ordinary course of business that, in the opinion of our management, are individually or in the aggregate material to our financial statements.

### **ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K**

(a) The following exhibits are included herein or incorporated by reference:

31.1 Certifications Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certifications Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) Reports on Form 8-K

We filed a report on Form 8-K on May 10, 2004 reporting under Items 5 and 7 the issuance of a press release announcing the redemption of 1,000,000 shares of our Series A Preferred Stock.

We filed a report on Form 8-K on May 24, 2004 reporting under Items 5 and 7 the issuance of a press release announcing the filing of a shelf registration statement registering 24,367,348 shares of our common stock held by certain of our stockholders.

We filed a report on Form 8-K on June 2, 2004 reporting under Items 5 and 7 the issuance of a press release announcing the appointment of Jacklyn Horton to our Board of Directors and announcing the resignation of James Cahill from our Board of Directors.

We filed a report on Form 8-K on June 9, 2004 reporting under Items 5 and 7 the issuance of a press release announcing the completion of the redemption of 1,000,000 shares of our Series A Preferred Stock.



**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 thereunto duly authorized.

PRICE LEGACY CORPORATION  
*Registrant*

Date: August 9, 2004

*/s/ Jack McGrory*  
Jack McGrory  
*Chief Executive Officer*

Date: August 9, 2004

*/s/ Jeffrey R. Fisher*  
Jeffrey R. Fisher  
*Chief Financial Officer*