

ASSOCIATED ESTATES REALTY CORP  
Form 10-Q  
July 31, 2015

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

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

For the quarterly period ended June 30, 2015

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

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

OHIO  
(State or other jurisdiction of  
incorporation or organization)

34-1747603  
(I.R.S. Employer  
Identification Number)

1 AEC Parkway, Richmond Hts., Ohio 44143-1550  
(Address of principal executive offices)  
(216) 261-5000  
(Registrant's telephone number, including area code)

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

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

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

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

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

The number of Common Shares outstanding as of July 27, 2015 was 58,020,888.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## ASSOCIATED ESTATES REALTY CORPORATION

## CONSOLIDATED BALANCE SHEETS

## (UNAUDITED)

(In thousands, except share and per share amounts)	June 30, 2015	December 31, 2014
<b>ASSETS</b>		
Real estate assets		
Land	\$279,570	\$261,777
Buildings and improvements	1,435,902	1,346,870
Furniture and fixtures	42,367	41,609
Construction in progress	47,886	73,581
Gross real estate	1,805,725	1,723,837
Less: Accumulated depreciation	(398,659)	(397,210)
Net real estate owned	1,407,066	1,326,627
Investment in unconsolidated entities	59,396	54,800
Total net real estate	1,466,462	1,381,427
Cash and cash equivalents	7,411	4,692
Restricted cash	36,186	46,361
Accounts receivable, net		
Rents	1,142	1,093
Other	3,855	2,977
Other assets, net	30,805	29,147
Total assets	\$1,545,861	\$1,465,697
<b>LIABILITIES AND EQUITY</b>		
Mortgage notes payable	\$288,355	\$272,613
Unsecured notes	250,000	250,000
Unsecured revolving credit facility	136,000	76,500
Unsecured term loan	150,000	150,000
Total debt	824,355	749,113
Accounts payable and other liabilities	41,745	47,070
Dividends payable	1,027	12,886
Resident security deposits	3,921	3,860
Accrued interest	5,254	5,192
Total liabilities	876,302	818,121
<b>Equity</b>		
Common shares, without par value, \$.10 stated value; 91,000,000 authorized; 58,021,078 issued and 58,020,888 outstanding at June 30, 2015 and 57,708,675 issued and 57,649,609 outstanding at December 31, 2014, respectively	5,802	5,771
Paid-in capital	760,274	758,079
Accumulated distributions in excess of accumulated net income	(96,644)	(114,551)
Accumulated other comprehensive loss	(218)	(1,093)
Less: Treasury shares, at cost, 190 and 56,066 shares at June 30, 2015 and December 31, 2014, respectively	(5)	(980)
Total shareholders' equity attributable to AERC	669,209	647,226
Noncontrolling interest	350	350

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Total equity	669,559	647,576
Total liabilities and equity	\$1,545,861	\$1,465,697

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

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CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME  
(UNAUDITED)

(In thousands, except per share amounts)	Three Months Ended		Six Months Ended	
	June 30, 2015	2014	June 30, 2015	2014
<b>REVENUE</b>				
Property revenue	\$48,314	\$47,268	\$95,631	\$96,417
Commercial revenue	580	455	1,192	933
Property management and construction services revenue	307	179	621	267
Total revenue	49,201	47,902	97,444	97,617
<b>EXPENSES</b>				
Property operating and maintenance	19,162	18,132	38,073	37,500
Depreciation and amortization	16,741	15,885	32,676	32,180
General and administrative	6,972	4,596	13,491	9,915
Development costs	133	198	332	528
Construction services	248	33	451	90
Costs associated with acquisitions	11	27	73	113
Total expenses	43,267	38,871	85,096	80,326
Operating income	5,934	9,031	12,348	17,291
Interest expense	(6,417)	(6,587)	(12,530)	(13,540)
Gain on change in control	—	—	444	—
Gain on disposition of properties	30,022	59,904	30,022	100,870
Net income	29,539	62,348	30,284	104,621
Allocation to participating securities	(73)	(212)	(75)	(355)
Net income applicable to common shares	\$29,466	\$62,136	\$30,209	\$104,266
Earnings per common share - basic:				
Net income applicable to common shares - basic	\$0.51	\$1.08	\$0.52	\$1.82
Earnings per common share - diluted:				
Net income applicable to common shares - diluted	\$0.51	\$1.07	\$0.52	\$1.80
Comprehensive income:				
Net income	\$29,539	\$62,348	\$30,284	\$104,621
Other comprehensive income:				
Change in fair value and reclassification of hedge instruments	1,011	(683)	875	(746)
Total comprehensive income	30,550	61,665	31,159	103,875
Dividends declared per common share	\$—	\$0.19	\$0.21	\$0.38
Weighted average shares outstanding - basic	57,744	57,475	57,678	57,419
Weighted average shares outstanding - diluted	58,346	57,919	58,285	57,876

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

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CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

	Six Months Ended	
	June 30,	
(In thousands)	2015	2014
Cash flow from operating activities:		
Net income	\$30,284	\$104,621
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	32,676	32,180
Gain on change in control	(444)	) —
Gain on disposition of properties	(30,022)	) (100,870)
Amortization of deferred financing costs and other	597	549
Share-based compensation expense	2,032	2,170
Net change in assets and liabilities:		
Accounts receivable	30	16
Accounts payable and accrued expenses	(61)	) (4,180)
Other operating assets and liabilities	786	667
Total adjustments	5,594	(69,468)
Net cash flow provided by operating activities	35,878	35,153
Cash flow from investing activities:		
Recurring fixed asset additions	(5,263)	) (4,203)
Revenue enhancing/non-recurring fixed asset additions	(3,335)	) (696)
Acquisition fixed asset additions	(82,330)	) (46,385)
Development fixed asset additions	(28,972)	) (27,609)
Acquisition of unconsolidated entity	(8,316)	) —
Net proceeds from disposition of operating properties	47,994	168,756
Contributions to joint ventures	(13,384)	) (5,636)
Deposits on potential future acquisitions	(1,903)	) 3,193
Cash proceeds from sale of equity interest in development property	—	24,075
Escrow deposits related to property sales	(32,100)	) (72,292)
Escrow disbursements related to property acquisitions	43,295	52,414
Costs paid on behalf of joint venture	—	(5,639)
Reimbursements of costs paid on behalf of joint venture	—	4,420
Other investing activity	(397)	) (589)
Net cash flow (used for) provided by investing activities	(84,711)	) 89,809
Cash flow from financing activities:		
Principal amortization payments on mortgage notes payable	(1,137)	) (1,041)
Principal repayments of mortgage notes payable	—	(20,038)
Payment of debt procurement costs	(42)	) (130)
Proceeds from secured construction loans	17,257	20,782
Unsecured revolving credit facility borrowings	157,000	117,000
Unsecured revolving credit facility repayments	(97,500)	) (214,500)
Common share dividends paid	(24,037)	) (22,579)
Exercise of stock options	1,198	714
Purchase of treasury shares	(1,187)	) (999)
Other financing activities, net	—	127
Net cash flow provided by (used for) financing activities	51,552	(120,664)

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Increase in cash and cash equivalents	2,719	4,298
Cash and cash equivalents, beginning of period	4,692	4,586
Cash and cash equivalents, end of period	\$7,411	\$8,884
Supplemental disclosure of non-cash transactions:		
Dividends declared but not paid	\$1,027	\$11,495
Net change in accounts payable related to fixed asset additions	(5,768	) 5,028
Increase in consolidated net assets due to change in control	8,400	—
Deconsolidation of net assets	—	26,238

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

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ASSOCIATED ESTATES REALTY CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)

1. BUSINESS

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

We are a fully-integrated, self-administered and self-managed equity real estate investment trust ("REIT") specializing in multifamily ownership, operation, acquisition, development, disposition and property management activities. Our primary source of income is rental payments from the leasing of apartment units. Additional income is derived from commercial rents, property management fees and construction services fees. As of June 30, 2015, our operating portfolio consisted of 50 apartment communities containing 12,786 units in nine states that are owned, either directly or indirectly, through subsidiaries. In conjunction with our acquisition of land for development of an apartment community, we acquired a commercial building in Los Angeles, California, containing approximately 78,800 total square feet of office and commercial space. Additionally, we provide property management services for two apartment communities that we expect to acquire pursuant to existing contracts.

2. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared by management in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and applicable rules and regulations of the Securities and Exchange Commission ("SEC"). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments consisting only of normal and recurring adjustments considered necessary for a fair statement have been included. The reported results of operations are not necessarily indicative of the results that may be expected for the full year. These financial statements should be read in conjunction with the audited financial statements and accompanying notes in our Annual Report on Form 10-K for the year ended December 31, 2014.

Principles of Consolidation

The Company follows the provisions of Accounting Standards Codification No. 810, Consolidation. This standard requires a company to perform an analysis to determine whether its variable interests give it a controlling financial interest in a Variable Interest Entity ("VIE"). This analysis identifies the primary beneficiary of a VIE as the entity that has the power to direct the activities of the VIE that most significantly affect the VIE's economic performance and the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. In determining whether it has the power to direct the activities of the VIE that most significantly affect the VIE's performance, this standard requires a company to assess whether it has an implicit financial responsibility to ensure that a VIE operates as designed. When an entity is not deemed to be a VIE, the Company considers the provisions to determine whether a general partner, or the general partners as a group, controls a limited partnership or similar entity when the limited partners have certain rights. Investments in real estate joint ventures in which the Company has the ability to exercise significant influence, but does not have financial or operating control, are accounted for using the equity method of accounting.

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In February 2015, the FASB issued ASU 2015-02, Consolidation (Topic 810) ("ASU 2015-02"), an amendment to the consolidation accounting guidance. This guidance changes the required analysis to determine whether certain types of legal entities should be consolidated. The amendment modifies the evaluation of whether limited partnerships and similar legal entities are VIEs or voting interest entities, eliminates the presumption that a general partner should consolidate a limited partnership and may affect the consolidation analysis of entities involved in VIEs, particularly those having fee arrangements and related party relationships. ASU 2015-02 will become effective for the Company for fiscal years, and for interim reporting periods within those fiscal years, beginning after December 15, 2015. The Company is currently in the process of evaluating the impact the adoption of ASU 2015-02 will have on the Company's financial position.

### Segment Reporting

Substantially all of our properties are multifamily communities and, while the economic climate of the markets in which they are located may vary from time to time, the communities offer similar products and services and have similar economic characteristics. Management evaluates the performance of our properties and makes acquisition/disposition decisions on an individual basis. During the six months ended June 30, 2015, substantially all of our consolidated revenue was provided by our multifamily properties. We have determined that, as of June 30, 2015, we have one reportable segment which is multifamily properties.

### Discontinued Operations

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

### Debt Issuance Costs

In April 2015, the FASB issued ASU 2015-03, Interest - Imputation of Interest (Subtopic 835-30) ("ASU 2015-03"). In order to simplify presentation of debt issuance costs, ASU 2015-03 requires that debt issuance costs be presented in the balance sheet as a direct deduction from the carrying amount of debt liability, consistent with debt discounts or premiums, rather than as a deferred asset. This updated guidance requires retrospective application for all prior periods disclosed and will be effective for financial statements issued for fiscal years beginning after December 15, 2015. The amendments in ASU 2015-03 require disclosure over the nature of and reason for the change in accounting principle, the transition method, a description of the prior-period information that has been retrospectively adjusted and the effect of the change on the financial statement line items. ASU 2015-03 will become effective for the Company on January 1, 2016. The Company does not expect a material impact on our financial position from the adoption of ASU 2015-03.

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## 3. ACQUISITION, DEVELOPMENT, AND DISPOSITION ACTIVITY

## Acquisition Activity

On September 20, 2013, we entered into an agreement to acquire a portfolio of seven properties for a total purchase price of \$323.9 million, including the assumption of \$28.0 million of existing mortgage financing. During the year ended December 31, 2013, we closed on three of the seven properties: The Apartments at Blakeney, St. Mary's Square and Lofts at Weston Lakeside. During the year ended December 31, 2014, we closed on an additional two properties: Alpha Mill Phase I and Alpha Mill Phase II, which we operate as one property. During the six months ended June 30, 2015, we closed on one property: 1160 Hammond. We expect to acquire the remaining property based on the closing period set forth in the following table. This remaining closing is contingent upon the completed construction of the property. Our obligation to purchase this property is subject to certain closing conditions specified in the agreement. If we choose not to purchase the remaining property, despite the closing conditions having been satisfied within the time period contemplated by the purchase agreement, we would forfeit the then-remaining balance of our earnest money deposit, which was, as of June 30, 2015, \$10.0 million. This remaining balance of our earnest money deposit represents our maximum exposure to loss until the closing of the remaining portfolio property. We consider our deposit allocated to the entity developing the property under construction to be a variable interest and the development entity to be a VIE for which we are not the primary beneficiary as of this reporting date as we do not have control over the entity. Although we intend to acquire the remaining property, and regard our acquisition as probable, there can be no assurance that we will acquire the property.

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

(Dollar amounts in thousands)

Property	Location	Units	Estimated Closing Period	Purchase Price
Varela Westshore	Tampa, FL	350	Q3 2015	\$79,450

During the year ended December 31, 2012, we entered into an agreement to acquire for a purchase price of \$80.2 million a 331-unit property in Ft. Lauderdale, Florida. Our purchase obligation is conditioned upon the successful completion of the property in accordance with agreed upon plans and specifications and up to an 18-month period to allow for lease up of the property. Closing will not occur unless the conditions are satisfied, which is currently expected to occur in March 2016. The developer may elect to terminate our agreement to purchase by agreeing to the release of our \$4.0 million earnest money deposit from escrow and paying us an \$8.0 million termination fee. If we choose not to purchase the property, despite the closing conditions having been satisfied within the time period contemplated by the purchase agreement, we would forfeit our \$4.0 million earnest money deposit. This earnest money deposit represents our maximum exposure to loss until the closing of the property. We consider our deposit to be a variable interest and the development entity to be a VIE for which we are not the primary beneficiary as of this reporting date as we do not have control over the entity.

On March 2, 2015, we acquired 1160 Hammond, a 345-unit property located in Atlanta, Georgia, for a total purchase price of \$80.4 million. This acquisition was funded by borrowings from our unsecured revolving line of credit and proceeds from property dispositions held for a 1031 exchange.

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

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The following table represents the purchase price allocation for the properties acquired during the six months ended June 30, 2015 and 2014, respectively.

(In thousands)	Six Months Ended	
	June 30, 2015	2014
Land	\$6,953	\$8,140
Buildings and improvements	71,664	36,044
Furniture and fixtures	1,270	468
Existing leases (Other assets)	463	423
Total	\$80,350	\$45,075

The following table presents actual and pro forma information related to the properties acquired during the three and six months ended June 30, 2015 and 2014, respectively. The pro forma information is presented as if the properties were acquired on January 1, 2014. We recognized acquisition costs during the six months ended June 30, 2015 totaling \$54,000 related to the current year acquisition, which are included in "Costs associated with acquisitions" in the Consolidated Statements of Operations and Comprehensive Income. Additionally, we recognized acquisition costs totaling \$26,000 and \$24,000 related to the current year acquisition during 2014 and 2013, respectively. The pro forma presentation is presented for informational purposes only, and is not necessarily indicative of what our actual results of operations would have been had the acquisition occurred at such time.

(In thousands, except per share amounts)	Three Months Ended		Six Months Ended	
	June 30, 2015	2014	June 30, 2015	2014
Actual revenue from acquisitions	\$938	\$161	\$1,177	\$161
Actual net loss from acquisitions	(534)	(45)	(786)	(45)
Pro forma revenue	49,201	48,372	97,782	98,678
Pro forma net income applicable to common shares	29,577	62,288	29,989	104,493
Pro forma earnings per common share - basic:				
Pro forma net income applicable to common shares	\$0.51	\$1.08	\$0.52	\$1.82
Pro forma earnings per common share - diluted:				
Pro forma net income applicable to common shares	\$0.51	\$1.08	\$0.51	\$1.81

Development Activity

During the year ended December 31, 2013, we entered into a partnership agreement with an unrelated third-party for the limited purpose of acquiring a property in Monrovia, California, known as 5th and Huntington, and to produce construction drawings for improvements to the property. The land, upon which the partnership planned to develop a 154-unit multifamily apartment community, was purchased by the partnership on August 9, 2013 for \$13.1 million. We held a 50.0% equity interest in the partnership, which was accounted for under the equity method. On February 3, 2015, we purchased our partner's 50.0% interest in 5th and Huntington for an agreed upon price of \$8.4 million, increasing our ownership percentage in the development to 100%. We recognized a gain of \$444,000 related to this acquisition, which represented the amount by which the \$8.4 million fair value of our interest in the partnership exceeded our carrying value at the date of acquisition. The gain is included in "Gain on change in control" in the Consolidated Statements of Operations and Comprehensive Income. As of June 30, 2015, this development project is fully consolidated in our financial statements.

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On May 28, 2013, we acquired a 3.36-acre parcel of land in the SoMa neighborhood of San Francisco, California for \$46.6 million. On February 2, 2014, we entered into a 50/50 partnership with AIG to develop and own this site known as 350 8th. The partnership is developing a 410-unit apartment community with 40,000 square feet commercial space and underground parking. See Note 6 for additional information related to this partnership.

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

(Dollar amounts in thousands)			Total	Total	Total	Actual	Actual/	
Under Construction	Location	Ownership %	Total Units	Estimated Capital Cost <sup>(1)</sup>	Cost to Date	Total Debt	Construction Start	Estimated Construction Completion
Cantabria at Turtle Creek	Dallas, TX	100.0%	249	\$55,912	\$55,912	\$39,120	Q2 2013	Q1 2015
7001 Arlington at Bethesda	Bethesda, MD	98.1%	<sup>(2)</sup> 140	53,400	52,306	26,816	Q4 2012	Q2 2015
The Desmond on Wilshire	Los Angeles, CA	100.0%	175	77,800	57,540	—	Q2 2013	Q4 2015
Total			564	\$187,112	\$165,758	\$65,936		

Total capital costs are calculated as if owned 100% by AEC and represent estimated costs for projects under (1) development inclusive of all capitalized costs in accordance with GAAP. Based on current projections as of July 31, 2015.

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

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

(Dollar amounts in thousands)			Total	AEC	AEC	Actual	Estimated			
Under Construction	Location	Ownership %	Total Units	Estimated Capital Cost <sup>(1)</sup>	Investment to Date	Investment to Date Debt	Share of Debt	Construction Start	Estimated Construction Completion	
350 8th	San Francisco, CA	50.01%	410	\$245,000	\$117,003	\$47,735	\$6,481	\$3,241 <sup>(2)</sup>	Q2 2014	Q4 2016
950 East Third	Los Angeles, CA	50.0%	472	176,300	42,003	11,661	—	—	Q3 2014	Q4 2017
Total			882	\$421,300	\$159,006	\$59,396	\$6,481	\$3,241		

Total capital costs are calculated as if owned 100% by AEC and represent estimated costs for projects under (1) development inclusive of all capitalized costs in accordance with GAAP. Based on current projections as of July 31, 2015.

(2) AEC has guaranteed 100% of a \$143.6 million construction loan.

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The following table identifies our consolidated development activity that is in the planning phase:

(Dollar amounts in thousands)

Name	Location	Ownership %	Estimated Total Units <sup>(1)</sup>	Cost to Date	Total Debt <sup>(2)</sup>
5th and Huntington	Monrovia, CA	100.0%	154	\$16,970	\$—
Warner Center	Woodland Hills, CA	100.0%	379	21,351	—
Total			533	\$38,321	\$—

(1) Based on current projections as of July 31, 2015.

(2) Does not include the \$444 gain on change in control related to the acquisition of our partner's interest.

Capitalized Interest and Development Payroll. Total capitalized interest during the three and six months ended June 30, 2015 was \$1.4 million and \$2.7 million, respectively. Total capitalized interest during the three and six months ended June 30, 2014 was \$1.2 million and \$2.2 million, respectively. Capitalized payroll costs, including share-based compensation, are allocated to projects based upon time incurred by the applicable personnel. Capitalized costs related to development and construction are transferred to buildings and improvements and/or furniture and fixtures, as applicable, upon substantial completion of the project (i.e., certificate of occupancy has been obtained). Total capitalized payroll costs during the three and six months ended June 30, 2015 were \$1.1 million and \$2.0 million, respectively. Total capitalized payroll costs during the three and six months ended June 30, 2014 were \$860,000 and \$1.6 million, respectively.

## Disposition Activity

During the six months ended June 30, 2015, we completed the sale of two properties located in southeast Michigan for an aggregated sales price of \$49.5 million, and recognized aggregate gains of \$30.0 million.

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

We classify properties as held for sale when all significant contingencies surrounding the completion of the disposition have been resolved. We discontinue the depreciation of assets we have specifically identified as held for sale. There were no properties classified as held for sale at June 30, 2015 or December 31, 2014.

We have, on occasion, engaged Hancock Real Estate Strategies ("HRES"), a full service investment real estate brokerage and advisory firm, to provide certain real estate brokerage services. HRES is owned by Matthew E. Friedman, a son of our Chief Executive Officer ("CEO"). For the six months ended June 30, 2015, in conjunction with the sale of two properties in southeast Michigan for an aggregate total sales price of \$49.5 million, HRES received commissions totaling \$721,800. For the six months ended June 30, 2014, in conjunction with the sale of one property in Nashville, Tennessee for \$53.3 million on April 2, 2014, HRES was paid a commission totaling \$244,500. These transactions were approved by the Company's independent directors in compliance with Company policy.

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## 4. DEBT

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

(Dollar amounts in thousands)	June 30, 2015		December 31, 2014		
	Balance Outstanding	Weighted Average Interest Rate	Balance Outstanding	Weighted Average Interest Rate	
<b>Fixed Rate Debt:</b>					
Secured	\$222,419	4.8	% \$223,934	4.8	%
Unsecured - notes	250,000	4.4	% 250,000	4.4	%
Total Fixed Rate Debt	472,419	4.6	% 473,934	4.6	%
<b>Variable Rate Debt Swapped to Fixed:</b>					
Unsecured - term loan <sup>(1) (2)</sup>	125,000	2.7	% 125,000	2.7	%
Unsecured - term loan <sup>(3)</sup>	25,000	1.6	% —	—	%
Total Variable Rate Debt Swapped to Fixed	150,000	2.5	% 125,000	2.7	%
<b>Variable Rate Debt Unhedged:</b>					
Secured	65,936	1.5	% 48,679	1.5	%
Unsecured - revolving credit facility	136,000	1.5	% 76,500	1.5	%
Unsecured - term loan <sup>(3)</sup>	—	—	% 25,000	1.6	%
Total Variable Rate Debt Unhedged	201,936	1.5	% 150,179	1.5	%
Total Debt	\$824,355	3.4	% \$749,113	3.7	%

The Company entered into a forward starting swap in December 2011 fixing the rate beginning in June 2013 until June 2016 at a rate of 1.26% per annum plus the credit spread which was 1.40% per annum as of June 30, 2015, or (1) an all-in rate of 2.66% per annum. Additionally, the Company entered into a forward starting swap in April 2013 fixing the rate beginning June 2016 at a rate of 1.55% per annum plus the credit spread which was 1.40% per annum as of June 30, 2015, or an all-in rate of 2.95% per annum until January 2018.

The Company entered into a forward starting swap in January 2015 fixing the rate beginning January 2018 at a rate (2) of 1.75% per annum plus the credit spread which was 1.40% per annum as of June 30, 2015, or an all-in rate of 3.15% per annum until the loan matures in January 2020.

The Company entered into a forward starting swap in January 2015 fixing the rate beginning January 2016 at a rate (3) of 1.42% per annum plus the credit spread which was 1.40% per annum as of June 30, 2015, or an all-in rate of 2.82% per annum until the loan matures in January 2020.

**Mortgage Notes Payable**

On April 25, 2014, the 350 8th partnership, in which we are a 50.01% partner and that we account for under the equity method, entered into a construction loan agreement for \$143.6 million with a five-year term and, based on our current credit ratings, has a per annum interest rate of LIBOR plus 160 basis points. There were borrowings of \$6.5 million on this loan as of June 30, 2015, of which our pro rata share was \$3.2 million. We have guaranteed the payment of all current and future borrowings from this loan and the completion of construction in connection with the partnership's development. Additionally, we have drawn \$39.1 million on the Cantabria at Turtle Creek construction loan and \$26.8 million on the 7001 Arlington at Bethesda construction loan as of June 30, 2015. Cash paid for interest net of capitalized interest was \$11.8 million and \$13.3 million for the six months ended June 30, 2015 and 2014, respectively.

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## 5. GOODWILL AND OTHER INTANGIBLE ASSETS

## Goodwill

Our goodwill was allocated to our properties on a relative fair value basis. Upon disposition of properties, the goodwill allocated is included in the calculation of the gain or loss on disposal and subsequently written off. During the six months ended June 30, 2015, we wrote off \$41,000 of our goodwill as the result of property dispositions. The carrying value of our goodwill as of June 30, 2015 and December 31, 2014 was \$1.3 million. Our annual review of goodwill impairment is completed during the first quarter of each year (and more frequently if events or changes in circumstances indicate the carrying value may not be recoverable). The review, completed during the three months ended March 31, 2015, determined that goodwill was not impaired, and no other events have occurred that would require goodwill to be reevaluated. In performing this analysis, we compared the net assets of each property on which goodwill has been allocated, including the amount of allocated goodwill, to its estimated fair market value. Should the estimates used to determine the fair value of the properties change, impairment may result, which could impact our results of operations for the period in which it is recorded.

## Intangible Assets

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

## 6. INVESTMENT IN UNCONSOLIDATED ENTITIES

The following table identifies our investment in unconsolidated entities as of June 30, 2015:

(Dollar amounts in thousands)		Ownership	Total	Partner Contribution	Construction Management Fee Recognized to Date	Cumulative Basis Difference to Date	Maximum Exposure to Loss
Partnership	Location	%	Units	to Date			
350 8th	San Francisco, CA	50.01%	410	\$46,061	\$560	\$1,656	\$47,735
950 East Third	Los Angeles, CA	50.0%	472	30,000	(1) 500	618	11,661
Total			882	\$76,061	\$1,060	\$2,274	\$59,396

(1) Land valued at \$30.0 million was contributed by our partner, Legendary Investors Group No. 1 LLC ("Legendary"), to the partnership.



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350 8th

On February 3, 2014, we entered into a partnership agreement with AIG, an unrelated third-party, for the development and operation of 350 8th, an apartment community with 40,000 square feet of commercial space and underground parking located in San Francisco, California. The land upon which the partnership is developing was purchased by us for \$46.6 million on May 28, 2013. Upon the formation of our partnership with AIG, the land and improvements to date, with a carrying value of \$50.3 million, were deconsolidated. Any future equity capital needs will be funded according to the partners' percentage interests in the partnership. On April 25, 2014, the partnership entered into a construction loan agreement for \$143.6 million with a five-year term. There were borrowings of \$6.5 million on this loan at June 30, 2015, of which our pro rata share was \$3.2 million. We have guaranteed the payment of all current and future borrowings from this loan and the completion of construction in connection with the partnership's development. See Note 4 for more information related to this loan and Note 13 for more information related to the guarantees.

950 East Third

During the year ended December 31, 2013, we entered into a partnership agreement with Legendary, an unrelated third-party, for the development and operation of 950 East Third, an apartment community with 19,700 square feet of commercial space located in Los Angeles, California. We expect to fund the remaining portion of our capital contribution during the development and construction process.

Investment in Unconsolidated Entities

As the 350 8th and 950 East Third partnerships are not sufficiently funded to finance the activities of the entities, and not all of the capital will be funded up front, the partnerships are not deemed to have sufficient equity, and have therefore been determined to be VIEs. We have equal voting rights with respect to all major decisions in both partnerships, and all such decisions must be unanimous, including, among other things, development planning, budgeting and operational budgets. It has also been determined that we do not control the decisions that most significantly affect the economics of either entity, and that we do not hold a controlling financial interest in either entity. As such, our investments in the entities are accounted for in our consolidated financial statements using the equity method.

We perform construction management and property management services for both partnerships in accordance with the approved budgets for which we receive fees.

The cumulative basis differences in the partnerships are due to capitalization of interest on our investment and internal payroll and overhead costs directly related to the development of the properties. This excess of our investment over our equity in the underlying net assets of the joint ventures is included in "Investment in unconsolidated entities" in our Consolidated Balance Sheets, and will be amortized as a reduction to earnings on a straight-line basis over the lives of the related assets.

Our maximum exposure to loss, as a result of our involvement in these entities, is the carrying value of our investment. See Note 3 for more information related to these unconsolidated development projects.

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## 7. NONCONTROLLING INTERESTS

On July 14, 2011, we entered into a partnership agreement with Keating Project Development, Inc., an unrelated third-party, pursuant to which we hold a 98.1% equity interest in the partnership. In March 2012, the partnership acquired a 2.5-acre parcel of land in Bethesda, Maryland for \$12.2 million on which it is developing 140 apartment units and 6,898 square feet of commercial space. We have determined that this entity is not a VIE and that we hold a controlling interest in the entity. As such, this entity is included in our consolidated financial statements. We have also determined that the noncontrolling interest in this entity, which as of June 30, 2015 and 2014 was \$350,000, meets the criteria to be classified as a component of permanent equity.

## 8. EQUITY

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

	Six Months Ended June 30, 2015					
	Common Shares (at \$.10 stated value)	Paid-in Capital	Accumulated Distributions in Excess of Net Income	Accumulated Other Comprehensive Loss	Treasury Shares (at Cost)	Noncontrolling Interest
(In thousands)						
Balance, December 31, 2014	\$5,771	\$758,079	\$(114,551 )	\$(1,093 )	\$(980 )	\$350
Net income applicable to common shares	—	—	30,284	—	—	—
Other comprehensive income:						
Change in fair value of hedge instruments	—	—	—	875	—	—
Share-based compensation	—	1,931	1	—	1,237	—
Purchase of common shares	—	—	—	—	(1,187 )	—
Issuance of common shares	31	264	—	—	925	—
Common share dividends declared	—	—	(12,378 )	—	—	—
Balance, June 30, 2015	\$5,802	\$760,274	\$(96,644 )	\$(218 )	\$(5 )	\$350

## 9. EARNINGS PER SHARE

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

	Three Months Ended		Six Months Ended	
	June 30, 2015	2014	June 30, 2015	2014
(In thousands, except per share amounts)				
Numerator - basic and diluted:				
Net income	\$29,539	\$62,348	\$30,284	\$104,621
Allocation to participating securities	(73 )	(212 )	(75 )	(355 )
Net income applicable to common shares	\$29,466	\$62,136	\$30,209	\$104,266
Denominator - basic:	57,744	57,475	57,678	57,419
Effect of dilutive securities	602	444	607	457
Denominator - diluted:	58,346	57,919	58,285	57,876
Net income applicable to common shares - basic:				
Net income applicable to common shares - basic	\$0.51	\$1.08	\$0.52	\$1.82
Net income applicable to common shares - diluted:				
Net income applicable to common shares - diluted	\$0.51	\$1.07	\$0.52	\$1.80



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## 10. EQUITY BASED AWARD PLANS

During the three and six months ended June 30, 2015, we recognized share-based compensation cost of \$730,000 and \$2.0 million, respectively, in "General and administrative" expense in the Consolidated Statements of Operations and Comprehensive Income. During the three and six months ended June 30, 2014, we recognized share-based compensation cost of \$840,000 and \$2.2 million, respectively, in "General and administrative" expense in the Consolidated Statements of Operations and Comprehensive Income. Additionally, during the three and six months ended June 30, 2015, we capitalized \$160,000 and \$460,000, respectively, of share-based compensation related to time incurred on development projects. During the three and six months ended June 30, 2014, we capitalized \$120,000 and \$220,000, respectively, of share-based compensation related to time incurred on development projects. See Note 3 for additional information related to capitalized payroll.

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

The following table represents restricted share and DRSU activity for the six months ended June 30, 2015:

	Number of Restricted Shares	Weighted Average Grant-Date Fair Value	Number of DRSUs	Weighted Average Grant-Date Fair Value
Nonvested at beginning of period	702,860	\$10.31	45,365	\$17.06
Granted	108,156	\$24.84	13,249	\$24.27
Vested	142,136	\$18.33	26,865	\$18.73
Forfeited	10,280	\$10.98	1,192	\$17.46
Nonvested at end of period	658,600	\$10.95	30,557	\$18.70

The weighted average grant-date fair value of restricted shares granted during the six months ended June 30, 2014 was \$16.11. The total fair value of restricted shares vested during the six months ended June 30, 2015 and 2014 was \$3.5 million and \$3.2 million, respectively. The total fair value of DRSUs vested during the six months ended June 30, 2015 and 2014 was \$733,000 and \$462,000, respectively, recognized as "Paid-in capital." At June 30, 2015, there was a total of \$5.5 million of unrecognized compensation cost related to nonvested restricted share awards and DRSUs that we expect to recognize over a weighted average period of 1.9 years. See Note 14 for additional information related to the Agreement and Plan of Merger entered into by the the Company on April 22, 2015.

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

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

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

Stock Options. We use the Black-Scholes option pricing model to estimate the fair value of stock options awarded. There were no options awarded, 125,000 options exercised and no options forfeited during the six months ended June 30, 2015. There were no options awarded, 76,930 options exercised and 5,000 options forfeited during the six months ended June 30, 2014.

The following table represents stock option activity for the six months ended June 30, 2015:

	Number of Stock Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contract Life
Outstanding at beginning of period	360,376	\$11.29	
Exercised	125,000	\$9.58	
Outstanding at end of period	235,376	\$12.20	2.4
Exercisable at end of period	235,376	\$12.20	2.4

The aggregate intrinsic value of stock options outstanding and stock options exercisable at June 30, 2015 and 2014 was \$3.9 million and \$2.4 million, respectively.

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## 11. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

We utilize interest rate swaps, from time to time, to add stability to interest risk and to manage our exposure to interest rate movements.

As of June 30, 2015, the Company had the following outstanding interest rate derivatives that were designated as cash flow hedges:

Interest Rate Derivative	Number of Instruments	Notional Amount
Interest Rate Swaps	4	\$150.0 million

On January 30, 2015, we entered into a forward starting interest rate swap on \$25.0 million of our \$150 million unsecured term loan, fixing the rate beginning January 2016 at a rate of 1.42% per annum plus the credit spread, which was 1.40% per annum as of June 30, 2015, or an all-in rate of 2.82% per annum until the loan matures in January 2020. Additionally, on January 30, 2015, we entered into a forward starting interest rate swap on \$125.0 million of our \$150 million unsecured term loan, fixing the rate beginning January 2018 at a rate of 1.75% per annum plus the credit spread, which was 1.40% per annum as of June 30, 2015, or an all-in rate of 3.15% per annum, through the maturity date of January 2020. The credit spread is subject to change, from time to time, from a minimum of 0.90% per annum to a maximum of 1.90% per annum over LIBOR based upon our qualified ratings as defined in the agreement.

On April 2, 2013, we entered into a forward starting interest rate swap on \$125.0 million of our \$150 million unsecured term loan, fixing the rate beginning June 2, 2016 at a rate of 1.55% per annum plus the credit spread, which was 1.40% per annum as of June 30, 2015, or an all-in rate of 2.95% per annum until January 2018. The credit spread is subject to change, from time to time, from a minimum of 0.90% per annum to a maximum of 1.90% per annum over LIBOR based upon our qualified ratings as defined in the agreement.

On December 19, 2011, we entered into a forward starting interest rate swap effective June 7, 2013. This swap hedges the future cash flows of interest payments on \$125.0 million of our \$150 million unsecured term loan by fixing the rate until June 2016 at a rate of 1.26% per annum plus the credit spread, which was 1.40% per annum at June 30, 2015, or an all-in rate of 2.66% per annum. The credit spread is subject to change, from time to time, from a minimum of 0.90% per annum to a maximum of 1.90% per annum over LIBOR based upon our qualified ratings as defined in the agreement.

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

## Fair Value of Derivative Instruments

(In thousands)	Asset Derivatives As of June 30, 2015		As of December 31, 2014	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments:				
Interest rate swap	Other assets, net	\$ 1,354	Other assets, net	\$ 256

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## Fair Value of Derivative Instruments

(In thousands)	Liability Derivatives As of June 30, 2015		As of December 31, 2014	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments:				

Interest rate swap	Accounts payable and other liabilities	\$ 1,572	Accounts payable and other liabilities	\$ 1,349
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The following table presents the effect of our derivative financial instruments on the Consolidated Statements of Operations and Comprehensive Income:

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

(In thousands)	Location of Gain or (Loss) Recognized in Income on Derivative	Three Months Ended		Six Months Ended	
		June 30, 2015	2014	June 30, 2015	2014
Derivatives in Cash Flow Hedging Relationships (Interest Rate Swaps)	Amount of gain/(loss) recognized in OCI on derivative	\$ 670	\$(1,032 )	\$ 194	\$(1,439 )
Amount of loss reclassified from accumulated OCI into interest expense	Interest expense	\$(341 )	\$(349 )	\$(681 )	\$(693 )

Amount of gain/(loss) recognized in income on derivative (ineffective portion and amount excluded from effectiveness testing)	Other expense	\$—	\$—	\$—	\$—
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The following table presents the effect of offsetting financial assets and liabilities on the Consolidated Balance Sheets:  
Offsetting of Derivative Assets and Liabilities

(In thousands)	Gross Amounts of Recognized Assets/Liabilities	Gross Amounts Offset in the Balance Sheets	Net Amounts of Assets/Liabilities Presented in the Balance Sheets	Gross Amounts Not Offset in the Balance Sheets		
				Financial Instruments	Cash Collateral Received	Net Amount
June 30, 2015						
Offsetting Derivative						
Assets	\$ 1,354	\$—	\$ 1,354	\$—	\$—	\$ 1,354
Liabilities	\$ 1,572	\$—	\$ 1,572	\$—	\$—	\$ 1,572
December 31, 2014						
Offsetting Derivative						
Assets	\$ 256	\$—	\$ 256	\$—	\$—	\$ 256
Liabilities	\$ 1,349	\$—	\$ 1,349	\$—	\$—	\$ 1,349

As of June 30, 2015, the fair value of the derivative in a liability position, excluding any adjustment for nonperformance risk, was \$1.7 million. As of June 30, 2015, we have not posted any collateral related to this agreement. If we had breached any of the provisions in the agreement with our derivative counterparty at June 30, 2015, we could have been required to settle our obligations under the agreement at its termination value of \$1.7 million, which includes accrued interest of \$86,000. The expected amount of other comprehensive income to be

reclassified as earnings within the next twelve months is \$1.2 million.



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## 12. FAIR VALUE

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

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

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

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

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

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

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

We estimate the fair value of our mortgage notes payable by discounting the associated cash flows using the interest rates available to us as of the dates reported for issuance of debt with similar terms, remaining maturities and loan to value ratios, which ranged from 41% to 52% at June 30, 2015. We classify the fair value of our mortgage notes payable as Level 3.

We estimate the fair value of our unsecured debt by discounting the associated cash flows using the interest rates available to us as of the dates reported for issuance of debt with similar terms and remaining maturities. We classify the fair value of our unsecured debt as Level 2.

	Carrying Value	Fair Value at June 30, 2015 Using Quoted Prices in Active Markets		
		for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(In thousands)				
Mortgage notes payable	\$288,355	\$—	\$—	\$307,558
Unsecured debt	\$536,000	\$—	\$541,524	\$—

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	Carrying Value	Fair Value at December 31, 2014 Using Quoted Prices in Active Markets		
		for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(In thousands)				
Mortgage notes payable	\$272,613	\$—	\$—	\$283,728
Unsecured debt	\$476,500	\$—	\$489,558	\$—

## 13. CONTINGENCIES

## Legal Proceedings

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

On February 19, 2013 (the scheduled trial date for our unlawful detainer suit), Tenant filed its Chapter 11 petition with the U.S. Bankruptcy Court (the "Bankruptcy Court") for the Central District of California.

On March 29, 2013, Tenant filed a motion to assume the Lease. We opposed Tenant's lease assumption motion. On September 12, 2013, the Bankruptcy Court granted Tenant's motion to assume the Lease. We appealed the Bankruptcy Court's order granting Tenant's motion to assume the Lease to the U.S. District Court for the Central District of California (the "District Court"). On December 2, 2013, the District Court ruled in our favor and held the Bankruptcy Court had erred when it concluded the Lease had not been terminated prior to the date Tenant filed its Chapter 11 petition. Tenant appealed the District Court's decision to the U.S. Court of Appeals for the Ninth Circuit. The District Court remanded the case back to the Bankruptcy Court for further proceedings consistent with the District Court's determination. On October 27, 2014, the Bankruptcy Court, on the matter remanded by the District Court, denied Tenant's lease assumption motion. Tenant has appealed the Bankruptcy Court's decision, and petitioned the Bankruptcy Court for a stay pending the outcome of Tenant's appeals. On December 29, 2014, the Bankruptcy Court granted Tenant's motion for stay pending the appeals, which stayed the effect of the Bankruptcy Court's denial of Tenant's lease assumption motion, including the requirement that Tenant surrender the Property.

If we conclude, based on the outcome of this proceeding, that it is unlikely Tenant will remain at the Property, we will accelerate the amortization of the remaining intangible asset associated with the Lease at that time. The intangible asset is being amortized over the initial five-year term of the Lease, beginning May 2012, and had a balance of \$700,000 at June 30, 2015. In addition, we may be required to refund to Tenant the \$630,000 cure payment Tenant paid to us in connection with its assumption of the lease.

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

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Guarantees

On April 25, 2014, the 350 8th partnership, in which we are a 50.01% partner and that we account for under the equity method, entered into a construction loan agreement for \$143.6 million with a five-year term. We have guaranteed the payment of all current and future borrowings from this loan and the completion of construction in connection with the partnership's development. We have determined that the fair value of these guarantees are immaterial and thus have not recorded any liability as of June 30, 2015.

14. PLAN OF MERGER

On April 22, 2015, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") by and among the Company, BSREP II Aries Pooling LLC, a Delaware limited liability company ("Brookfield"), and BSREP II Aries DE Merger Sub Inc., a Delaware corporation and a wholly owned subsidiary of Brookfield ("Merger Sub"). Pursuant to the terms of the Merger Agreement, Merger Sub will be merged with the Company (the "Merger").

Pursuant to the Merger Agreement:

each common share of the Company ("Company Common Shares") issued and outstanding at the effective time of the Merger (the "Effective Time"), other than Company Common Shares held (a) in the treasury of the Company, (b) by Brookfield or any subsidiary of Brookfield or (c) shareholders who have effectively exercised dissenter's rights, will be canceled and extinguished and converted into the right to receive \$28.75 in cash (the "Per Share Merger Consideration"), without interest;

each option to purchase Company Common Shares ("Option") that is outstanding and unexercised at the Effective Time (whether vested or unvested) will become fully vested and be cancelled, extinguished and converted into the right of the holder to receive an amount in cash, without interest, equal to the product of (i) the total number of Company Common Shares issuable upon exercise of such Option and (ii) the excess, if any, of the Per Share Merger Consideration over the exercise price per share of such Option;

each share of restricted stock granted under any Company equity plan ("Restricted Share") that is outstanding immediately before the Effective Time (whether vested or unvested, and including restricted stock granted as dividends) will, as of immediately before the Effective Time, become vested and will be treated as an outstanding Company Common Share that will be canceled and extinguished and converted into the right to receive the Per Share Merger Consideration, without interest; to the extent the performance period relating to any Restricted Share that remains subject to performance-based vesting criteria ("Performance Restricted Share") has not expired as of the Effective Time, the Performance Restricted Share will vest in that number of Company Common Shares determined as if the applicable performance-based vesting criteria had been achieved at the maximum level; to the extent the performance period relating to any Performance Restricted Share has expired as of the Effective Time, the Performance Restricted Share will vest in that number of Company Common Shares determined at the end of the performance period based on actual performance through the end of the performance period;

any accrued but unpaid dividends and any interest earned thereon as of the Effective Time attributed to Performance Restricted Shares granted under any Company equity plan will be paid in cash to such holder promptly following the Effective Time;

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all equity-based awards deferred under any Company deferred compensation plan, and accounts that represent amounts notionally invested in Company Common Shares in the Directors' Deferred Compensation Plan, will become vested and no longer subject to restrictions, and will be adjusted and converted into the right to have the account credited with an amount denominated in cash equal to the product of (i) the total number of Company Common Shares deemed invested under or otherwise referenced by such account and (ii) the Per Share Merger Consideration, reduced to the extent applicable, but not below zero, by the exercise price applicable to such award(s).

Each of Brookfield and the Company has made customary representations and warranties in the Merger Agreement. Each of Brookfield and the Company has agreed to use reasonable best efforts to cause the Merger to be consummated. The Company has also agreed to various covenants in the Merger Agreement, including, among other things, (i) to conduct its business in the ordinary course consistent with past practice during the period between the execution of the Merger Agreement and the closing of the Merger, (ii) to call a special meeting of the shareholders to adopt the Merger Agreement and (iii) not to solicit alternative acquisition proposals.

The Merger Agreement includes a “no-shop” provision that restricts the Company’s ability to solicit alternative acquisition proposals, and to provide information or engage in discussions with third parties. The no-shop provision is subject to a “fiduciary-out” provision that allows the Company, under certain circumstances, to provide information and participate in discussions with respect to unsolicited alternative acquisition proposals.

The Merger Agreement contains certain termination rights for both the Company and Brookfield. Upon termination under specified circumstances, the Company would be required to pay Brookfield a termination fee of \$60 million. Further, if the Merger Agreement is terminated due to shareholder adoption of the Merger Agreement having not been obtained at the special meeting of the Company’s shareholders called for that purpose, the Company will be required to reimburse Brookfield for transaction expenses in the amount of \$20 million. The Company’s reimbursement of Brookfield’s expenses would be credited against any termination fee that may become payable by Company.

Brookfield has obtained equity and debt financing commitments for the transactions contemplated by the Merger Agreement. The aggregate proceeds of the equity commitment will be sufficient to fully finance the Merger and the other transactions contemplated thereby. Consummation of the Merger is not subject to a financing condition, but is subject to customary conditions to closing, including the adoption of the Merger Agreement by the Company’s shareholders. The affirmative vote of a majority of the Company’s outstanding shares is required to adopt the Merger Agreement.

The Company is entitled to seek specific performance against Brookfield and Merger Sub in order to enforce their respective obligations under the Merger Agreement. The Company is also a named third party beneficiary of the equity commitment. In addition, Brookfield’s liability for any breaches of the Merger Agreement, up to the aggregate Per Share Merger Consideration amount, is guaranteed by certain affiliates of Brookfield.

The Board of Directors of the Company (the “Board of Directors”) unanimously approved the Merger Agreement on April 21, 2015. On April 21, 2015, Citigroup Global Markets Inc. rendered a written opinion to the Board of Directors that, as of the date of such opinion, the consideration to be offered to the shareholders of the Company in the Merger is fair, from a financial point of view, to such shareholders. A special meeting at which shareholders will have the opportunity to vote their shares to adopt the Merger Agreement is scheduled for August 5, 2015.

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15. GENERAL AND ADMINISTRATIVE

Included in "General and Administrative" during the three and six months ended June 30, 2015 are shareholder activism and merger related costs. During the three and six months ended June 30, 2015, we recognized shareholder activism costs of \$561,000 and \$1.7 million, respectively. During the three and six months ended June 30, 2015, we recognized merger related costs of zero and \$2.0 million, respectively.

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

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included in Part I, Item 1 of this report on Form 10-Q, as well as Part I, Item 1A, "Risk Factors," of the Company's Annual Report of Form 10-K for the year ended December 31, 2014. This discussion may contain forward-looking statements based on current judgments and current knowledge of management, which are subject to certain risks, trends and uncertainties that could cause actual results to vary from those projected, including but not limited to, expectations regarding our 2015 performance that are based on certain assumptions. Accordingly, readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date of this report. These forward-looking statements are intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The words "expects," "projects," "believes," "plans," "anticipates" and similar expressions are intended to identify forward-looking statements. Investors are cautioned that these forward-looking statements involve risks and uncertainty that could cause actual results to differ from estimates or projections contained in these forward-looking statements, including without limitation the following:

changes in the economic climate in the markets in which we own and manage properties, including interest rates, the overall level of economic activity, the availability of consumer credit and mortgage financing, unemployment rates and other factors;

elimination of, or limitations on, federal government support for Fannie Mae and/or Freddie Mac that may result in significantly reduced availability of mortgage financing sources, as well as increases in interest rates for mortgage financing;

our ability to refinance debt on favorable terms at maturity;

risks of a lessening of demand for the multifamily units we own;

competition from other available multifamily units, single family units available for rental or purchase, and changes in market rental rates;

- the failure of development projects or redevelopment activities to achieve expected results due to, among other causes, construction and contracting risks, unanticipated increases in materials and/or labor, delays in project completion and/or lease-up that result in increased costs and/or reduce the profitability of a completed project, and the absence of our right to control all activities and decisions of joint venture developments where the applicable agreement allocate decision making authority to, or require the consent of, our joint venture partner;

the failure to enter into development joint venture arrangements on acceptable terms;

increases in property and liability insurance costs;

unanticipated increases in real estate taxes and other operating expenses;

weather conditions that adversely affect operating expenses;

expenditures that cannot be anticipated, such as utility rate and usage increases and unanticipated repairs;

our inability to control operating expenses or achieve increases in revenue;

shareholder ownership limitations that may discourage a takeover otherwise considered favorable by shareholders;

the cost, disruption and diversion of management's attention associated with campaigns commenced by activist

investors seeking to influence the Company to take particular actions favored by the activist or gain representation on our Board of Directors;

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information security breaches and other disruptions that could compromise our information or expose us to business interruption;

the results of litigation involving us;

changes in tax legislation;

risks of personal injury and property damage claims that are not covered by our insurance;

catastrophic property damage losses that are not covered by our insurance;

risks associated with property acquisitions, such as failure to achieve expected results or matters not discovered in due diligence;

risks related to the perception of residents and prospective residents as to the attractiveness, convenience and safety of our properties or the neighborhoods in which they are located;

failure of the Company's shareholders to approve the Merger;

risks, liabilities and costs associated with the failure to consummate the Merger in accordance with the Merger Agreement; and

those risk factors and special considerations set forth in the documents the Company files from time to time with the SEC.

OVERVIEW

We are engaged primarily in the ownership and operation of multifamily apartment units. Our subsidiary, Merit, is a construction manager that acts as our in-house construction management division. Our primary source of cash and revenue from operations is rental payments from the leasing of apartment units, which represented substantially all of our consolidated revenue for the six months ended June 30, 2015 and June 30, 2014.

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

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

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## LIQUIDITY AND CAPITAL RESOURCES

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

(In thousands)	Six Months Ended	
	June 30, 2015	2014
Net cash flow provided by operating activities	\$35,878	\$35,153
Fixed assets:		
Recurring, revenue enhancing and non-recurring fixed asset additions	(8,598	) (4,899
Acquisition and development fixed asset additions	(111,302	) (73,994
Acquisition of unconsolidated entity	(8,316	) —
Net proceeds from disposition of operating properties	47,994	168,756
Contributions to joint ventures	(13,384	) (5,636
Cash proceeds from sale of equity interest in development property	—	24,075
Escrow deposits related to property sales	(32,100	) (72,292
Escrow disbursements related to property acquisitions	43,295	52,414
Debt:		
Increase (decrease) in mortgage notes payable and construction loans, net	16,120	(297
Increase (decrease) in unsecured revolving credit facility borrowings, net	59,500	(97,500
Common share dividends paid	(24,037	) (22,579
Purchase of treasury shares	(1,187	) (999

Our primary sources of liquidity are cash flow provided by operations, short-term borrowings on our unsecured revolving credit facility, project-specific loans and the sale of debt or equity securities. We have one scheduled debt maturity for 2015, a mortgage loan totaling approximately \$19.4 million. We intend to repay this loan from one or more of the following sources: borrowings on our unsecured revolving credit facility or proceeds from property sales. The maximum amount of borrowings available to us under the unsecured revolving credit facility is \$350 million and, as of July 27, 2015, there were outstanding borrowings of \$133.0 million on this facility. We were in compliance with the covenants of our debt instruments at June 30, 2015.

On January 30, 2015, we entered into a forward starting interest rate swap on \$25.0 million of our \$150 million unsecured term loan, fixing the rate beginning January 2016 at a rate of 1.42% per annum plus the credit spread, which was 1.40% per annum as of June 30, 2015, or an all-in rate of 2.82% per annum until the loan matures in January 2020. Additionally, on January 30, 2015, we entered into a forward starting interest rate swap on \$125.0 million of our \$150 million unsecured term loan, fixing the rate beginning January 2018 at a rate of 1.75% per annum plus the credit spread, which was 1.40% per annum as of June 30, 2015, or an all-in rate of 3.15% per annum, through the maturity date of January 2020. The credit spread is subject to change, from time to time, from a minimum of 0.90% per annum to a maximum of 1.90% per annum over LIBOR based upon our qualified ratings as defined in the agreement.

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



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Cash flow provided by operations increased 2.1% during the six months ended June 30, 2015, compared to the six months ended June 30, 2014, as a result of changes in accounts payable due to the timing of payments.

During the remainder of 2015, we anticipate incurring approximately \$11.3 million in additional capital expenditures for replacements and improvements at our operating properties. This includes replacement of worn carpet and appliances and refurbishing parking lots and similar items in accordance with our current property expenditure plan, as well as commitments for investment/revenue enhancing and non-recurring expenditures, including \$1.5 million for in-unit upgrades throughout the portfolio. We expect to use cash provided by operating activities to pay for these expenditures.

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

(In thousands)	2015	2014	Variance
Recurring fixed asset additions	\$5,263	\$4,203	\$1,060
Revenue enhancing/non-recurring fixed asset additions	3,335	696	2,639
Acquisition fixed asset additions <sup>(1)</sup>	82,330	46,385	35,945
Acquisition of unconsolidated entity <sup>(2)</sup>	8,316	—	8,316
Development fixed asset additions:			
Internal costs	2,000	1,600	400
Capitalized interest	2,700	2,200	500
Land and other development costs	24,272	23,809	463
Total development fixed asset additions	\$28,972	\$27,609	\$1,363
Total fixed asset additions	\$128,216	\$78,893	\$49,323

The increase in acquisition fixed asset additions in 2015 compared to 2014 is primarily due to the acquisition of (1) 1160 Hammond on March 2, 2015 for \$80.4 million compared to the acquisition of Alpha Mill Phase I and II on June 10, 2014 for \$45.1 million.

The increase in acquisition of unconsolidated entity in 2015 compared to 2014 is due to the purchase of our (2) partner's 50.0% interest in 5th and Huntington for \$8.4 million, increasing our ownership percentage in the development to 100%. See Note 3 in part I, Item 1 of this report on Form 10-Q, "Acquisition, Development and Disposition Activity" for additional information.

## Development

On February 3, 2014, we entered into a partnership agreement with AIG for the development and operation of 350 8th, a 410-unit apartment community with 40,000 square feet commercial space and underground parking located in the SoMa neighborhood of San Francisco, California. We are a 50.01% partner with AIG, which has contributed \$46.1 million to the partnership. The land upon which the partnership is being developed was purchased by us for \$46.6 million on May 28, 2013. As of December 31, 2013, this land was included in our consolidated financial statements. Upon the formation of our partnership with AIG, the land and improvements to date, with a carrying value of \$50.3 million, were deconsolidated. On April 25, 2014, the partnership entered into a construction loan agreement for \$143.6 million with a five-year term. We have guaranteed the payment of all current and future borrowings from this loan and the completion of construction in connection with the partnership's development. Our strategy with respect to this entity is to reduce the overall financial risk related to the development of the property. However, we do not believe that this investment has a materially different impact upon our liquidity, cash flows, capital resources, credit or market risk than the other consolidated development activities. See Note 6 in part I, Item 1 of this report on Form 10-Q for additional information.

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During the year ended December 31, 2013, we entered into a partnership agreement with an unrelated third-party for the limited purpose of acquiring a property in Monrovia, California, known as 5th and Huntington, and to produce construction drawings for improvements to the property. The land, upon which the partnership planned to develop a 154-unit multifamily apartment community, was purchased by the partnership on August 9, 2013 for \$13.1 million. We held a 50.0% equity interest in the partnership, which was accounted for under the equity method. On February 3, 2015, we purchased our partner's 50.0% interest in 5th and Huntington for \$8.4 million, increasing our ownership percentage in the development to 100%.

**RESULTS OF OPERATIONS**

Comparison of the three and six months ended June 30, 2015 to the three and six months ended June 30, 2014: Our Same Community portfolio represents operating properties that we owned for all of the comparison periods. Acquired Properties are added to our Same Community portfolio after they have been owned for all of the comparison periods. Development Properties are added to our Same Community portfolio after they have been stabilized for all of the comparison periods. We consider a property to be stabilized when it has reached 93% occupancy. For the three and six-month comparison periods ended June 30, 2015 and 2014, the Same Community portfolio consisted of 46 owned properties containing 11,686 units. In 2015, the five properties we acquired in 2013 (Doral West, Rienzi at Turtle Creek, The Apartments at Blakeney, St. Mary's Square and Lofts at Weston Lakeside), containing 1,184 units in total, moved into the Same Community portfolio from the Acquired/Development Properties portfolio. Properties that are sold or considered held for sale are removed from the Same Community portfolio at that time. Acquired and Development Properties for the three and six-month comparison periods ended June 30, 2015 and 2014 include one property acquired in 2015, one property acquired in 2014, a 99-unit expansion in Dallas, Texas that was completed during the fourth quarter of 2013 and stabilized during the first quarter of 2014, a 249-unit development in Dallas, Texas that was completed during the first quarter of 2015 and a 140-unit development in Bethesda, Maryland that was completed during the second quarter of 2015.

Net income for the three months ended June 30, 2015, decreased \$32.8 million to \$29.5 million when compared to the \$62.3 million of net income recognized for the three months ended June 30, 2014. This change was primarily due to a decrease of \$29.9 million on gain on disposition of properties in the three months ended June 30, 2015 compared to the three months ended June 30, 2014. Net income for the six months ended June 30, 2015, decreased \$74.3 million to \$30.3 million when compared to the \$104.6 million of net income recognized for the six months ended June 30, 2014. This change was primarily due to a decrease of \$70.8 million on gain on disposition of properties in the six months ended June 30, 2015 compared to the six months ended June 30, 2014.

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

(Dollar amounts in thousands)	Increase (Decrease) When Comparing the Three Months Ended June 30,		Increase (Decrease) When Comparing the Six Months Ended June 30,		
	2015	2014	2015	2014	
Property revenue	\$1,046	2.2	% \$(786	) (0.8	)%
Property operating and maintenance expenses	1,030	5.7	% 573	1.5	%
Depreciation and amortization	856	5.4	% 496	1.5	%
General and administrative expenses	2,376	51.7	% 3,576	36.1	%
Interest expense	(170	) (2.6	)% (1,010	) (7.5	)%
Gain on change in control	—	—	% 444	100.0	%
Gain on disposition of properties	(29,882	) (49.9	)% (70,848	) (70.2	)%

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We use property NOI as a measure of the results of our properties' activities. We believe the changes in property NOI can help explain how the properties' activities influenced our results of operations. Property NOI is determined by deducting property operating and maintenance expenses from property revenue. We consider property NOI to be an appropriate supplemental measure of our performance because it reflects the operating performance of our property portfolio and is used to assess regional property level performance. Property NOI should not be considered (i) as an alternative to net income determined in accordance with GAAP, (ii) as an indicator of financial performance, (iii) as cash flow from operating activities (determined in accordance with GAAP), or (iv) as a measure of liquidity, nor is it necessarily indicative of sufficient cash flow to fund all of our needs. Other real estate companies may define property NOI in a different manner.

A reconciliation of property NOI to net income is as follows:

(In thousands)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2015	2014	2015	2014
Property NOI	\$29,152	\$29,136	\$57,558	\$58,917
Commercial revenue	580	455	1,192	933
Property management and construction services revenue, net	59	146	170	177
Depreciation and amortization	(16,741)	(15,885)	(32,676)	(32,180)
General and administrative expenses	(6,972)	(4,596)	(13,491)	(9,915)
Development costs	(133)	(198)	(332)	(528)
Costs associated with acquisitions	(11)	(27)	(73)	(113)
Interest expense	(6,417)	(6,587)	(12,530)	(13,540)
Gain on change in control	—	—	444	—
Gain on disposition of properties	30,022	59,904	30,022	100,870
Net income	\$29,539	\$62,348	\$30,284	\$104,621

Property NOI remained flat for the three months ended June 30, 2015 while it decreased for the six months ended June 30, 2015 due to fewer operating properties owned as of June 30, 2015 compared to June 30, 2014, partially offset by increased Same Community property operating revenue.

The following table presents property NOI results by region:

(In thousands)	Property NOI			Property NOI		
	Three Months Ended		Increase/ (Decrease)	Six Months Ended		Increase/ (Decrease)
	June 30,	2014		June 30,	2014	
Same Community Properties:						
Midwest	\$10,153	\$9,909	\$244	\$20,010	\$19,519	\$491
Mid-Atlantic	10,810	10,901	(91)	21,192	21,186	6
Southeast	4,522	3,999	523	8,917	7,991	926
Southwest	1,943	2,021	(78)	3,942	4,057	(115)
Total Same Community	27,428	26,830	598	54,061	52,753	1,308
Acquired Properties	994	102	892	1,711	104	1,607
Development Properties <sup>(1)</sup>	478	123	355	626	309	317
Dispositions	252	2,081	(1,829)	1,160	5,751	(4,591)
Total Property NOI	\$29,152	\$29,136	\$16	\$57,558	\$58,917	\$(1,359)

The three and six months ended June 30, 2015 and June 30, 2014 reflect a 99-unit expansion in Dallas, Texas that was completed in 2013 and stabilized in 2014, a 249-unit development in Dallas, Texas that was completed during the first quarter of 2015 and a 140-unit development in Bethesda, Maryland that was completed during the second quarter of 2015.



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Property Revenue. Property revenue is impacted by a combination of rental rates, fees and occupancy levels, i.e., property revenue per occupied unit. Average occupancy for each period and property revenue per occupied unit are presented in the following tables:

	Average Occupancy <sup>(1)</sup> Three Months Ended June 30,		Average Occupancy <sup>(1)</sup> Six Months Ended June 30,	
	2015	2014	2015	2014
Same Community Properties:				
Midwest	96.3%	96.5%	95.7%	96.4%
Mid-Atlantic	96.0%	96.4%	95.9%	96.0%
Southeast	95.8%	95.2%	95.5%	95.8%
Southwest	93.5%	96.0%	93.9%	96.2%
Total Same Community	95.9%	96.2%	95.5%	96.1%
Acquired Properties	70.4%	63.2%	68.3%	63.2%
Development Properties <sup>(2)</sup>	96.3%	98.0%	96.0%	90.8%
Total	94.4%	95.5%	94.0%	95.3%

(1) Average occupancy is defined as the average number of units occupied during the period divided by total number of units.

The three and six months ended June 30, 2015 and June 30, 2014 reflect a 99-unit expansion in Dallas, Texas that (2) was completed in 2013 and stabilized in 2014. We have excluded our 249-unit Cantabria and our 140-unit 7001 Arlington development, which have not yet reached stabilization as of June 30, 2015.

	Monthly Property Revenue Per Occupied Unit Three Months Ended June 30,		Monthly Property Revenue Per Occupied Unit Six Months Ended June 30,	
	2015	2014	2015	2014
Same Community Properties:				
Midwest	\$1,105	\$1,072	\$1,100	\$1,064
Mid-Atlantic	\$1,458	\$1,441	\$1,453	\$1,438
Southeast	\$1,572	\$1,481	\$1,565	\$1,472
Southwest	\$1,459	\$1,424	\$1,456	\$1,417
Total Same Community	\$1,316	\$1,279	\$1,311	\$1,273
Acquired Properties	\$1,480	\$1,379	\$1,480	\$1,379
Development Properties <sup>(1)</sup>	\$1,310	\$1,156	\$1,292	\$1,712
Total	\$1,324	\$1,280	\$1,319	\$1,279

The three and six months ended June 30, 2015 and June 30, 2014 reflect a 99-unit expansion in Dallas, Texas that (1) was completed in 2013 and stabilized in 2014. We have excluded our 249-unit Cantabria and our 140-unit 7001 Arlington development, which have not yet reached stabilization as of June 30, 2015.

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The following table presents property revenue results:

(In thousands)	Property Revenue Three Months Ended			Property Revenue Six Months Ended		
	June 30, 2015	2014	Increase/ (Decrease)	June 30, 2015	2014	Increase/ (Decrease)
Same Community Properties:						
Midwest	\$16,776	\$16,299	\$477	\$33,180	\$32,328	\$852
Mid-Atlantic	15,914	15,792	122	31,686	31,397	289
Southeast	7,451	6,975	476	14,781	13,946	835
Southwest	4,066	4,074	(8	) 8,152	8,125	27
Total Same Community	44,207	43,140	1,067	87,799	85,796	2,003
Acquired Properties	1,914	162	1,752	3,127	162	2,965
Development Properties <sup>(1)</sup>	1,482	337	1,145	2,353	628	1,725
Dispositions	711	3,629	(2,918	) 2,352	9,831	(7,479
Total Property Revenue	\$48,314	\$47,268	\$1,046	\$95,631	\$96,417	\$(786

The three and six months ended June 30, 2015 and June 30, 2014 reflect a 99-unit expansion in Dallas, Texas that was completed in 2013 and stabilized in 2014, a 249-unit development in Dallas, Texas that was completed during the first quarter of 2015 and a 140-unit development in Bethesda, Maryland that was completed during the second quarter of 2015.

The increase in Same Community property revenue was due to increased rental revenue as a result of an increase in overall monthly property revenue per occupied unit (net rent less vacancies) in 2015 compared to 2014. All regions except the Southwest produced improved property revenue as noted above.

Property Operating and Maintenance Expenses. The property operating and maintenance expenses increases during the three and six months ended June 30, 2015 compared to the three and six months ended June 30, 2014 were primarily due to increases in real estate taxes in the Mid-Atlantic, Acquired and Development, offset by the impact of properties that were sold.

Depreciation and Amortization. The depreciation and amortization expense increases during the three and six months ended June 30, 2015 compared to the three and six months ended June 30, 2014 were primarily due to increased depreciation related to the Acquired and Development properties offset by fewer sold properties in the current year. This amount was partially offset by decreased intangible asset amortization. This decrease relates to the timing of acquisitions, where we had one Acquired Property and one commercial lease with an amortizing intangible asset during the three and six months ended June 30, 2015 compared to five Acquired Properties and one commercial lease with amortizing intangible assets during the three and six months ended June 30, 2014.

General and Administrative Expenses. General and administrative expenses increased during the three and six months ended June 30, 2015 compared to the three and six months ended June 30, 2014 primarily due to shareholder activism and merger related costs. In the three months ended June 30, 2015 and March 31, 2015, we recognized shareholder activism costs of \$561,000 and \$1.1 million, respectively. In the three months ended June 30, 2015 and March 31, 2015, we recognized merger related costs of \$2.0 million and zero, respectively.

Interest Expense. Interest expense decreased primarily due to the payoff of three mortgages during the year ended December 31, 2014 as well as increased capitalized interest expense during three and six months ended June 30, 2015.

Gain on Change in Control. The corresponding increase of \$444,000 in gain on change in control during the six months ended June 30, 2015 reflects the gain from the acquisition of our joint venture partner's interest in 5th and Huntington that was recognized in the three months ended March 31, 2015.

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Gain on Disposition of Properties. The decrease of \$29.9 million in gain on disposition of properties in the three months ended June 30, 2015 reflects the gain from the sale of two operating properties during the three months ended June 30, 2015 compared to the gain from the sale of three operating properties during the three months ended June 30, 2014. The decrease of \$70.8 million in gain on disposition of properties in the six months ended June 30, 2015 reflects the gain from the sale of two operating properties during the six months ended June 30, 2015 compared to the gain from the sale of four operating properties during the three months ended June 30, 2014.

We also use FFO, a non-GAAP financial measure, as a measure of our results of operations. We calculate FFO in accordance with the definition adopted by the Board of Governors of the National Association of Real Estate Investment Trusts. This definition includes all operating results, both recurring and non-recurring, except those results defined as "extraordinary items" under GAAP, adjusted for depreciation on real estate assets, amortization of intangible assets and amortization of lease up costs for development properties, and excludes impairment write-downs of depreciable real estate and gains and losses from the disposition of previously depreciated real estate. We calculate FFO per share using the weighted average shares outstanding amounts used in the calculation of basic and diluted earnings per share in accordance with GAAP. FFO does not represent cash generated from operating activities in accordance with GAAP, is not necessarily indicative of cash available to fund cash needs and should not be considered an alternative to net income as an indicator of our operating performance or as an alternative to cash flow as a measure of liquidity. FFO is used in the real estate industry as a supplemental measure of the operating performance of real estate companies because it excludes charges such as real estate depreciation that are generally considered not to be reflective of the actual value of real estate assets over time. Operating FFO is FFO, as defined above, adjusted for certain corporate transactions to provide an amount that is more representative of the operations of our real estate portfolio. Other real estate companies may define FFO in a different manner.

A reconciliation of net income to FFO and Operating FFO is as follows:

(In thousands, except per share amounts)	Three Months Ended		Six Months Ended	
	June 30, 2015	2014	June 30, 2015	2014
Net income	\$29,539	\$62,348	\$30,284	\$104,621
Depreciation - real estate assets	15,837	14,351	30,980	29,146
Amortization of intangible assets	290	1,008	456	1,982
Gain on disposition of properties	(30,022 )	(59,904 )	(30,022 )	(100,870 )
Funds from operations (FFO), applicable to AERC	\$15,644	\$17,803	\$31,698	\$34,879
Shareholder activism and merger costs	2,540	—	3,653	—
Gain on change in control	—	—	(444 )	—
Operating funds from operations (Operating FFO), applicable to AERC	\$18,184	\$17,803	\$34,907	\$34,879
Funds from operations per common share - basic	\$0.27	\$0.31	\$0.55	\$0.61
Funds from operations per common share - diluted	\$0.27	\$0.31	\$0.54	\$0.60
Operating funds from operations per common share - basic	\$0.31	\$0.31	\$0.61	\$0.61
Operating funds from operations per common share - diluted	\$0.31	\$0.31	\$0.60	\$0.60

Weighted average shares outstanding - basic	57,744	57,475	57,678	57,419
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Weighted average shares outstanding - diluted	58,346	57,919	58,285	57,876
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**CONTINGENCIES**

For a discussion of contingencies, see Note 13 in Part I, Item 1 of this report on Form 10-Q.





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

We are exposed to interest rate changes associated with variable rate debt and the refinancing risk on our fixed rate debt. Based on our variable rate debt outstanding at June 30, 2015 and 2014, an interest rate change of 100 basis points would impact interest expense by approximately \$2.0 million and \$900,000 on an annual basis, respectively. We occasionally use derivative instruments to manage our exposure to interest rates. See Note 11 in Part I, Item 1 of this report on Form 10-Q for additional information regarding derivative instruments and "Item 7A, Qualitative and Quantitative Disclosures About Market Risk" of our Annual Report on Form 10-K for the year ended December 31, 2014, for a more complete discussion of interest rate sensitive assets and liabilities.

**ITEM 4. CONTROLS AND PROCEDURES**

**Disclosure Controls and Procedures.** We evaluated the design and operation of our disclosure controls and procedures to determine whether they are effective in ensuring the disclosure of required information is made timely in accordance with the Securities Exchange Act of 1934 ("Exchange Act") and the rules and forms of the SEC using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in "Internal Control - Integrated Framework (2013)." This evaluation was made under the supervision and with the participation of management, including our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), as of the end of the period covered by this report on Form 10-Q. The CEO and CFO have concluded, based on their review, that our disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e), as of the end of period covered by this report on Form 10-Q, were effective to ensure that information required to be disclosed in reports that we file under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) accumulated and communicated to management, including the CEO and CFO, as appropriate, to allow timely decisions regarding disclosure.

**Changes in Internal Control over Financial Reporting.** There were no changes in our internal control over financial reporting during the second quarter of 2015 that materially affected or are reasonably likely to materially affect, our internal control over financial reporting.

We believe that because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

Two putative class action and shareholder derivative lawsuits, captioned Cutler v. Friedman, et al., No. 1:15-cv-00857, and Berkman v. Friedman, et. al., No. 1:15-cv-00928, were filed in the United States District Court for the Northern District of Ohio in connection with the announcement of the Merger. Two putative class action and shareholder derivative lawsuits, captioned Witkowski v. Associated Estates Realty Corp., et. al., No. CV 15 845978, and Kessler v. Associated Estates Realty Corp., et al., No. CV 15 845987, also were filed in the Court of Common Pleas of Cuyahoga County, Ohio. The lawsuits, filed by purported shareholders of the Company, challenge the proposed Merger and allege, among other things, that the Company's directors breached their fiduciary duties to shareholders by engaging in a flawed sale process, agreeing to a transaction price that does not adequately compensate shareholders, and agreeing to certain unfair deal protection terms. The complaints also allege that Parent and Merger Sub have aided and abetted the directors' breaches of fiduciary duties. Among other things, the shareholder litigation seeks to enjoin the Merger.

The two District Court actions were consolidated by order of the Court dated July 2, 2015, and the consolidated action is now governed by an amended complaint that includes, in addition to the fiduciary duty and aiding and abetting claims, claims against all defendants for violation of disclosure requirements of federal proxy law and rules, specifically sections 14(a) and 20(a) of the Exchange Act and associated SEC Rule 14a-9.

We believe that the shareholder litigation and the underlying claims are without merit.

On July 24, 2015, counsel for the parties in the above-described lawsuits entered into a Memorandum of Understanding (the "MOU"), in which they agreed on the terms of a settlement that would dispose of all actions in both federal and state courts, including the dismissal with prejudice of the actions and a release of all claims made therein against all defendants. The proposed settlement is conditioned upon, among other things, the execution of an appropriate stipulation of settlement, consummation of the Merger, and final court approval of the proposed settlement following notice and hearing. In addition, in connection with the settlement and as provided in the MOU, the parties contemplate that plaintiffs' counsel will seek an award of attorneys' fees and expenses as part of the settlement. There can be no assurance that the Merger will be consummated, that the parties ultimately will enter into a stipulation of settlement, or that the settlement will receive court approval even if the parties enter into such stipulation. If the settlement conditions are not met, the proposed settlement as contemplated by the MOU would become void. The settlement will not affect the amount of the Merger consideration that the Company's stockholders are entitled to receive in the Merger.

For other information related to legal proceedings, see Note 13 in Part I, Item 1 of this report on Form 10-Q.

**ITEM 1A. RISK FACTORS**

See Part I, Item 2 of this report on Form 10-Q for changes to the "Risk Factors" disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2014.

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## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

## Issuer Purchases of Equity Securities for the Three Months Ended June 30, 2015

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased As Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs (in thousands) <sup>(1)</sup>
April 1 through April 30	589	\$24.79	—	\$26,288
May 1 through May 31	73	28.52	—	26,288
June 1 through June 30	190	28.58	—	26,288
Total	852	<sup>(2)</sup> \$25.95	—	

There is a total of \$26.3 million remaining on our Board of Director authorizations to repurchase our common (1) shares. We did not repurchase any common shares using this authority during the three months ended June 30, 2015, and we have no present intention to use this authority to repurchase shares.

We have a policy that allows employees to pay their portion of the income taxes related to restricted shares vesting (2) by surrendering a number of shares to us equal in value on the day of vesting to the amount of taxes due up to the statutory withholding amount. All shares repurchased during the three months ended June 30, 2015, were purchased in connection with that policy.

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ITEM 6. EXHIBITS

Number	Title	Filed herewith or incorporated herein by reference
2.1	Agreement and Plan of Merger.	Exhibit 2.1 to Form 8-K Filed April 27, 2015.
10.1	Executive Change in Control Retention Plan.	Exhibit 10.1 to Form 10-Q filed herewith.
10.2	Amendment No.1 Directors' Deferred Compensation Plan.	Exhibit 10.2 to Form 10-Q filed herewith.
10.3	Amendment No.1 Supplemental Executive Retirement Plan.	Exhibit 10.3 to Form 10-Q filed herewith.
10.4	Change in Control Retention Plan.	Exhibit 10.4 to Form 10-Q filed herewith.
31	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes Oxley Act.	Exhibit 31 to Form 10-Q filed herewith.
31.1	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes Oxley Act.	Exhibit 31.1 to Form 10-Q filed herewith.
32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes Oxley Act.	Exhibit 32 to Form 10-Q filed herewith.
101	XBRL (eXtensible Business Reporting Language). The following materials from Associated Estates Realty Corporation's Quarterly Report on Form 10-Q for the period ended June 30, 2015, tagged in XBRL: (i) consolidated balance sheets, (ii) consolidated statements of operations and other comprehensive income, (iii) consolidated statements of cash flows, (iv) notes to consolidated financial statements.	

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SIGNATURES

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

ASSOCIATED ESTATES REALTY CORPORATION

July 31, 2015  
(Date)

/s/ Lou Fatica  
Lou Fatica, Senior Vice President,  
Treasurer and Chief Financial Officer

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