

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 March 31, 2001

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 1-10709

**PS BUSINESS PARKS, INC.**

(Exact name of registrant as specified in its charter)

**California**  
(State or Other Jurisdiction  
of Incorporation)

**95-4300881**  
(I.R.S. Employer  
Identification Number)

**701 Western Avenue, Glendale, California 91201-2397**  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: **(818) 244-8080**

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

Number of shares outstanding of each of the issuer's classes of common stock, as of May 10, 2001:

Common Stock, \$0.01 par value, 22,621,778 shares outstanding

**PS BUSINESS PARKS, INC.**

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**PS BUSINESS PARKS, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

	March 31, 2001 (unaudited)	December 31, 2000
<b><u>ASSETS</u></b>		
Cash and cash equivalents .....	\$ 49,544,000	\$ 49,295,000
Marketable securities .....	5,696,000	6,065,000
Real estate facilities, at cost:		
Land .....	214,020,000	214,020,000
Buildings and equipment .....	711,264,000	709,328,000
	925,284,000	923,348,000
Accumulated depreciation .....	(93,411,000)	(83,841,000)
	831,873,000	839,507,000
Land held for development .....	5,768,000	5,737,000
Construction in progress .....	22,271,000	19,467,000
	859,912,000	864,711,000
Receivables .....	487,000	461,000
Deferred rent receivables .....	8,067,000	7,697,000
Intangible assets, net .....	905,000	981,000
Other assets .....	641,000	1,546,000
Total assets .....	\$ 925,252,000	\$ 930,756,000

**LIABILITIES AND SHAREHOLDERS' EQUITY**

Accrued and other liabilities .....	\$ 25,512,000	\$ 28,964,000
Mortgage notes payable .....	30,769,000	30,971,000
Total liabilities .....	56,281,000	59,935,000
Minority interest:		
Preferred units .....	144,750,000	144,750,000
Common units .....	161,951,000	161,728,000
Shareholders' equity:		
Preferred stock, \$0.01 par value, 50,000,000 shares authorized, 2,200 shares issued and outstanding at March 31, 2001 and December 31, 2000 .....	55,000,000	55,000,000
Common stock, \$0.01 par value, 100,000,000 shares authorized, 22,873,482 shares issued and outstanding at March 31, 2001 (23,044,635 shares issued and outstanding at December 31, 2000) .....	229,000	230,000
Paid-in capital .....	459,401,000	464,855,000
Cumulative net income .....	136,455,000	124,990,000
Other comprehensive loss .....	(140,000)	-
Cumulative distributions .....	(88,675,000)	(80,732,000)
Total shareholders' equity .....	562,270,000	564,343,000
Total liabilities and shareholders' equity .....	\$ 925,252,000	\$ 930,756,000

See accompanying notes.

**PS BUSINESS PARKS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
**(Unaudited)**

	For the Three Months Ended March 31,	
	2001	2000
Revenues:		
Rental income.....	\$ 38,393,000	\$ 34,053,000
Facility management fees primarily from affiliates .....	161,000	123,000
Business services.....	157,000	-
Interest income .....	760,000	1,270,000
Dividend income .....	4,000	418,000
	39,475,000	35,864,000
Expenses:		
Cost of operations.....	10,371,000	9,552,000
Cost of facility management .....	36,000	25,000
Cost of business services .....	184,000	-
Depreciation and amortization.....	9,646,000	8,376,000
General and administrative .....	1,128,000	883,000
Interest expense.....	237,000	374,000
	21,602,000	19,210,000
Income before gain on investment and minority interest.....	17,873,000	16,654,000
Gain on investment in Pacific Gulf Properties Inc. ....	15,000	-
Income before minority interest.....	17,888,000	16,654,000
Minority interest in income – preferred units ...	(3,187,000)	(2,920,000)
Minority interest in income – common units ....	(3,236,000)	(2,991,000)
Net income.....	\$ 11,465,000	\$ 10,743,000
Net income allocation:		
Allocable to preferred shareholders.....	\$ 1,272,000	\$ 1,272,000
Allocable to common shareholders.....	10,193,000	9,471,000
	\$ 11,465,000	\$ 10,743,000
Net income per common share:		
Basic .....	\$ 0.44	\$ 0.40
Diluted.....	\$ 0.44	\$ 0.40
Weighted average common shares outstanding:		
Basic.....	23,021,000	23,592,000

See accompanying notes.

**PS BUSINESS PARKS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
**(Unaudited)**

Diluted .....	<u>23,097,000</u>	<u>23,643,000</u>
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See accompanying notes.

**PS BUSINESS PARKS, INC.**  
**CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY**  
**FOR THE THREE MONTHS ENDED MARCH 31, 2001**  
**(Unaudited)**

	Preferred Stock		Common Stock		Paid-in Capital	Cumulative Net Income	Other Comprehensive Loss	Cumulative Distributions	Shareholders' Equity
	Shares	Amount	Shares	Amount					
<b>Balances at December 31, 2000</b> .....	2,200	\$55,000,000	23,044,635	\$ 230,000	\$464,855,000	\$124,990,000	-	\$ (80,732,000)	\$ 564,343,000
Issuance of common stock:									
Exercise of stock options.....	-	-	70,247	1,000	1,233,000	-	-	-	1,234,000
Unrealized loss – depreciation in marketable securities.....	-	-	-	-	-	-	(140,000)	-	(140,000)
Repurchase of common stock.....	-	-	(241,400)	(2,000)	(6,548,000)	-	-	-	(6,550,000)
Net income .....	-	-	-	-	-	11,465,000	-	-	11,465,000
Distributions paid:									
Preferred stock.....	-	-	-	-	-	-	-	(1,272,000)	(1,272,000)
Common stock.....	-	-	-	-	-	-	-	(6,671,000)	(6,671,000)
Adjustment to reflect minority interest to underlying ownership interest .....	-	-	-	-	(139,000)	-	-	-	(139,000)
<b>Balances at March 31, 2001</b> .....	<u>2,200</u>	<u>\$55,000,000</u>	<u>22,873,482</u>	<u>\$ 229,000</u>	<u>\$459,401,000</u>	<u>\$136,455,000</u>	<u>\$ (140,000)</u>	<u>\$(88,675,000)</u>	<u>\$ 562,270,000</u>

See accompanying notes.

**PS BUSINESS PARKS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited)

	For the Three Months Ended March 31,	
	2001	2000
<b>Cash flows from operating activities:</b>		
Net income.....	\$ 11,465,000	\$ 10,743,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on investment in Pacific Gulf Properties Inc. ....	(15,000)	-
Depreciation and amortization expense.....	9,646,000	8,376,000
Minority interest in income .....	6,423,000	5,911,000
Decrease in receivables and other assets.....	509,000	21,000
(Decrease) increase in accrued and other liabilities .....	(3,677,000)	1,251,000
Total adjustments .....	12,886,000	15,559,000
Net cash provided by operating activities.....	24,351,000	26,302,000
<b>Cash flows from investing activities:</b>		
Investment in marketable securities .....	(4,799,000)	(500,000)
Sale of marketable securities.....	5,043,000	-
Acquisition of real estate facilities .....	(43,000)	(25,386,000)
Capital improvements to real estate facilities.....	(1,893,000)	(3,669,000)
Land held for development and construction in progress.....	(2,835,000)	(5,177,000)
Net cash used in investing activities .....	(4,527,000)	(34,732,000)
<b>Cash flows from financing activities:</b>		
Principal payments on mortgage notes payable .....	(202,000)	(5,514,000)
Exercise of stock options .....	1,234,000	-
Repurchase of common stock .....	(6,550,000)	(6,774,000)
Redemption of common operating partnership units .....	(808,000)	-
Distributions paid to preferred shareholders.....	(1,272,000)	(1,272,000)
Distributions paid to minority interests – preferred units.....	(3,187,000)	(2,920,000)
Distributions paid to common shareholders.....	(6,671,000)	(5,877,000)
Distributions paid to minority interests – common units .....	(2,119,000)	(1,861,000)
Net cash used in financing activities.....	(19,575,000)	(24,218,000)
Net increase (decrease) in cash and cash equivalents.....	249,000	(32,648,000)
Cash and cash equivalents at the beginning of the period .....	49,295,000	74,220,000
Cash and cash equivalents at the end of the period .....	\$ 49,544,000	\$ 41,572,000

See accompanying notes.

**PS BUSINESS PARKS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

	For the Three Months Ended March 31,	
	2001	2000
<b>Supplemental schedule of non cash investing and financing activities:</b>		
Conversion of common OP units into shares of common stock:		
Minority interest – common units .....	\$ -	\$ (2,190,000)
Common stock .....	-	1,000
Paid-in capital .....	-	2,189,000
Adjustment to reflect minority interest to underlying ownership interest:		
Minority interest – common units .....	139,000	(70,000)
Paid-in capital .....	(139,000)	70,000
Unrealized loss:		
Marketable securities .....	140,000	-
Other comprehensive income.....	(140,000)	-

See accompanying notes.

**PS BUSINESS PARKS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2001**

**1. Organization and description of business**

PS Business Parks, Inc. (“PSB”) was incorporated in the state of California in 1990. As of March 31, 2001, PSB owned an approximate 75% general and limited partnership interest in PS Business Parks, L.P. (the “Operating Partnership” or “OP”). PSB, as the sole general partner of the Operating Partnership, has full, exclusive and complete responsibility and discretion in managing and controlling the Operating Partnership. PSB and the Operating Partnership are collectively referred to as the “Company.”

The Company is a fully-integrated, self-advised and self-managed real estate investment trust (“REIT”) that acquires, develops, owns and operates commercial properties containing commercial and industrial rental space. As of March 31, 2001, the Company owned and operated 140 commercial properties (approximately 12.6 million net rentable square feet) located in 9 states. The Company also managed 39 commercial properties (approximately 1.3 million net rentable square feet), on behalf of Public Storage, Inc. (“PSI”), affiliated entities and a third party owner.

**2. Summary of significant accounting policies**

*Basis of presentation*

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The preparation of the condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Actual results could differ from estimates. In the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2001 are not necessarily indicative of the results that may be expected for the year ended December 31, 2001. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2000.

The condensed consolidated financial statements include the accounts of PSB and the Operating Partnership. All significant intercompany balances and transactions have been eliminated in the condensed consolidated financial statements.

*Financial instruments*

The methods and assumptions used to estimate the fair value of financial instruments is described below. The Company has estimated the fair value of financial instruments using available market information and appropriate valuation methodologies. Considerable judgment is required in interpreting market data to develop estimates of market value. Accordingly, estimated fair values are not necessary indicative of the amounts that could be realized in current market exchanges.

The Company considers all highly liquid investments with an original maturity of three months or less at the date of purchase to be cash equivalents. Due to the short period to maturity of the Company’s cash and cash equivalents, accounts receivable, other assets and accrued and other liabilities, the carrying values as presented on the condensed consolidated balance sheets are reasonable estimates of fair value. Based on borrowing rates currently available to the Company, the carrying amount of debt approximates fair value.

**PS BUSINESS PARKS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2001**

Financial assets that are exposed to credit risk consist primarily of cash and cash equivalents and accounts receivable. Cash and cash equivalents, which consist of short-term investments, including commercial paper, are only invested in entities with an investment grade rating. Accounts receivable are not a significant portion of total assets and are comprised of a large number of customers.

*Marketable securities*

Marketable securities are classified as "available-for-sale" in accordance with Statement of Financial Accounting Standards ("SFAS") No. 115, Accounting for Certain Investments in Debt and Equity Securities. The investment is reflected on the balance sheet at fair market value based upon the quoted market price. The unrealized loss of \$140,000 is excluded from earnings and reported in a separate component of shareholders' equity. Dividend income is recognized when earned.

Pacific Gulf Properties Inc. ("PAG") is currently in the liquidation process. The Company sold most of its investment in PAG during the three months ended March 31, 2001 and recognized a realized gain of \$142,000. The remaining investment is classified as "trading securities" in accordance with SFAS No. 115 and reflected on the balance sheet at fair market value based upon the quoted market price. The unrealized loss related to this investment of \$127,000 is included in earnings.

*Real estate facilities*

Real estate facilities are recorded at cost. Costs related to the renovation or improvement of the properties are capitalized. Expenditures for repairs and maintenance are expensed as incurred. Buildings and equipment are depreciated on the straight-line method over the estimated useful lives, which are generally 30 and 5 years, respectively.

Interest cost and property taxes incurred during the period of construction of real estate facilities are capitalized. The Company capitalized \$412,000 and \$398,000 of interest expense during the three months ended March 31, 2001 and 2000, respectively.

*Intangible assets*

Intangible assets consist of property management contracts for properties managed, but not owned, by the Company. The intangible assets are being amortized over seven years. Intangible assets are net of accumulated amortization of \$1,251,000 and \$1,175,000 at March 31, 2001 and December 31, 2000, respectively.

*Evaluation of asset impairment*

The Company evaluates its assets used in operations by identifying indicators of impairment and by comparing the sum of the estimated undiscounted future cash flows for each asset to the asset's carrying amount. When indicators of impairment are present and the sum of the undiscounted future cash flows is less than the carrying value of such asset, an impairment loss is recorded equal to the difference between the asset's current carrying value and its value based on discounting its estimated future cash flows. At March 31, 2001, no such indicators of impairment have been identified.

*Loans to affiliate*

The Company loaned an aggregate of \$77 million to PSI and received \$153,000 in interest income during the period of January 5, 2000 through March 20, 2000. The notes bore interest at 5.9% (per annum) and were repaid as of March 20, 2000.

**PS BUSINESS PARKS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2001**

*Revenue and expense recognition*

All leases are classified as operating leases. Rental income is recognized on a straight-line basis over the terms of the leases. Reimbursements from tenants for real estate taxes and other recoverable operating expenses are recognized as revenues in the period the applicable costs are incurred.

Costs incurred in connection with leasing (primarily tenant improvements and leasing commissions) are capitalized and amortized over the lease period.

Property management fees are recognized in the period earned.

*General and administrative expense*

General and administrative expense includes executive compensation, office expense, professional fees, state income taxes, cost of acquisition personnel and other such administrative items. Such amounts include amounts incurred by PSI on behalf of the Company, which were subsequently charged to the Company in accordance with the allocation methodology set forth in the cost allocation and administrative service agreement between the Company and PSI.

*Acquisition costs*

In March 1998, the Emerging Issues Task Force ("EITF") of the Financial Accounting Standards Board issued guidance (the "97-11 Guidance") with respect to Issue No. 97-11, "Accounting for Internal Acquisition Costs Relating to Real Estate Property Acquisitions." The 97-11 Guidance provides that a company shall expense internal pre-acquisition costs (such as costs of an internal acquisitions department) related to the purchase of an operating property. The Company does not capitalize such internal pre-acquisition costs with respect to the acquisition of operating real estate facilities. Accordingly, the 97-11 Guidance had no impact upon the consolidated financial statements and would have had no impact upon financial statements for periods prior to the issuance of the 97-11 Guidance.

*Income taxes*

The Company qualified and intends to continue to qualify as a REIT, as defined in Section 856 of the Internal Revenue Code. As a REIT, the Company is not subject to federal income tax to the extent that it distributes its taxable income to its shareholders. A REIT must distribute at least 90% of its taxable income each year. In addition, REITs are subject to a number of organizational and operating requirements. If the Company fails to qualify as a REIT in any taxable year, the Company will be subject to federal income tax (including any applicable alternative minimum tax) based on its taxable income using corporate income tax rates. Even if the Company qualifies for taxation as a REIT, the Company may be subject to certain state and local taxes on its income and property and to federal income and excise taxes on its undistributed taxable income. The Company believes it met all organization and operating requirements to maintain its REIT status during 2000 and intends to continue to meet such requirements for 2001. Accordingly, no provision for income taxes has been made in the accompanying financial statements.

**PS BUSINESS PARKS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2001**

*Net income per common share*

Per share amounts are computed using the weighted average common shares outstanding. "Diluted" weighted average common shares outstanding include the dilutive effect of stock options under the treasury stock method. "Basic" weighted average common shares outstanding excludes such effect. Earnings per share has been calculated as follows:

	For the Three Months Ended March 31,	
	2001	2000
Net income allocable to common shareholders.....	\$ 10,193,000	\$ 9,471,000
Weighted average common shares outstanding:		
Basic weighted average common shares outstanding .....	23,021,000	23,592,000
Net effect of dilutive stock options - based on treasury stock method using average market price .....	76,000	51,000
Diluted weighted average common shares outstanding .....	23,097,000	23,643,000
Basic earnings per common share.....	\$ 0.44	\$ 0.40
Diluted earnings per common share.....	\$ 0.44	\$ 0.40

*Reclassifications*

Certain reclassifications have been made to the condensed consolidated financial statements for 2000 in order to conform to the 2001 presentation.

**3. Real estate facilities**

The activity in real estate facilities for the three months ended March 31, 2001 is as follows:

	Land	Buildings	Accumulated Depreciation	Total
Balances at December 31, 2000 ....	\$ 214,020,000	\$ 709,328,000	\$(83,841,000)	\$ 839,507,000
Property acquisitions .....	-	43,000	-	43,000
Capital improvements.....	-	1,893,000	-	1,893,000
Depreciation expense .....	-	-	(9,570,000)	(9,570,000)
Balances at March 31, 2001 .....	\$ 214,020,000	\$ 711,264,000	\$(93,411,000)	\$ 831,873,000

During the three months ended March 31, 2001, the Company incurred \$2,835,000 in development costs.

**PS BUSINESS PARKS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2001**

**4. Leasing activity**

The Company leases space in its real estate facilities to tenants under non-cancelable leases generally ranging from one to ten years. Future minimum rental revenues excluding recovery of expenses as of March 31, 2001 under these leases are as follows:

2001 (April – December) .....	\$ 88,737,000
2002.....	91,944,000
2003.....	66,913,000
2004.....	46,246,000
2005.....	31,083,000
Thereafter .....	34,680,000
	\$ 359,603,000

In addition to minimum rental payments, tenants pay reimbursements for their pro rata share of specified operating expenses, which amounted to \$4,790,000 and \$4,054,000 for the three months ended March 31, 2001 and 2000, respectively. These amounts are included as rental income and cost of operations in the accompanying condensed consolidated statements of income.

**5. Revolving line of credit**

In September 2000, the Company extended its unsecured line of credit (the “Credit Facility”) with Wells Fargo Bank. The Credit Facility has a borrowing limit of \$100 million and an expiration date of August 6, 2003. The expiration date may be extended by one year on each anniversary of the Credit Facility. Interest on outstanding borrowings is payable monthly. At the option of the Company, the rate of interest charged is equal to (i) the prime rate or (ii) a rate ranging from the London Interbank Offered Rate (“LIBOR”) plus 0.75% to LIBOR plus 1.35% depending on the Company’s credit ratings and coverage ratios, as defined (currently LIBOR plus 1.00%). In addition, the Company is required to pay an annual commitment fee of 0.25% of the borrowing limit. The Company had no outstanding balance and \$100 million available on its line of credit at March 31, 2001 and December 31, 2000.

The Credit Facility requires the Company to meet certain covenants including (i) maintain a balance sheet leverage ratio (as defined) of less than 0.50 to 1.00, (ii) maintain interest and fixed charge coverage ratios (as defined) of not less than 2.25 to 1.0 and 1.75 to 1.0, respectively, (iii) maintain a minimum total shareholders’ equity (as defined) and (iv) limit distributions to 95% of funds from operations. In addition, the Company is limited in its ability to incur additional borrowings (the Company is required to maintain unencumbered assets with an aggregate book value equal to or greater than two times the Company’s unsecured recourse debt) or sell assets. The Company was in compliance with the covenants of the Credit Facility at March 31, 2001.

**PS BUSINESS PARKS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2001**

**6. Mortgage notes payable**

Mortgage notes consist of the following:

	March 31, 2001	December 31, 2000
7.125% mortgage note, principal and interest payable monthly, due May 2006.....	\$ 8,523,000	\$ 8,570,000
8.190% mortgage note, principal and interest payable monthly, due March 2007 .....	6,434,000	6,482,000
7.290% mortgage note, principal and interest payable monthly, due February 2009.....	6,245,000	6,272,000
7.280% mortgage note, principal and interest payable monthly, due February 2003.....	4,155,000	4,186,000
8.000% mortgage note, principal and interest payable monthly, due April 2003 .....	2,000,000	2,022,000
8.500% mortgage note, principal and interest payable monthly, due July 2007 .....	1,837,000	1,850,000
8.000% mortgage note, principal and interest payable monthly, due April 2003 .....	1,575,000	1,589,000
	<u>\$30,769,000</u>	<u>\$30,971,000</u>

At March 31, 2001, approximate principal maturities of mortgage notes payable are as follows:

2001 (April - December) .....	\$ 626,000
2002.....	894,000
2003.....	7,871,000
2004.....	696,000
2005.....	752,000
Thereafter .....	19,930,000
	<u>\$ 30,769,000</u>

**7. Minority interests**

*Common units*

The Company presents the accounts of PSB and the Operating Partnership on a consolidated basis. Ownership interests in the Operating Partnership, other than PSB's interest, are classified as minority interest in the condensed consolidated financial statements. Minority interest in income consists of the minority interests' share of the condensed consolidated operating results.

Beginning one year from the date of admission as a limited partner and subject to certain limitations described below, each limited partner other than PSB has the right to require the redemption of its partnership interest.

A limited partner that exercises its redemption right will receive cash from the Operating Partnership in an amount equal to the market value (as defined in the Operating Partnership Agreement) of the partnership interests redeemed. In lieu of the Operating Partnership redeeming the partner for cash, PSB, as general partner,

**PS BUSINESS PARKS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2001**

has the right to elect to acquire the partnership interest directly from a limited partner exercising its redemption right, in exchange for cash in the amount specified above or by issuance of one share of PSB common stock for each unit of limited partnership interest redeemed.

A limited partner cannot exercise its redemption right if delivery of shares of PSB common stock would be prohibited under the Company's articles of incorporation or if the general partner believes that there is a risk that delivery of shares of common stock would cause the general partner to no longer qualify as a REIT, would cause a violation of the applicable securities laws, or would result in the Operating Partnership no longer being treated as a partnership for federal income tax purposes.

On January 12, 2001, the Company redeemed 30,484 common units from unaffiliated third parties for an aggregate cost of \$808,000.

At March 31, 2001, there were 7,305,355 OP units owned by PSI and affiliated entities. On a fully converted basis, assuming all 7,305,355 minority interest OP units were converted into shares of common stock of PSB at March 31, 2001, the minority interests would own approximately 24% of the common shares outstanding. At the end of each reporting period, PSB determines the amount of equity (book value of net assets) which is allocable to the minority interest based upon the ownership interest and an adjustment is made to the minority interest, with a corresponding adjustment to paid-in capital, to reflect the minority interests' equity in the Company.

*Preferred units*

On April 23, 1999, the Operating Partnership completed a private placement of 510,000 preferred units with a preferred distribution rate of 8 7/8%. The net proceeds from the placement of preferred units were approximately \$12.5 million and were used to repay borrowings from an affiliate.

On September 3, 1999, the Operating Partnership completed a private placement of 3,200,000 preferred units with a preferred distribution rate of 8 3/4%. The net proceeds from the placement of preferred units were approximately \$78 million and part of the proceeds was used to prepay a mortgage note payable of approximately \$8.5 million.

On September 7 and 23, 1999, the Operating Partnership completed private placements of 1,200,000 and 400,000 preferred units, respectively, with a preferred distribution rate of 8 7/8%. The net proceeds from the placement of preferred units were approximately \$39.2 million.

On July 12, 2000, the Operating Partnership completed a private placement of 480,000 preferred units with a preferred distribution rate of 8 7/8%. The net proceeds from the placement of preferred units were approximately \$11.7 million.

The Operating Partnership has the right to redeem the preferred units on or after the fifth anniversary of the issuance date at the original capital contribution plus the cumulative priority return, as defined, to the redemption date to the extent not previously distributed. The preferred units are exchangeable for Cumulative Redeemable Preferred Stock of the respective series of PS Business Parks, Inc. on or after the tenth anniversary of the date of issuance at the option of the Operating Partnership or a majority of the holders of the preferred units. The Preferred Stock will have the same distribution rate and par value as the respective units and will have equivalent terms to those described in Note 9.

**PS BUSINESS PARKS, INC.**  
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**8. Property management contracts**

The Operating Partnership manages industrial, office and retail facilities for PSI and affiliated entities. These facilities, all located in the United States, operate under the "Public Storage" or "PS Business Parks" name. In addition, the Operating Partnership manages an office building for a third party owner.

The property management contracts provide for compensation of a percentage of the gross revenues of the facilities managed. Under the supervision of the property owners, the Operating Partnership coordinates rental policies, rent collections, marketing activities, the purchase of equipment and supplies, maintenance activities, and the selection and engagement of vendors, suppliers and independent contractors. In addition, the Operating Partnership assists and advises the property owners in establishing policies for the hire, discharge and supervision of employees for the operation of these facilities, including property managers and leasing, billing and maintenance personnel.

The property management contract with PSI is for a seven year term with the term being extended one year on each anniversary. The property management contracts with affiliates of PSI are cancelable by either party upon sixty days notice.

**9. Shareholders' equity**

*Preferred stock*

On April 30, 1999, the Company issued 2,200,000 depository shares each representing 1/1,000 of a share of 9 1/4% Cumulative Preferred Stock, Series A. Net proceeds from the public perpetual preferred stock offering were approximately \$53.1 million and were used to repay borrowings from an affiliate and a mortgage note payable of approximately \$11 million. The remaining proceeds were used for investment in real estate. See Note 12 for subsequent offering.

Holders of the Company's preferred stock will not be entitled to vote on most matters, except under certain conditions. In the event of a cumulative arrearage equal to six quarterly dividends, the holders of the preferred stock will have the right to elect two additional members to serve on the Company's Board of Directors until all events of default have been cured. At March 31, 2001, there were no dividends in arrears.

Except under certain conditions relating to the Company's qualification as a REIT, the preferred stock is not redeemable prior to April 30, 2004. On or after April 30, 2004, the preferred stock will be redeemable, at the option of the Company, in whole or in part, at \$25 per depository share, plus any accrued and unpaid dividends.

The Company paid \$1,272,000 (\$0.578125 per depository share) and \$1,272,000 (\$0.578125 per depository share) in distributions to its preferred shareholders for the three months ended March 31, 2001 and 2000, respectively.

*Common stock*

On March 2, 2000, the Board of Directors authorized the repurchase from time to time of up to 1,000,000 shares of the Company's common stock on the open market or in privately negotiated transactions. On July 27, 2000, the Board of Directors authorized the repurchase of up to an additional 600,000 shares of the Company's common stock (for a total repurchase authorization of up to 1,600,000 shares) on the open market or in privately negotiated transactions. Purchases will be made subject to market conditions and other investment opportunities available to the Company. As of December 31, 2000, the Company had repurchased 722,600 shares of common stock at an aggregate cost of approximately \$16.6 million. The Company repurchased an additional 241,400

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shares of common stock at an aggregate cost of approximately \$6.6 million for the three months ended March 31, 2001.

On March 31, 2000, a holder of common OP units exercised its option and converted its 107,517 common OP units into an equal number of shares of PSB common stock. The conversion resulted in an increase in shareholders' equity and a corresponding decrease in minority interest of approximately \$2,531,000 representing the book value of the OP units at the time of conversion.

The Company paid \$6,671,000 (\$0.29 per common share) and \$5,877,000 (\$0.25 per common share) in distributions to its common shareholders for the three months ended March 31, 2001 and 2000, respectively. Pursuant to restrictions on the Credit Facility, distributions may not exceed 95% of funds from operations, as defined.

*Equity stock*

In addition to common and preferred stock, the Company is authorized to issue 100,000,000 shares of Equity Stock. The Articles of Incorporation provide that the Equity Stock may be issued from time to time in one or more series and gives the Board of Directors broad authority to fix the dividend and distribution rights, conversion and voting rights, redemption provisions and liquidation rights of each series of Equity Stock.

**10. Recent accounting pronouncements**

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," which is required to be adopted by the Company on January 1, 2001. This statement provides a comprehensive and consistent standard for the recognition and measurement of derivatives and hedging activities. The Company adopted SFAS No. 133 on January 1, 2001. This adoption had no material impact on the Company's consolidated financial statements.

**11. Commitments and contingencies**

Substantially all of the Company's properties have been subjected to Phase I environmental reviews. Such reviews have not revealed, nor is management aware of, any probable or reasonably possible environmental costs that management believes would have a material adverse effect on the Company's business, assets or results of operations, nor is the Company aware of any potentially material environmental liability, except as discussed below.

The Company acquired a property in Beaverton, Oregon ("Creekside Corporate Park") in May 1998. A portion of Creekside Corporate Park, as well as properties adjacent to Creekside Corporate Park, are currently the subject of an environmental remedial investigation/feasibility study ("RI/FS") that is being conducted by two current and past owner/operators of an industrial facility on adjacent property, pursuant to an order issued by the Oregon Department of Environmental Quality ("ODEQ"). As part of that study, ODEQ ordered the owner/operators of the industrial facility to sample soil and groundwater on the Company's property to determine the nature and extent of contamination resulting from past operations at the industrial facility. The Company, which is not a party to the Order on Consent, executed separate Access Agreements with the two owner/operators to allow access to portions of Creekside Corporate Park to conduct the required sampling and testing. The sampling and testing is ongoing; results to date indicate that the contamination from the industrial facility has migrated onto portions of Creekside Corporate Park owned by the Company.

There is no evidence that the Company's past or current use of the Creekside Corporate Park property contributed in any way to the contamination that is the subject of the current investigation. Nevertheless, upon

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completion of the RI/FS, it is likely that removal or remedial measures will be required to address contamination detected during the current investigation, including any contamination on or under the Creekside Corporate Park property. Because of the preliminary nature of the investigation, the Company cannot predict the outcome of the investigation, nor can it estimate the costs of any remediation or removal activities that may be required.

One of the two owner/operators that are conducting the RI/FS pursuant to the Order on Consent recently filed for Chapter 11 bankruptcy protection. It is not clear at this point what impact, if any, this filing will have on the completion of the RI/FS, or on any removal or remedial activities ordered by the ODEQ. It is possible that the ODEQ could require the Company to participate in completing the RI/FS and implementing removal or remedial actions that may be required on the Company's property, or to pay a portion of the costs to do so. In the event the Company is ultimately deemed responsible for any costs relating to this matter, the Company believes that the party from whom the property was purchased will be responsible for any expenses or liabilities that the Company may incur as a result of this contamination. In addition, the Company believes it may have recourse against other potentially responsible parties, including, but not limited to, one or both of the owner/operators of the adjacent industrial facility.

On November 3, 1999, the Company filed an action entitled *PS Business Parks, Inc. v. Larry Howard, et al.* (Case No. BC219580) in the Los Angeles Superior Court seeking damages in excess of \$1 million, as well as equitable relief. The complaint alleges that Mr. Howard and entities controlled by him engaged in unfair trade practices, including (1) negotiating kickbacks, secret rebates and/or unearned discounts from third party suppliers for "providing" Company business to those suppliers and (2) disrupting the Company's relationship with various suppliers. Mr. Howard is not an officer, employee or authorized agent of the Company. On November 13, 2000, the Court entered a summary judgment against the Company. The Company is appealing the Court's decision.

On or about February 14, 2000, Mr. Howard and entities controlled by him filed a cross-complaint against the Company, Public Storage, Inc., and several other cross-defendants alleging, among other things, (1) interference with Mr. Howard's contractual relations with various third party suppliers, (2) violation of Title VII of the Civil Rights Act and (3) abuse of process. None of the cross-complainants assigned any dollar amount in the cross-complaint to the claims. All of the claims in this cross-complaint against the Company have been dismissed with the exception of one claim for interference. The Company intends to vigorously contest this remaining claim in the cross-complaint.

On November 27, 2000, Mary Jayne Howard, a former officer of the Company, filed a demand for arbitration with the American Arbitration Association alleging claims against the Company for breach of contract, gender discrimination, marital discrimination, and wrongful termination based on public policy. The demand seeks damages of approximately \$2 million. The Company plans to vigorously contest these claims.

On November 27, 2000, the Company filed an action in the Los Angeles Superior Court seeking damages in excess of \$1 million, as well as equitable relief, against Mr. Howard, entities controlled by him, and Mrs. Howard alleging claims for breach of fiduciary duty, fraud, constructive fraud, aiding and abetting, intentional interference with prospective economic advantage and unfair competition, among other things.

The Company currently is neither subject to any other material litigation nor, to management's knowledge, is any material litigation currently threatened against the Company other than routine litigation and administrative proceedings arising in the ordinary course of business. Management believes that these items will not have a material adverse impact on the Company's condensed consolidated financial position or results of operations.

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**12. Subsequent events**

On May 8, 2001, the Board of Directors increased the number of common shares authorized to be repurchased from 1,600,000 to 2,500,000. The shares may be repurchased periodically on the open market or in privately negotiated transactions. Subsequent to March 31, 2001, the Company repurchased an additional 254,900 shares of common stock at an aggregate cost of approximately \$6.8 million.

On May 10, 2001, the Company issued 1,840,000 depositary shares each representing 1/1,000 of a share of 9 $\frac{1}{2}$ % Cumulative Preferred Stock, Series D in a public offering. Net proceeds from the offering were approximately \$44.6 million and will be used for investment in real estate and general corporate purposes.

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

**Forward-Looking Statements:** Forward-looking statements are made throughout this Quarterly Report on Form 10-Q. For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, the words "believes," "anticipates," "plans," "expects," "seeks," "estimates," and similar expressions are intended to identify forward-looking statements. There are a number of important factors that could cause the results of the Company to differ materially from those indicated by such forward-looking statements, including those detailed under the heading "Item 2A. Risk Factors." In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by us or any other person that our objectives and plans will be achieved. Moreover, we assume no obligation to update these forward-looking statements to reflect actual results, changes in assumptions or changes in other factors affecting such forward-looking statements.

**Overview:** During 2000 and the first quarter of 2001, the Company focused on increasing cash flow from its existing core portfolio of properties, expanding its presence in existing markets through strategic acquisitions and developments and strengthening its balance sheet primarily through the issuance of preferred stock/units. The Company has maintained low debt and overall leverage levels including preferred stock /units to facilitate future growth.

During the first quarter of 2001, the Company did not complete any acquisitions. The Company plans to continue to build its presence in existing markets by acquiring high quality facilities in selected markets. The Company targets properties with below market rents which offer the Company the ability to achieve economies of scale resulting in more efficient operations.

During 2000, the Company added approximately 0.8 million square feet to its portfolio at an aggregate cost of approximately \$82 million. These acquisitions increased the Company's presence in its existing markets, which the Company believes have the characteristics necessary for long-term growth. The Company acquired 454,000 square feet in Southern California for \$40 million, 178,000 square feet in Northern California for \$23 million, 210,000 square feet in Northern Virginia for approximately \$19 million. In addition, the Company completed development on a property totaling 22,000 square feet in Oregon for approximately \$3 million. The Company also sold five properties aggregating 627,000 square feet for approximately \$23.8 million in non-core markets.

**Results of Operations:** Net income for the three months ended March 31, 2001 was \$11,465,000 compared to \$10,743,000 for the same period in 2000. Net income allocable to common shareholders (net income less preferred stock dividends) for the three months ended March 31, 2001 was \$10,193,000 compared to \$9,471,000 for the same period in 2000. Net income per common share on a diluted basis was \$0.44 for the three months ended March 31, 2001 compared to \$0.40 for the same period in 2000 (based on weighted average diluted common shares outstanding of 23,097,000 and 23,643,000, respectively).

The Company's property operations account for almost all of the net operating income earned by the Company. The following table presents the pre-depreciation operating results of the properties:

	Three Months Ended		Change
	March 31,		
	2001	2000	
Rental income:			
“Same Park” facilities (120 facilities, 11.7 million net rentable square feet) .....	\$35,298,000	\$32,700,000	7.9%
Other facilities .....	3,095,000	1,353,000	128.8%
Total rental income .....	<u>\$38,393,000</u>	<u>\$34,053,000</u>	<u>12.7%</u>
Cost of operations (excluding depreciation):			
“Same Park” facilities .....	\$9,616,000	\$8,957,000	7.4%
Other facilities .....	755,000	595,000	26.9%
Total cost of operations .....	<u>\$10,371,000</u>	<u>\$9,552,000</u>	<u>8.6%</u>
Net operating income (rental income less cost of operations):			
“Same Park” facilities .....	\$25,682,000	\$23,743,000	8.2%
Other facilities .....	2,340,000	758,000	208.7%
Total net operating income .....	<u>\$28,022,000</u>	<u>\$24,501,000</u>	<u>14.4%</u>

Rental income and rental income less cost of operations or net operating income (“NOI”) prior to depreciation are summarized for the three months ended March 31, 2001 by major geographic region below:

Region	Square Footage	Percent of Total	Rental Income	Percent of Total	NOI	Percent of Total
Southern California	3,548,000	28.2%	\$10,759,000	28.0%	\$7,982,000	28.5%
Northern California	1,495,000	11.9%	4,627,000	12.0%	3,535,000	12.6%
Southern Texas	1,032,000	8.2%	2,943,000	7.7%	1,707,000	6.1%
Northern Texas	1,849,000	14.7%	4,750,000	12.4%	3,369,000	12.0%
Virginia	1,822,000	14.4%	6,325,000	16.5%	4,602,000	16.4%
Maryland	866,000	6.9%	2,491,000	6.5%	1,856,000	6.6%
Oregon	1,191,000	9.4%	4,651,000	12.1%	3,767,000	13.4%
Other	797,000	6.3%	1,847,000	4.8%	1,204,000	4.4%
	<u>12,600,000</u>	<u>100.0%</u>	<u>\$38,393,000</u>	<u>100.0%</u>	<u>\$28,022,000</u>	<u>100.0%</u>

**Supplemental Property Data and Trends:** In order to evaluate the performance of the Company's overall portfolio, management analyzes the operating performance of a consistent group of 120 properties (11.7 million net rentable square feet). These 120 properties (herein referred to as the “Same Park” facilities) have been owned and operated by the Company for the comparable periods. The “Same Park” facilities represent approximately 93% of the square footage of the Company's portfolio at March 31, 2001.

The following table summarizes the pre-depreciation historical operating results of the “Same Park” facilities excluding the effects of accounting for rental revenues on a straight-line basis.

**“Same Park” Facilities (120 Properties)**

	Three Months Ended March 31,		Change
	2001	2000	
Rental income <sup>(1)</sup> .....	\$ 34,958,000	\$ 32,095,000	8.9%
Cost of operations .....	9,616,000	8,957,000	7.4%
Net operating income .....	<u>\$ 25,342,000</u>	<u>\$ 23,138,000</u>	<u>9.5%</u>
Gross margin <sup>(2)</sup> .....	72.5%	72.1%	0.4%
<u>Weighted average for period:</u>			
Occupancy .....	96.2%	96.3%	(0.1%)
Annualized realized rent per sq. ft. <sup>(3)</sup> .....	\$12.46	\$11.42	9.1%

(1) Rental income does not include the effect of straight-line accounting.

(2) Gross margin is computed by dividing property net operating income by rental income.

(3) Realized rent per square foot represents the actual revenues earned per occupied square foot.

The following tables summarize the “Same Park” operating results by major geographic region for the three months ended March 31, 2001 and 2000:

Region	Revenues 2001	Revenues 2000	Increase	NOI 2001	NOI 2000	Increase
Southern California....	\$9,359,000	\$8,631,000	8.4%	\$6,994,000	\$6,593,000	6.1%
Northern California....	3,864,000	3,565,000	8.4%	2,898,000	2,612,000	10.9%
Southern Texas .....	2,920,000	2,546,000	14.7%	1,683,000	1,489,000	13.0%
Northern Texas .....	4,712,000	4,265,000	10.5%	3,331,000	2,820,000	18.1%
Virginia .....	5,678,000	5,262,000	7.9%	4,060,000	3,829,000	6.0%
Maryland .....	2,472,000	2,380,000	3.9%	1,835,000	1,744,000	5.2%
Oregon .....	4,049,000	3,654,000	10.8%	3,302,000	2,956,000	11.7%
Other .....	1,904,000	1,792,000	6.3%	1,239,000	1,095,000	13.2%
	<u>\$34,958,000</u>	<u>\$32,095,000</u>	<u>8.9%</u>	<u>\$25,342,000</u>	<u>\$23,138,000</u>	<u>9.5%</u>

Northern Texas revenues increased in comparison to 2000 due primarily to increased occupancy and rates in Houston and rate increases at certain Dallas facilities. Southern Texas revenues benefited from an increase in rental rates and occupancies in Austin, Texas. Oregon revenues benefited from leases signed during the strong economy of 2000 in addition to maintaining high occupancy in the first quarter. Other markets grew to a lesser extent resulting in revenue and NOI increases in all of our markets.

**Facility Management Operations:** The Company's facility management accounts for a small portion of the Company's net operating income. During the three months ended March 31, 2001, \$125,000 in net operating income was recognized from facility management operations compared to \$98,000 for the same period in 2000. Facility management fees have increased due to the increase in rental rates of the properties managed by the Company and an additional property brought under management during 2000.

**Business Services:** Business services include construction management fees and fees from telecommunication service providers. During the three months ended March 31, 2001, the Company generated a net operating loss of \$27,000 compared to none for the same period in 2000.

**Interest Income:** Interest income reflects earnings on cash balances. Interest income was \$760,000 for the three months ended March 31, 2001 compared to \$1,270,000 for the same period in 2000. The decrease is attributable to lower average cash balances and interest rates. Average cash balances for the three months ended March 31, 2001 were approximately \$55 million compared to \$81 million for the same period in 2000.

**Dividend Income:** Dividend income reflects dividends received from marketable securities. Dividend income was \$4,000 for the three months ended March 31, 2001 compared to \$418,000 for the same period in 2000. No dividend income was received from Pacific Gulf Properties, Inc. during the three months ended March 31, 2001.

**Cost of Operations:** Cost of operations for the three months ended March 31, 2001 was \$10,371,000 compared to \$9,552,000 for the same period in 2000. The increase is due primarily to increased utilities, repairs and maintenance and payroll costs and the growth in the total square footage of the Company's portfolio of properties. Cost of operations as a percentage of rental income decreased from 28.1% to 27.0% as a result of economies of scale achieved through the acquisition and development of properties in core markets and the disposition of properties outside of the Company's core markets in addition to revenue increases in excess of expense increases at the Company's "Same Park" facilities. Cost of operations for the three months ended March 31, 2001 consisted primarily of property taxes (\$3,374,000), property maintenance (\$2,070,000), utilities (\$1,936,000) and direct payroll (\$1,697,000).

**Depreciation and Amortization Expense:** Depreciation and amortization expense for the three months ended March 31, 2001 was \$9,646,000 compared to \$8,376,000 for the same period in 2000. The increase is due to the acquisition and development of real estate facilities during 2000.

**General and Administrative Expense:** General and administrative expense was \$1,128,000 for the three months ended March 31, 2001 compared to \$883,000 for the same period in 2000. The increase is due primarily to the increased size and activities of the Company. Included in general and administrative costs are acquisition costs and abandoned transaction costs. Acquisition expenses were \$203,000 and \$131,000 for the three months ended March 31, 2001 and 2000, respectively. Abandoned transaction costs were \$2,000 and \$7,000 for the three months ended March 31, 2001 and 2000, respectively.

**Interest Expense:** Interest expense was \$237,000 for the three months ended March 31, 2001 compared to \$374,000 for the same period in 2000. The decrease is attributable to lower average debt balances during the period and greater capitalized interest in 2001 as a result of greater construction in progress. Interest expense of \$412,000 and \$398,000 was capitalized as part of building costs associated with properties under development during the three months ended March 31, 2001 and 2000, respectively.

**Gain on Investment in PAG:** Pacific Gulf Properties Inc ("PAG") is currently in the liquidation process. The Company sold most of its investment in PAG during the three months ended March 31, 2001. The gain on investment in PAG of \$15,000 reflects a realized gain of \$142,000 offset by an unrealized loss of \$127,000 for the three months ended March 31, 2001.

**Minority Interest in Income:** Minority interest in income reflects the income allocable to equity interests in the Operating Partnership that are not owned by the Company. Minority interest in income for the three months ended March 31, 2001 was \$6,423,000 (\$3,187,000 allocated to preferred unitholders and \$3,236,000 allocated to common unitholders) compared to \$5,911,000 (\$2,920,000 allocated to preferred unitholders and \$2,991,000 allocated to common unitholders) for the same period in 2000. The increase in minority interest in income is due primarily to the issuance of preferred operating partnership units during 2000 and higher earnings at the operating partnership level, partially offset by a conversion of units to common stock during 2000.

### **Liquidity and Capital Resources**

Net cash provided by operating activities for the three months ended March 31, 2001 and 2000 was \$24,351,000 and \$26,302,000, respectively. Management believes that its internally generated net cash provided by operating activities will continue to be sufficient to enable it to meet its operating expenses, capital improvements, debt service requirements and maintain the current level of distributions to shareholders.

The following table summarizes the Company's cash flow from operating activities:

	Three Months Ended March 31,	
	2001	2000
Net income.....	\$11,465,000	\$10,743,000
Gain on investment in Pacific Gulf Properties, Inc.....	(15,000)	-
Depreciation and amortization.....	9,646,000	8,376,000
Minority interest in income.....	6,423,000	5,911,000
Change in working capital .....	(3,168,000)	1,272,000
Net cash provided by operating activities .....	<u>24,351,000</u>	<u>26,302,000</u>
Maintenance capital expenditures.....	(573,000)	(532,000)
Tenant improvements.....	(929,000)	(1,030,000)
Capitalized lease commissions.....	(391,000)	(665,000)
Funds available for distributions to shareholders, minority interests, acquisitions and other corporate purposes .....	<u>22,458,000</u>	<u>24,075,000</u>
Cash distributions to shareholders and minority interests .....	<u>(13,249,000)</u>	<u>(11,930,000)</u>
Excess funds available for principal payments on debt, investments in real estate and other corporate purposes .....	<u>\$ 9,209,000</u>	<u>\$ 12,145,000</u>

The Company's capital structure is characterized by a low level of leverage. As of March 31, 2001, the Company had seven fixed rate mortgage notes payable totaling \$30,769,000, which represented 3.4% of its total capitalization (based on book value, including minority interests and debt). The weighted average interest rate for the mortgage notes is 7.59%.

The Company expects to fund its growth strategies with permanent capital, including issuances of common and preferred stock and retained internally generated cash flows. In addition, the Company may sell properties that no longer meet its investment criteria. The Company may finance acquisitions on a temporary basis with borrowings from its unsecured line of credit (the "Credit Facility"). The Company intends to repay amounts borrowed under the Credit Facility from undistributed cash flow or, as market conditions permit and as determined to be advantageous, from the public or private placement of preferred and common stock/OP units of the Company or Operating Partnership or the formation of joint ventures. The Company targets a leverage ratio of 40% (defined as debt and preferred equity as a percentage of market capitalization). In addition, the Company targets a Funds from Operations

(“FFO”) to combined fixed charges and preferred distributions ratio of 3.0 to 1.0. As of March 31, 2001 and for the three months then ended, the leverage ratio was 22% (based on the fair market capitalization) and the FFO to fixed charges and preferred distributions coverage ratio was 5.4 to 1.0.

On May 10, 2001, the Company issued 1,840,000 depository shares each representing 1/1,000 of a share of 9% Cumulative Preferred Stock, Series D in a public offering. Net proceeds from the offering were approximately \$44.6 million and will be used for investment in real estate and general corporate purposes.

In September 2000, the Company extended its Credit Facility with Wells Fargo Bank. The Credit Facility has a borrowing limit of \$100 million and an expiration date of August 6, 2003. The expiration date may be extended by one year on each anniversary of the Credit Facility. Interest on outstanding borrowings is payable monthly. At the option of the Company, the rate of interest charged is equal to (i) the prime rate or (ii) a rate ranging from the London Interbank Offered Rate (“LIBOR”) plus 0.75% to LIBOR plus 1.35% depending on the Company’s credit ratings and coverage ratios, as defined (currently LIBOR plus 1.00%). In addition, the Company is required to pay an annual commitment fee of 0.25% of the borrowing limit. As of March 31, 2001, the Company had no balance outstanding on the Credit Facility.

**Funds from Operations:** FFO is defined as net income, computed in accordance with accounting principles generally accepted in the United States, before depreciation, amortization, minority interest in income, straight-line rent adjustments and extraordinary or non-recurring items. FFO is presented because the Company considers FFO to be a useful measure of the operating performance of a REIT which, together with net income and cash flows, provides investors with a basis to evaluate the operating and cash flow performances of a REIT. FFO does not represent net income or cash flows from operations as defined by accounting principles generally accepted in the United States. FFO does not take into consideration scheduled principal payments on debt or capital improvements. Accordingly, FFO is not necessarily a substitute for cash flow or net income as a measure of liquidity or operating performance or ability to make acquisitions and capital improvements or ability to pay distributions or debt principal payments. Also, FFO as computed and disclosed by the Company may not be comparable to FFO computed and disclosed by other REITs.

FFO for the Company is computed as follows:

	Three Months Ended March 31,	
	2001	2000
Net income allocable to common shareholders.....	\$ 10,193,000	\$ 9,471,000
Less: Gain on investment in Pacific Gulf Properties Inc.....	(15,000)	-
Depreciation and amortization .....	9,646,000	8,376,000
Minority interest in income – common units.....	3,236,000	2,991,000
Less: Straight-line rent adjustment.....	(370,000)	(630,000)
Consolidated FFO allocable to common shareholders and minority interests .....	22,690,000	20,208,000
FFO allocated to common minority interest – common units .....	(5,468,000)	(4,810,000)
FFO allocated to common shareholders.....	<u>\$ 17,222,000</u>	<u>\$ 15,398,000</u>

**Capital Expenditures:** During the three months ended March 31, 2001, the Company incurred \$1.9 million in maintenance capital expenditures, tenant improvements and capitalized lease commissions. On a recurring annual basis, the Company expects \$0.90 to \$1.20 per square foot in recurring capital expenditures (\$11 - \$15 million based on square footage at March 31, 2001). In addition, the Company expects to make \$1.0 million in renovations on a property in Southern California.

**Stock Repurchase:** On May 8, 2001, the Board of Directors increased the number of common shares authorized to be repurchased from 1,600,000 to 2,500,000. The shares may be repurchased periodically on the open

market or in privately negotiated transactions. The Company repurchased 241,400 shares of common stock at an aggregate cost of approximately \$6.6 million for the three months ended March 31, 2001.

***Distributions:*** The Company has elected and intends to qualify as a REIT for federal income tax purposes. In order to maintain its status as a REIT, the Company must meet, among other tests, sources of income, share ownership and certain asset tests. As a REIT, the Company is not taxed on that portion of its taxable income that is distributed to its shareholders provided that at least 90% of its taxable income is distributed to its shareholders prior to filing of its tax return.

The Board of Directors declared a quarterly dividend of \$0.29 per common share on May 8, 2001. Distributions are payable on June 28, 2001 to shareholders of record as of the close of business on June 15, 2001. The Board of Directors has established a distribution policy to maximize the retention of cash flow. In addition, the Board of Directors declared a quarterly dividend of \$0.578125 and a prorated quarterly dividend of \$0.343056 per share on the depository shares that represent 1/1,000 of a share of the Company's 9 1/4% Cumulative Preferred Stock, Series A and 9 1/2% Cumulative Preferred Stock, Series D, respectively. Distributions are payable on June 29, 2001 to shareholders of record as of the close of business on June 15, 2001.

## ITEM 2A. RISK FACTORS

In addition to the other information in this Form 10-Q, the following factors should be considered in evaluating our company and our business.

### **PSI has significant influence over us.**

***PSI owns a substantial number of our shares:*** At March 15, 2001, PSI owned 24% of the outstanding shares of our common stock (42% upon conversion of its interest in our operating partnership). Consequently, PSI has the ability to significantly influence all matters submitted to a vote of our shareholders, including electing directors, changing our articles of incorporation, dissolving and approving other extraordinary transactions. In addition, PSI's ownership may make it more difficult for another party to take over our company without PSI's approval.

***PSI has a voting agreement with another large shareholder:*** PSI and an institutional shareholder owning 27% of our common stock as of March 15, 2001 have both agreed to vote their shares to support specified nominees to our board of directors until the voting agreement expires, which is not before December 2001. This voting agreement may further increase PSI's influence over our company.

### **Provisions in our organizational documents may prevent changes in control.**

***Our articles generally prohibit owning more than 7% of our shares:*** Our articles of incorporation restrict the number of shares that may be owned by any person (other than PSI and certain other specified shareholders), and the partnership agreement of our operating partnership contains an anti-takeover provision. No shareholder (other than PSI and certain other specified shareholders) may own more than 7% of the outstanding shares of our common stock, unless our board of directors waives this limitation. We imposed this limitation to avoid, to the extent possible, a concentration of ownership that might jeopardize our ability to qualify as a real estate investment trust, or REIT. This limitation, however, also makes a change of control much more difficult even if it may be favorable to our public shareholders. These provisions will prevent future takeover attempts not approved by PSI even if a majority of our public shareholders consider it to be in their best interests because they would receive a premium for their shares over the shares' then market value or for other reasons.

***Our board can set the terms of certain securities without shareholder approval:*** Our board of directors is authorized, without shareholder approval, to issue up to 50,000,000 shares of preferred stock and up to 100,000,000 shares of equity stock, in each case in one or more series. Our board has the right to set the terms of each of these series of stock. Consequently, the board could set the terms of a series of stock that could make it difficult (if not impossible) for another party to take over our company even if it might be favorable to our public shareholders. Our articles of incorporation also contain other provisions that could have the same effect. We can also cause our operating partnership to issue additional interests for cash or in exchange for property.

***The partnership agreement of our operating partnership restricts mergers:*** The partnership agreement of our operating partnership provides that generally we may not merge or engage in a similar transaction unless limited partners of our operating partnership are entitled to receive the same proportionate payments as our shareholders. In addition, we have agreed not to merge with another entity unless the merger would have been approved had the limited partners been able to vote together with our shareholders. These provisions may make it more difficult for us to merge with another entity.

### **Our operating partnership poses additional risks to us.**

Limited partners of our operating partnership, including PSI, have the right to vote on certain changes to the partnership agreement. They may vote in a way that is contrary to the interests of our shareholders. Also, as general partner of our operating partnership, we are required to protect the interests of the limited partners of our operating partnership. The interests of the limited partners and of our shareholders may differ.

**We cannot sell certain properties without PSI's approval.**

Before 2007, we may not sell 13 specified properties without PSI's approval. Since PSI would be taxed on a sale of these properties, the interests of PSI and our shareholders may differ as to the best time to sell.

**Certain institutional investors have special rights.**

Certain institutional investors have rights, such as the right to approve nominees to our board of directors, the right to purchase our securities in certain circumstances and the right to require registration of their shares, not available to our public shareholders.

**We would incur adverse tax consequences if we fail to qualify as a REIT.**

***Our cash flow would be reduced if we fail to qualify as a REIT:*** While we believe that we have qualified since 1990 to be taxed as a REIT, and will continue to be qualified, we cannot be certain. To continue to qualify as a REIT, we need to satisfy certain requirements under the federal income tax laws relating to our income, assets, distributions to shareholders and shareholder base. In this regard, the share ownership limits in our articles of incorporation do not necessarily ensure that our shareholder base is sufficiently diverse for us to qualify as a REIT. For any year we fail to qualify as a REIT, we would be taxed at regular corporate tax rates on our taxable income unless certain relief provisions apply. Taxes would reduce our cash available for distributions to shareholders or for reinvestment, which could adversely affect us and our shareholders. Also we would not be allowed to elect REIT status for five years after we fail to qualify unless certain relief provisions apply.

***Our cash flow would be reduced if our predecessor failed to qualify as a REIT:*** For us to qualify to be taxed as a REIT, our predecessor, American Office Park Properties, also needed to qualify to be taxed as a REIT. We believe American Office Park Properties qualified as a REIT beginning in 1997 until its March 1998 merger with us. If it is determined that it did not qualify as a REIT, we could also lose our REIT qualification. Before 1997, our predecessor was a taxable corporation and, to qualify as a REIT, was required to distribute all of its profits before the end of 1996. While we believe American Office Park Properties qualified as a REIT since 1997, we did not obtain an opinion of an outside expert at the time of its merger with us.

***We may need to borrow funds to meet our REIT distribution requirements:*** To qualify as a REIT, we must generally distribute to our shareholders 90% of our taxable income. Our income consists primarily of our share of our operating partnership's income. We intend to make sufficient distributions to qualify as a REIT and otherwise avoid corporate tax. However, differences in timing between income and expenses and the need to make nondeductible expenditures such as capital improvements and principal payments on debt could force us to borrow funds to make necessary shareholder distributions.

**Since we buy and operate real estate, we are subject to general real estate investment and operating risks.**

***Summary of real estate risks:*** We own and operate commercial properties and are subject to the risks of owning real estate generally and commercial properties in particular. These risks include:

- the national, state and local economic climate and real estate conditions, such as oversupply of or reduced demand for space and changes in market rental rates;
- how prospective tenants perceive the attractiveness, convenience and safety of our properties;
- our ability to provide adequate management, maintenance and insurance;
- our ability to collect rent from tenants on a timely basis;
- the expense of periodically renovating, repairing and reletting spaces;

- increasing operating costs, including real estate taxes and utilities, if these increased costs cannot be passed through to tenants; and
- changes in tax, real estate and zoning laws.

Certain significant costs, such as mortgage payments, real estate taxes, insurance and maintenance costs, generally are not reduced even when a property's rental income is reduced. In addition, environmental and tax laws, interest rate levels, the availability of financing and other factors may affect real estate values and property income. Furthermore, the supply of commercial space fluctuates with market conditions.

If our properties do not generate sufficient income to meet operating expenses, including any debt service, tenant improvements, leasing commissions and other capital expenditures, we may have to borrow additional amounts to cover fixed costs, and we may have to reduce our distributions to shareholders.

***We may encounter significant delays in reletting vacant space, resulting in losses of income:*** When leases expire, we will incur expenses and we may not be able to release the space on the same terms. Certain leases provide tenants with the right to terminate early if they pay a fee. While we have estimated our cost of renewing leases that expire in 2001, our estimates could be wrong. If we are unable to release space promptly, if the terms are significantly less favorable than anticipated or if the costs are higher, we may have to reduce our distributions to shareholders.

***Tenant defaults and bankruptcies may reduce our cash flow and distributions:*** We may have difficulty in collecting from tenants in default, particularly if they declare bankruptcies. This could reduce our cash flow and distributions to shareholders.

***We may be adversely affected by significant competition among commercial properties:*** Many other commercial properties compete with our properties for tenants and we expect that new properties will be built in our markets. Also, we compete with other buyers, many of whom are larger than us, in seeking to acquire commercial properties. Therefore, we may not be able to grow as rapidly as we would like.

***We may be adversely affected if losses on our properties are not covered by insurance:*** We carry insurance on our properties that we believe is comparable to the insurance carried by other operators for similar properties. However, we could suffer uninsured losses that adversely affect us or even result in loss of the property. We might still remain liable on any mortgage debt related to that property.

***The illiquidity of our real estate investments may prevent us from adjusting our portfolio to respond to market changes:*** There may be delays and difficulties in selling real estate. Therefore, we cannot easily change our portfolio when economic conditions change. Also, tax laws limit a REIT's ability to sell properties held for less than four years.

***We may be adversely affected by changes in laws:*** Increases in income and service taxes may reduce our cash flow and ability to make expected distributions to our shareholders. Our properties are also subject to various federal, state and local regulatory requirements, such as state and local fire and safety codes. If we fail to comply with these requirements, governmental authorities could fine us or courts could award damages against us. We believe our properties comply with all significant legal requirements. However, these requirements could change in a way that would reduce our cash flow and ability to make distributions to shareholders.

***We may incur significant environmental remediation costs:*** Under various federal, state and local environmental laws an owner or operator of real estate interests may have to clean spills or other releases of hazardous or toxic substances on or from a property. Certain environmental laws impose liability whether or not the owner knew of, or was responsible for, the presence of the hazardous or toxic substances. In some cases, liability may exceed the value of the property. The presence of toxic substances, or the failure to properly remedy any resulting contamination, may make it more difficult for the owner or operator to sell, lease or operate its property or

to borrow money using its property as collateral. Future environmental laws may impose additional material liabilities on us.

We acquired a property in Beaverton, Oregon in May 1998 known as Creekside Corporate Park. A portion of Creekside Corporate Park, as well as properties adjacent to Creekside Corporate Park, are currently the subject of an environmental remedial investigation/feasibility study, or RI/FS, that is being conducted by two current and past owner/operators of an industrial facility on adjacent property, pursuant to a consent order issued by the Oregon Department of Environmental Quality, or ODEQ. As part of that study, ODEQ ordered the owner/operators of the industrial facility to sample soil and groundwater on our property to determine the nature and extent of contamination resulting from past operations at the industrial facility. Because we are not a party to the consent order, we executed separate agreements with the two owner/operators to allow them access to portions of Creekside Corporate Park to conduct the required sampling and testing. The sampling and testing is ongoing; results to date indicate that the contamination from the industrial facility has migrated onto portions of Creekside Corporate Park owned by us.

There is no evidence that our past or current use of the Creekside Corporate Park property contributed in any way to the contamination that is the subject of the current investigation. Nevertheless, upon completion of the RI/FS, it is likely that removal or remedial measures will be required to address contamination detected during the current investigation, including any contamination on or under the Creekside Corporate Park property. Because of the preliminary nature of the investigation, we cannot predict the outcome of the investigation, nor can we estimate the costs of any remediation or removal activities that may be required.

One of the two owner/operators that are conducting the RI/FS pursuant to the consent order recently filed for Chapter 11 bankruptcy protection. It is not clear at this point what impact, if any, this filing will have on the completion of the RI/FS, or on any removal or remedial activities ordered by the ODEQ. It is possible that the ODEQ could require us to participate in completing the RI/FS and implementing removal or remedial actions that may be required on our property, or to pay a portion of the costs to do so. In the event we are ultimately deemed responsible for any costs relating to this matter, we believe that the party from whom the property was purchased will be responsible for any expenses or liabilities that we may incur as a result of this contamination. In addition, we believe that we may have recourse against other potentially responsible parties, including, but not limited to, one or both of the owner/operators of the adjacent industrial facility. However, if we are deemed responsible for any expenses related to removal or remedial actions on the property, and we are not successful in obtaining reimbursement from one or more third parties, our operations and financial condition could be harmed.

*We may be affected by the Americans with Disabilities Act:* The Americans with Disabilities Act of 1990 requires that access and use by disabled persons of all public accommodations and commercial properties be facilitated. Existing commercial properties must be made accessible to disabled persons. While we have not estimated the cost of complying with this act, we do not believe the cost will be material.

**Our ability to control our properties may be adversely affected by ownership through partnerships and joint ventures.**

We own most of our properties through our operating partnership. Our organizational documents do not limit our ability to invest funds with others in partnerships or joint ventures. This type of investment may present additional risks. For example, our partners may have interests that differ from ours or that conflict with ours, or our partners may become bankrupt.

**We can change our business policies and increase our level of debt without shareholder approval.**

Our board of directors establishes our investment, financing, distribution and our other business policies and may change these policies without shareholder approval. Our organizational documents do not limit our level of debt. A change in our policies or an increase in our level of debt could adversely affect our operations or the price of our common stock.

**We can issue additional securities without shareholder approval.**

We can issue preferred and common stock without shareholder approval. Holders of preferred stock have priority over holders of common stock, and the issuance of additional shares of common stock reduces the interest of existing holders in our company.

**Increases in interest rates may adversely affect the market price of our common stock.**

One of the factors that influences the market price of our common stock is the annual rate of distributions that we pay on our common stock, as compared with interest rates. An increase in interest rates may lead purchasers of REIT shares to demand higher annual distribution rates, which could adversely affect the market price of our common stock.

**Shares that become available for future sale may adversely affect the market price of our common stock.**

Substantial sales of our common stock, or the perception that substantial sales may occur, could adversely affect the market price of our common stock. Certain of our shareholders hold significant numbers of shares of our common stock and, subject to compliance with applicable securities laws, could sell their shares.

**We depend on key personnel.**

We depend on our executive officers, including Ronald L. Havner, Jr., our chief executive officer and president. The loss of Mr. Havner could adversely affect our operations. We maintain no key person insurance on him.

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

To limit the Company's exposure to market risk, the Company principally finances its operations and growth with permanent equity capital consisting of either common or preferred stock. At March 31, 2001, the Company's debt as a percentage of shareholders' equity (based on book values) was 5.5%.

The Company's market risk sensitive instruments include mortgage notes payable which totaled \$30,769,000 at March 31, 2001. All of the Company's mortgage notes payable bear interest at fixed rates. See Note 6 of the Notes to Consolidated Financial Statements for terms, valuations and approximate principal maturities of the mortgage notes payable as of March 31, 2001. Based on borrowing rates currently available to the Company, the carrying amount of debt approximates fair value.

**PART II. OTHER INFORMATION**

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

(a) Exhibits

- 3.1 Certificate of Determination of Preferences of 9 1/2% Series D Cumulative Preferred Stock of PS Business Parks, Inc. Filed with Registrant's Current Report on Form 8-K dated May 7, 2001 and incorporated herein by reference.
- 10.1 Amendment to Agreement of Limited Partnership of PS Business Parks L.P. Relating to 9 1/2% Series D Cumulative Redeemable Preferred Units, dated as of May 10, 2001. Filed herewith.
- 12 Statement re: Computation of Ratio of Earnings to Fixed Charges. Filed herewith.

(b) Reports on Form 8-K

The Registrant filed a Current Report on Form 8-K dated February 16, 2001 (filed February 26, 2001) pursuant to Item 9, relating to Regulation FD Disclosure.

**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.

Dated: May 14, 2001

PS BUSINESS PARKS, INC.

BY: /s/ Jack Corrigan

Jack Corrigan

Vice President and Chief Financial Officer

PS BUSINESS PARKS, L.P.

AMENDMENT TO AGREEMENT OF LIMITED  
PARTNERSHIP RELATING TO  
9½% SERIES D CUMULATIVE REDEEMABLE  
PREFERRED UNITS

This Amendment to the Agreement of Limited Partnership of PS Business Parks, L.P., a California limited partnership (the "**Partnership**"), dated as of May 10, 2001 (this "**Amendment**"), amends the Agreement of Limited Partnership of the Partnership, dated as of March 17, 1998, as amended, by and among PS Business Parks, Inc. (the "**General Partner**") and each of the limited partners described on Exhibit A to that partnership agreement (the "**Partnership Agreement**"). Section references are (unless otherwise specified) references to sections in this Amendment.

WHEREAS, the General Partner agreed to issue 1,840,000 Depositary Shares each representing 1/1000th of a share of the General Partner's preferred stock designated as the "9.500% Cumulative Preferred Stock, Series D" (the "**Depositary Shares**") for a price of \$25.00 per Depositary Share;

WHEREAS, Section 4.1(b)(2) of the Partnership Agreement requires the General Partner to contribute to the Partnership the funds raised through the issuance of additional shares of the General Partner in return for additional Partnership Units, and provides that the General Partner's capital contribution shall be deemed to equal the amount of the gross proceeds of that share issuance (i.e., the net proceeds actually contributed, plus any underwriter's discount or other expenses incurred, with any such discount or expense deemed to have been incurred on behalf of the Partnership);

WHEREAS, Section 4.2(a) of the Partnership Agreement provides generally for the creation and issuance of Partnership Units with such designations, preferences and relative, participating, optional or other special rights, powers and duties, including rights, powers and duties senior to other Partnership Interests, all as shall be determined by the General Partner, without the consent of the Limited Partners, and Section 4.2(b) of the Partnership Agreement specifically contemplates the issuance of Units to the General Partner having designations, preferences and other rights, all such that the economic interests are substantially similar to the designations, preferences and other rights of shares issued by the General Partner, such as the Depositary Shares;

WHEREAS, the General Partner desires to cause the Partnership to issue additional Units of a new class and series, with the designations, preferences and relative, participating, optional or other special rights, powers and duties set forth herein; and

WHEREAS, the General Partner desires by this Amendment to so amend the Partnership Agreement as of the date first set forth above to provide for the designation and issuance of such new class and series of Units.

NOW, THEREFORE, the Partnership Agreement is hereby amended by establishing and fixing the rights, limitations and preferences of a new class and series of Units as follows:

**Section 1. Definitions.** Capitalized terms not otherwise defined herein shall have their respective meanings set forth in the Partnership Agreement. Capitalized terms that are used in this Amendment shall have the meanings set forth below:

(a) **"Liquidation Preference"** means, with respect to the Series D Preferred Units (as defined below), \$25.00 per Series D Preferred Unit, plus the amount of any accumulated and unpaid Priority Return (as defined below) with respect to such Series D Preferred Unit, whether or not declared, minus any distributions in excess of the Priority Return that has accrued with respect to such Series D Preferred Units, to the date of payment.

(b) **"Parity Preferred Units"** means any class or series of Partnership Interests (as such term is defined in the Partnership Agreement) of the Partnership now or hereafter authorized, issued or outstanding and expressly designated by the Partnership to rank on a parity with the Series D Preferred Units with respect to distributions and rights upon voluntary or involuntary liquidation, winding-up or dissolution of the Partnership. The  $8\frac{7}{8}\%$  Series B Cumulative Redeemable Preferred Units of the Partnership created pursuant to an amendment to the Partnership Agreement dated as of April 23, 1999 (the **"Series B Preferred Units"**), the  $9\frac{1}{4}\%$  Series A Cumulative Redeemable Preferred Units of the Partnership created pursuant to an amendment to the Partnership Agreement dated April 30, 1999 (the **"Series A Preferred Units"**), the  $8\frac{3}{4}\%$  Series C Cumulative Redeemable Preferred Units of the Partnership created pursuant to an amendment to the Partnership Agreement dated September 3, 1999 (the **"Series C Preferred Units"**), the  $8\frac{7}{8}\%$  Series X Cumulative Redeemable Preferred Units of the Partnership created pursuant to an amendment to the Partnership Agreement dated September 7, 1999 (the **"Series X Preferred Units"**), the  $8\frac{7}{8}\%$  Series Y Cumulative Redeemable Preferred Units of the Partnership created pursuant to an amendment to the Partnership Agreement dated July 12, 2000 (the **"Series Y Preferred Units"**) and the Series D Preferred Units are expressly designated as Parity Preferred Units with respect to each other. Notwithstanding the differing allocation rights set forth in Section 4 below that apply to the Series A, B, C and D Preferred Units (as compared to the Series X and Y Preferred Units), for purposes of this Amendment those Series A, B, C and D Preferred Units and any future series of preferred units that rank in parity with those series also shall be considered Parity Preferred Units to the Series X and Y Preferred Units.

(c) **"Priority Return"** means an amount equal to  $9\frac{1}{2}\%$  per annum, of the Liquidation Preference per Series D Preferred Unit, commencing on the date of issuance of such Series D Preferred Unit, determined on the basis of a 360-day year (and twelve 30-day months), cumulative to the extent not distributed on any Series D Preferred Unit Distribution Payment Date (as defined below).

**Section 2. Creation of Series D Preferred Units.** (a) **Designation and Number.** Pursuant to Section 4.2(a) of the Partnership Agreement, a series of Partnership Units (as such term is defined in the Partnership Agreement) in the Partnership designated as the  $9\frac{1}{2}\%$  Series D Cumulative Redeemable Preferred Units (the **"Series D Preferred Units"**) is hereby established effective as of May 10, 2001. The number of Series D Preferred Units shall be 1,840,000. The Holders of Series D Preferred Units shall not have any Percentage Interest (as such term is defined in the Partnership Agreement) in the Partnership.

(b) **Capital Contribution.** In return for the issuance to the General Partner of the Series D Preferred Units set forth on Exhibit C to this Amendment, the General Partner has contributed to the Partnership the funds raised through the General Partner's issuance of the Depositary Shares (the General Partner's capital contribution shall be deemed to equal the amount of the gross proceeds of that share issuance, *i.e.*, the net proceeds actually contributed, plus any underwriter's discount or other expenses incurred, with any such discount or expense deemed to have been incurred by the General Partner on behalf of the Partnership).

(c) **Construction.** The Series D Preferred Units have been created and are being issued in conjunction with the General Partner's issuance of the Depositary Shares relating to the General Partner's  $9\frac{1}{2}\%$  Cumulative Preferred Stock, Series D, and as such, the Series D Preferred Units are intended to have designations, preferences and other rights, all such that the economic interests are substantially similar to the designations,

preferences and other rights of the Depositary Shares, and the terms of this Amendment shall be interpreted in a fashion consistent with this intent.

**Section 3. Distributions.** (a) **Payment of Distributions.** Subject to the rights of holders of Parity Preferred Units as to the payment of distributions, pursuant to Section 5.1 of the Partnership Agreement, holders of Series D Preferred Units shall be entitled to receive, when, as and if declared by the Partnership acting through the General Partner, the Priority Return. Such distributions shall be cumulative, shall accrue from the original date of issuance of the Series D Preferred Units and, notwithstanding Section 5.1 of the Partnership Agreement, will be payable (i) quarterly in arrears on March 31, June 30, September 30 and December 31 of each year commencing on June 30, 2001 and (ii) in the event of a redemption of Series D Preferred Units (each a "**Series D Preferred Unit Distribution Payment Date**"). If any date on which distributions are to be made on the Series D Preferred Units is not a Business Day (as defined below), then payment of the distribution to be made on such date will be made on the Business Day immediately preceding such date with the same force and effect as if made on such date. Distributions on the Series D Preferred Units will be made to the holders of record of the Series D Preferred Units on the relevant record dates to be fixed by the Partnership acting through the General Partner, which record dates shall in no event exceed fifteen (15) Business Days prior to the relevant Series D Preferred Unit Distribution Payment Date. Business Day shall be any day other than a Saturday, Sunday or day on which banking institutions in the State of New York or the State of California are authorized or obligated by law to close, or a day which is or is declared a national or a New York or California state holiday.

(b) **Prohibition on Distribution.** No distributions on Series D Preferred Units shall be authorized by the General Partner or paid or set apart for payment by the Partnership at any such time as the terms and provisions of any agreement of the Partnership or the General Partner, including any agreement relating to their indebtedness, prohibits such authorization, payment or setting apart for payment or provides that such authorization, payment or setting apart for payment would constitute a breach thereof or a default thereunder, or to the extent that such authorization or payment shall be restricted or prohibited by law.

(c) **Distributions Cumulative.** Distributions on the Series D Preferred Units will accrue whether or not the terms and provisions of any agreement of the Partnership, including any agreement relating to its indebtedness at any time prohibit the current payment of distributions, whether or not the Partnership has earnings, whether or not there are funds legally available for the payment of such distributions and whether or not such distributions are authorized. Accrued but unpaid distributions on the Series D Preferred Units will accumulate as of the Series D Preferred Unit Distribution Payment Date on which they first become payable. Distributions on account of arrears for any past distribution periods may be declared and paid at any time, without reference to a regular Series D Preferred Unit Distribution Payment Date to holders of record of the Series D Preferred Units on the record date fixed by the Partnership acting through the General Partner which date shall not exceed fifteen (15) Business Days prior to the payment date. Accumulated and unpaid distributions will not bear interest.

(d) **Priority as to Distributions.** Subject to the provisions of Article 13 of the Partnership Agreement:

(i) So long as any Series D Preferred Units are outstanding, no distribution of cash or other property shall be authorized, declared, paid or set apart for payment on or with respect to any class or series of Partnership Interest ranking junior as to the payment of distributions or rights upon a voluntary or involuntary liquidation, dissolution or winding-up of the Partnership to the Series D Preferred Units (collectively, "Junior Units"), nor shall any cash or other property be set aside for or applied to the purchase, redemption or other acquisition for consideration of any Series D Preferred Units, any Parity Preferred Units or any Junior Units, unless, in each case, all distributions accumulated on all Series D Preferred Units and all classes and series of outstanding Parity Preferred Units have been paid in full. The foregoing sentence shall not prohibit (x) distributions payable solely in Junior Units, or (y) the conversion of Junior Units or Parity Preferred Units into Partnership Interests ranking junior to the Series D Preferred Units.

(ii) So long as distributions have not been paid in full (or a sum sufficient for such full payment is not irrevocably deposited in trust for payment) upon the Series D Preferred Units, all distributions authorized and

declared on the Series D Preferred Units and all classes or series of outstanding Parity Preferred Units shall be authorized and declared so that the amount of distributions authorized and declared per Series D Preferred Unit and such other classes or series of Parity Preferred Units shall in all cases bear to each other the same ratio that accrued distributions per Series D Preferred Unit and such other classes or series of Parity Preferred Units (which shall not include any accumulation in respect of unpaid distributions for prior distribution periods if such class or series of Parity Preferred Units do not have cumulative distribution rights) bear to each other.

(e) **No Further Rights.** Holders of Series D Preferred Units shall not be entitled to any distributions, whether payable in cash, other property or otherwise, in excess of the full cumulative distributions described herein.

**Section 4. Allocations.** Section 6.1(a)(ii) of the Partnership Agreement is amended to read, in its entirety, as follows:

“ (ii) (A) Notwithstanding anything to the contrary contained in this Agreement, in any taxable year: (1) the holders of series A, B, C and D Preferred Units shall first be allocated an amount of gross income equal to the Priority Return distributed to such holders in such taxable year, and (2) subject to any prior allocation of Profit pursuant to the loss chargeback set forth in Section 6.1(a)(ii)(B) below, the holders of Series X and Y Preferred Units shall then be allocated an amount of Profit equal to the Priority Return distributed to such holders either in such taxable year or in prior taxable years to the extent that such distributions have not previously been matched with an allocation of Profit pursuant to this Section 6.1(a)(ii)(A)(2).

(B) After the Capital Account balances of all Partners other than holders of any series of Preferred Units have been reduced to zero, Losses of the Partnership that otherwise would be allocated so as to cause deficit Capital Account balances for those other Partners shall be allocated to the holders of the Series A, B, C, D, X and Y Preferred Units in proportion to the positive balances of their Capital Accounts until those Capital Account balances have been reduced to zero. If Losses have been allocated to the holders of the Series A, B, C, D, X and Y Preferred Units pursuant to the preceding sentence, the first subsequent Profits shall be allocated to those preferred partners so as to recoup, in reverse order, the effects of the loss allocations.

(C) Upon liquidation of the Partnership or the interest of the holders of Series A, B, C, D, X or Y Preferred Units in the Partnership: (1) items of gross income or deduction shall first be allocated to the holders of Series A, B, C and D Preferred Units in a manner such that, immediately prior to such liquidation, the Capital Account balances of such holders shall equal the amount of their Liquidation Preferences, and (2) an amount of Profit or Loss shall then be allocated to the holders of Series X and Y Preferred Units in a manner such that, immediately prior to such liquidation, the Capital Account balances of such holders shall equal the amount of their Liquidation Preferences.”

**Section 5. Optional Redemption.** The Series D Preferred Units shall be redeemed at the same time, to the same extent, and applying, except as set forth below, similar procedures, as any redemption by the General Partner of the Depositary Shares. The redemption price, payable in cash, shall equal the Liquidation Preference (the "**Redemption Price**"). The Partnership will deliver into escrow with an escrow agent acceptable to the Partnership and the holders of the Series D Preferred Units being redeemed (the "**Escrow Agent**") the Redemption Price and an executed Redemption Agreement, in substantially the form attached as Exhibit A (the "**Redemption Agreement**"), and an Amendment to the Agreement of Limited Partnership evidencing the Redemption, in substantially the form attached as Exhibit B. The holders of the Series D Preferred Units to be redeemed will also deliver into escrow with the Escrow Agent an executed Redemption Agreement and an executed Amendment to the Agreement of Limited Partnership evidencing the redemption. Upon delivery of all of the above-described items by both parties, on the redemption date the Escrow Agent shall release the Redemption Price to the holders of the Series D Preferred Units and the fully-executed Redemption Agreement and Amendment to Agreement of Limited Partnership to both parties. On and after the date of redemption, distributions will cease to accumulate on the Series D Preferred Units called for redemption, unless the Partnership defaults in the payment of the Redemption Price. The Redemption Right (as such term is defined in the Partnership Agreement) given to Limited Partners (as such term is defined in the Partnership

Agreement) in Section 8.6 of the Partnership Agreement shall not be available to the holders of the Series D Preferred Units and all references to Limited Partners in said Section 8.6 (and related provisions of the Partnership Agreement) shall not include holders of the Series D Preferred Units.

**Section 6. Voting Rights.** Holders of the Series D Preferred Units will not have any voting rights or right to consent to any matter requiring the consent or approval of the Limited Partners, except as set forth in Section 14.1 of the Partnership Agreement and in this Section 6. Solely for purposes of Section 14.1 of the Partnership Agreement, each Series D Preferred Unit shall be treated as one Partnership Unit.

**Section 7. Transfer Restrictions.** The holders of Series D Preferred Units shall be subject to all of the provisions of Section 11 of the Partnership Agreement.

**Section 8. No Conversion Rights.** The holders of the Series D Preferred Units shall not have any rights to convert such units into shares of any other class or series of stock or into any other securities of, or interest in, the Partnership.

**Section 9. No Sinking Fund.** No sinking fund shall be established for the retirement or redemption of Series D Preferred Units.

**Section 10. Exhibit A to Partnership Agreement.** In order to duly reflect the issuance of the Series D Preferred Units provided for herein, the Partnership Agreement is hereby further amended pursuant to Section 12.3 of the Partnership Agreement by replacing the current form of Exhibit A to the Partnership Agreement with the form of Exhibit A that is attached to this Amendment as Exhibit C.

**Section 11. Inconsistent Provisions.** Nothing to the contrary contained in the Partnership Agreement shall limit any of the rights or obligations set forth in this Amendment.

IN WITNESS WHEREOF, this Amendment has been executed as of the date first above written.

PS BUSINESS PARKS, INC.

By: /s/ Jack Corrigan

Name: Jack E. Corrigan

Title: Chief Financial Officer

**PS BUSINESS PARKS, INC.**  
**EXHIBIT 12:**  
**STATEMENT RE: COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES**

	Three Months Ended	
	March 31,	
	2001	2000
Net income .....	\$ 11,465,000	\$ 10,743,000
Minority interest .....	6,423,000	5,911,000
Interest expense .....	237,000	374,000
Earnings available to cover fixed charges .....	\$ 18,125,000	\$ 17,028,000
Fixed charges (1) .....	\$ 649,000	\$ 772,000
Preferred distributions .....	4,459,000	4,192,000
Combined fixed charges and preferred distributions .....	\$ 5,108,000	\$ 4,964,000
Ratio of earnings to fixed charges .....	27.93	22.06
Ratio of earnings to combined fixed charges and preferred distributions .....	3.55	3.43

	Years Ended December 31,				
	2000	1999	1998	1997	1996
Net income.....	\$51,181,000	\$41,255,000	\$29,400,000	\$ 3,836,000	\$ 519,000
Minority interest .....	26,741,000	16,049,000	11,208,000	8,566,000	-
Interest expense .....	1,481,000	3,153,000	2,361,000	1,000	-
Earnings available to cover fixed charges .....	\$79,403,000	\$60,457,000	\$42,969,000	\$12,403,000	\$ 519,000
Fixed charges (1) .....	\$ 2,896,000	\$ 4,142,000	\$ 2,629,000	\$ 1,000	\$ -
Preferred distributions .....	17,273,000	7,562,000	-	-	-
Combined fixed charges and preferred distributions .....	\$20,169,000	\$11,704,000	\$ 2,629,000	\$ 1,000	\$ -
Ratio of earnings to fixed charges	27.42	14.60	16.34	12,403	N/A
Ratio of earnings to combined fixed charges and preferred distributions.....	3.94	5.17	16.34	12,403	N/A

(1) Fixed charges include interest expense plus capitalized interest.

**PS BUSINESS PARKS, INC.**

**EXHIBIT 12**

**STATEMENT RE: COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES**

Supplemental disclosure of Ratio of Funds from Operations (“FFO”) to fixed charges:

	Three Months Ended March 31,	
	2001	2000
FFO.....	\$ 22,690,000	\$ 20,208,000
Interest expense .....	237,000	374,000
Minority interest in income – preferred units.....	3,187,000	2,920,000
Preferred dividends.....	1,272,000	1,272,000
Adjusted FFO available to cover fixed charges.....	<u>\$ 27,386,000</u>	<u>\$ 24,774,000</u>
Fixed charges (1).....	\$ 649,000	\$ 772,000
Preferred distributions .....	4,459,000	4,192,000
Combined fixed charges and preferred distributions .....	<u>\$ 5,108,000</u>	<u>\$ 4,964,000</u>
Ratio of FFO to fixed charges .....	<u>42.20</u>	<u>32.09</u>
Ratio of FFO to combined fixed charges and preferred distributions .....	<u>5.36</u>	<u>4.99</u>

	Years Ended December 31,				
	2000	1999	1998	1997	1996
FFO.....	\$ 85,977,000	\$ 76,353,000	\$ 57,430,000	\$ 17,597,000	\$ 303,000
Interest expense .....	1,481,000	3,153,000	2,361,000	1,000	-
Minority interest in income – preferred units .....	12,185,000	4,156,000	-	-	-
Preferred dividends.....	5,088,000	3,406,000	-	-	-
Adjusted FFO available to cover fixed charges .....	<u>\$104,731,000</u>	<u>\$ 87,068,000</u>	<u>\$ 59,791,000</u>	<u>\$ 17,598,000</u>	<u>\$ 303,000</u>
Fixed charges (1).....	\$ 2,896,000	\$ 4,142,000	\$ 2,629,000	\$ 1,000	\$ -
Preferred distributions .....	17,273,000	7,562,000	-	-	-
Combined fixed charges and preferred distributions .....	<u>\$ 20,169,000</u>	<u>\$ 11,704,000</u>	<u>\$ 2,629,000</u>	<u>\$ 1,000</u>	<u>\$ -</u>
Ratio of FFO to fixed charges.....	<u>36.16</u>	<u>21.02</u>	<u>22.74</u>	<u>17,598</u>	<u>N/A</u>
Ratio of FFO to combined fixed charges and preferred distributions.....	<u>5.19</u>	<u>7.44</u>	<u>22.74</u>	<u>17,598</u>	<u>N/A</u>

(1) Fixed charges include interest expense plus capitalized interest.