

WASHINGTON REAL ESTATE INVESTMENT TRUST

Form 10-Q

August 07, 2009

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For quarterly period ended June 30, 2009

OR

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

COMMISSION FILE NO. 1-6622

WASHINGTON REAL ESTATE INVESTMENT TRUST

(Exact name of registrant as specified in its charter)

MARYLAND **53-0261100**
(State of incorporation) (IRS Employer Identification Number)
6110 EXECUTIVE BOULEVARD, SUITE 800, ROCKVILLE, MARYLAND 20852

(Address of principal executive office) (Zip code)

Registrant's telephone number, including area code: **(301) 984-9400**

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 such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past ninety (90) days. YES NO

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

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

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company

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

As of August 5, 2009, 58,250,386 common shares were outstanding.

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PART I

FINANCIAL INFORMATION

ITEM 1: FINANCIAL STATEMENTS

The information furnished in the accompanying unaudited Consolidated Balance Sheets, Statements of Income, Statement of Changes in Shareholders' Equity and Statements of Cash Flows reflects all adjustments, consisting of normal recurring items, which are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations and cash flows for the interim periods. The accompanying financial statements and notes thereto should be read in conjunction with the financial statements and notes for the three years ended December 31, 2008 included in WRIT's 2008 Annual Report on Form 10-K and the Current Report on Form 8-K filed July 10, 2009 with the Securities and Exchange Commission.

Table of Contents**WASHINGTON REAL ESTATE INVESTMENT TRUST AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(IN THOUSANDS, EXCEPT PER SHARE DATA)**

	(Unaudited) June 30, 2009	December 31, 2008⁽¹⁾
Assets		
Land	\$ 414,527	\$ 414,531
Income producing property	1,878,751	1,866,221
	2,293,278	2,280,752
Accumulated depreciation and amortization	(440,283)	(400,487)
Net income producing property	1,852,995	1,880,265
Development in progress	24,140	23,732
Total real estate held for investment, net	1,877,135	1,903,997
Investment in real estate sold or held for sale, net	3,838	16,408
Cash and cash equivalents	58,446	11,874
Restricted cash	21,038	18,823
Rents and other receivables, net of allowance for doubtful accounts of \$5,622 and \$6,278, respectively	49,320	45,244
Prepaid expenses and other assets	100,835	112,599
Other assets related to properties sold or held for sale	200	462
Total assets	\$ 2,110,812	\$ 2,109,407
Liabilities		
Notes payable	\$ 807,128	\$ 890,679
Mortgage notes payable	457,238	421,286
Lines of credit	15,000	67,000
Accounts payable and other liabilities	71,012	70,569
Advance rents	9,462	9,001
Tenant security deposits	10,150	10,237
Other liabilities related to properties sold or held for sale	67	210
Total liabilities	1,370,057	1,468,982
Equity		
Shareholders' equity		
Shares of beneficial interest; \$0.01 par value; 100,000 shares authorized: 58,250 and 52,434 shares issued and outstanding, respectively	584	526
Additional paid in capital	901,603	777,375
Distributions in excess of net income	(163,425)	(138,936)
Accumulated other comprehensive income (loss)	(1,808)	(2,335)
Total shareholders' equity	736,954	636,630
Noncontrolling interests in subsidiaries	3,801	3,795
Total equity	740,755	640,425

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Total liabilities and shareholders' equity	\$ 2,110,812	\$ 2,109,407
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(1) As adjusted (see Current Report on Form 8-K filed July 10, 2009)
See accompanying notes to the financial statements.

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	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Revenue				
Real estate rental revenue	\$ 76,752	\$ 68,739	\$ 154,612	\$ 138,085
Expenses				
Real estate expenses	25,590	22,310	52,994	44,988
Depreciation and amortization	23,501	20,995	46,776	41,328
General and administrative	3,716	3,058	6,898	6,081
	52,807	46,363	106,668	92,397
Real estate operating income	23,945	22,376	47,944	45,688
Other income (expense)				
Interest expense	(19,316)	(18,840)	(38,997)	(37,740)
Other income	339	220	659	458
Gain (loss) on extinguishment of debt	1,219		7,064	(8,449)
	(17,758)	(18,620)	(31,274)	(45,731)
Income (loss) from continuing operations	6,187	3,756	16,670	(43)
Discontinued operations:				
Gain on sale of real estate	6,674	15,275	6,674	15,275
Income from operations of properties held for sale	281	972	698	2,104
Net income	13,142	20,003	24,042	17,336
Less: Net income attributable to noncontrolling interests in subsidiaries	(52)	(53)	(101)	(110)
Net income attributable to the controlling interests	\$ 13,090	\$ 19,950	\$ 23,941	\$ 17,226
Basic net income attributable to the controlling interests per share				
Continuing operations	\$ 0.11	\$ 0.08	\$ 0.30	\$ 0.00
Discontinued operations, including gain on sale of real estate	0.12	0.34	0.14	0.36
Net income attributable to the controlling interests per share	\$ 0.23	\$ 0.42	\$ 0.44	\$ 0.36
Diluted net income attributable to the controlling interests per share				
Continuing operations	\$ 0.11	\$ 0.08	\$ 0.30	\$ 0.00
Discontinued operations, including gain on sale of real estate	0.12	0.33	0.14	0.36

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Net income attributable to the controlling interests per share		\$ 0.23	\$ 0.41	\$ 0.44	\$ 0.36
Weighted average shares outstanding	basic	56,276	47,933	54,604	47,278
Weighted average shares outstanding	diluted	56,277	48,033	54,605	47,278
Dividends declared and paid per share		\$ 0.4325	\$ 0.4325	\$ 0.8650	\$ 0.8550

See accompanying notes to the financial statements.

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WASHINGTON REAL ESTATE INVESTMENT TRUST AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY
(IN THOUSANDS)
(UNAUDITED)

	Shares	Shares of Beneficial Interest at Par Value	Additional Paid in Capital	Distributions in Excess of Net Income Attributable to the Controlling Interest	Accumulated Other Comprehensive Income	Total Shareholders' Equity	Noncontrolling Interests in Subsidiaries	Total Equity
Balance, December 31, 2008 ⁽¹⁾	52,434	\$ 526	\$ 777,375	\$ (138,936)	\$ (2,335)	\$ 636,630	\$ 3,795	\$ 640,425
Comprehensive income:								
Net income attributable to the controlling interest				23,941		23,941		23,941
Net income attributable to noncontrolling interests							101	101
Change in fair value of interest rate hedge					527	527		527
Total comprehensive income						24,468	101	24,569
Distributions to noncontrolling interests							(95)	(95)
Dividends				(48,430)		(48,430)		(48,430)
Issuance of common shares, net of issuance costs	5,808	58	121,955			122,013		122,013
Share grants, net of share grant amortization and forfeitures	8		2,273			2,273		2,273
Balance, June 30, 2009	58,250	\$ 584	\$ 901,603	\$ (163,425)	\$ (1,808)	\$ 736,954	\$ 3,801	\$ 740,755

⁽¹⁾ As adjusted (see Current Report on Form 8-K filed July 10, 2009)
See accompanying notes to the financial statements.

Table of Contents**WASHINGTON REAL ESTATE INVESTMENT TRUST AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(IN THOUSANDS)****(UNAUDITED)**

	Six Months Ended June 30,	
	2009	2008
Cash flows from operating activities		
Net income	\$ 24,042	\$ 17,336
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization, including amounts in discontinued operations	46,810	41,723
Provision for losses on accounts receivable	3,474	1,679
Amortization of share grants, net	1,504	1,031
Amortization of debt premiums, discounts and related financing costs	3,813	3,776
Gain on sale of real estate	(6,674)	(15,275)
Loss (gain) on extinguishment of debt, net	(7,064)	8,449
Changes in operating other assets	(5,546)	(3,244)
Changes in operating other liabilities	2,073	3,299
 Net cash provided by operating activities	 62,432	 58,774
 Cash flows from investing activities		
Real estate acquisitions, net		(16,842)
Net cash received for sale of real estate	19,320	40,231
Restricted cash tax free exchange escrow		(40,231)
Capital improvements to real estate	(13,256)	(18,016)
Development in progress	(1,179)	(13,700)
Non-real estate capital improvements	(141)	(224)
 Net cash provided by (used in) investing activities	 4,744	 (48,782)
 Cash flows from financing activities		
Line of credit borrowings	66,000	
Line of credit repayments	(118,000)	(177,500)
Dividends paid	(48,430)	(41,177)
Distributions to noncontrolling interests	(95)	(95)
Proceeds from equity offerings under dividend reinvestment program		2,560
Proceeds from mortgage notes payable	37,500	81,029
Principal payments mortgage notes payable	(1,894)	(1,938)
Proceeds from debt offering		100,000
Financing costs	(786)	(1,640)
Net proceeds from equity offerings	122,013	86,683
Notes payable repayments, including penalties for early extinguishment	(76,912)	(68,815)
Net proceeds from exercise of share options		2,137
 Net cash used in financing activities	 (20,604)	 (18,756)
 Net increase (decrease) in cash and cash equivalents	 46,572	 (8,764)
Cash and cash equivalents at beginning of year	11,874	21,488

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Cash and cash equivalents at end of the period	\$ 58,446	\$ 12,724
Supplemental disclosure of cash flow information:		
Cash paid for interest, net of amounts capitalized	\$ 35,799	\$ 35,248

See accompanying notes to the financial statements.

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WASHINGTON REAL ESTATE INVESTMENT TRUST AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2009

(UNAUDITED)

NOTE 1: NATURE OF BUSINESS

Washington Real Estate Investment Trust (we or WRIT), a Maryland real estate investment trust, is a self-administered, self-managed equity real estate investment trust, successor to a trust organized in 1960. Our business consists of the ownership and development of income-producing real estate properties in the greater Washington metro region. We own a diversified portfolio of office buildings, medical office buildings, industrial/flex centers, multifamily buildings and retail centers.

Federal Income Taxes

We believe that we qualify as a real estate investment trust (REIT) under Sections 856-860 of the Internal Revenue Code and intend to continue to qualify as such. To maintain our status as a REIT, we are required to distribute 90% of our ordinary taxable income to our shareholders. When selling properties, we have the option of (a) reinvesting the sale price of properties sold, allowing for a deferral of income taxes on the sale, (b) paying out capital gains to the shareholders with no tax to WRIT or (c) treating the capital gains as having been distributed to the shareholders, paying the tax on the gain deemed distributed and allocating the tax paid as a credit to the shareholders. In June 2008, two industrial properties, Sullyfield Center and The Earhart Building, were sold for a gain of \$15.3 million. The proceeds from the sale were treated as a distribution to shareholders. In May 2009, a multifamily property, Avondale, was sold for a gain of \$6.7 million. We currently anticipate that the proceeds from the gain will be treated as a distribution to shareholders. Generally, no provisions for income taxes are necessary except for taxes on undistributed REIT taxable income and taxes on the income generated by our taxable REIT subsidiaries (TRS). A TRS is subject to corporate federal and state income tax on its taxable income at regular statutory rates. There were no income tax provisions or material deferred income tax items for our TRS for the six month periods ended June 30, 2009 and 2008.

NOTE 2: ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been condensed or omitted pursuant to those rules and regulations, although we believe that the disclosures made are adequate to make the information presented not misleading. In addition, in the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the results for the periods presented have been included. These unaudited financial statements should be read in conjunction with the financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2008 and in our Current Report on Form 8-K filed July 10, 2009.

Within these notes to the financial statements, we refer to the three months ended June 30, 2009 and June 30, 2008 as the 2009 Quarter and the 2008 Quarter , respectively, and the six months ended June 30, 2009 and June 30, 2008 as the 2009 Period and the 2008 Period , respectively.

New Accounting Pronouncements

On May 9, 2008, the FASB issued FASB Staff Position APB14-1 (FSP 14-1). This guidance clarifies the accounting for convertible debt instruments that may be settled in cash (including partial cash settlement) upon conversion. This guidance significantly impacted the accounting of our convertible debt by requiring bifurcation of a component of the debt, classification of that component in shareholders' equity, and then accretion of the resulting discount on the debt to result in interest expense equal to the issuer's nonconvertible debt borrowing rate. Other than the impact on net income from the debt discount amortization, the calculation of earnings-per-share will not be affected. We adopted FSP 14-1 on January 1, 2009. The adoption of FSP 14-1 affected the accounting for our 3.875% convertible notes issued in 2006 and 2007 and due September 15, 2026. FSP 14-1 required retrospective application, and had been applied to all periods presented in these historical consolidated financial statements. We further disclose the impact of the adoption on our consolidated financial statements in note 11.

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In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (FAS 160), which clarifies the classification of noncontrolling interests in consolidated statements of financial position and the accounting for and reporting of transactions between the reporting entity and holders of such noncontrolling interests. Under the new standard noncontrolling interests are considered a component of total equity and should be reported as an element of consolidated equity. Net income encompasses the total income of all consolidated subsidiaries and there is a separate disclosure on the face of the income statement of the attribution of that income between the controlling and noncontrolling interests. Increases and decreases in the noncontrolling ownership interest amount are accounted for as equity transactions. We adopted FAS 160 effective for the fiscal year beginning January 1, 2009. The statement required retrospective application, and has been applied to all periods presented in these historical consolidated financial statements. As a result, all previous references to minority interest within these consolidated financial statements have been replaced with noncontrolling interest. In addition, we have changed the presentation of noncontrolling interests in our consolidated financial statements in accordance with FAS 160.

On June 16, 2008, the FASB issued FASB Staff Position EITF 03-6-1 (FSP 03-6-1). This guidance clarifies the accounting for unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents by requiring that such awards be included in the computation of earnings per share (EPS) pursuant to the two-class method. We adopted FSP 03-6-1 effective for the fiscal year beginning January 1, 2009. FSP 03-6-1 required retrospective application, and has been applied to all periods presented in these consolidated financial statements. The adoption of FSP 03-6-1 did not have a material impact on our EPS calculation. However, we have updated the presentation of the details of the calculation of EPS included in this footnote in accordance with FSP 03-6-1.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations*, a revision of SFAS No. 141. This statement changes the accounting for acquisitions by specifically eliminating the step acquisition model, changing the recognition of contingent consideration from being recognized when it was probable to being recognized at the time of acquisition, disallowing the capitalization of pre-acquisition and transaction costs, and delaying when restructuring related to acquisitions can be recognized. We adopted the standard for the fiscal year beginning January 1, 2009, and the new standard impacts the accounting for acquisitions we make after our adoption. Upon adoption of this pronouncement, we wrote off to general and administrative expense \$0.1 million of previously capitalized pre-acquisition costs. The impact of this pronouncement on our financial statements is dependent on the volume of our acquisition activity in 2009 and beyond. We currently expect the most significant impact of this statement to be the treatment of transaction costs, which are expensed as a period cost due to the adoption of this statement.

In March 2008 the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an Amendment of FASB Statement No. 133* (FAS 161). This statement requires entities to provide greater transparency about how and why an entity uses derivative instruments, and how derivative instruments and related hedged items affect an entity's financial position, results of operations, and cash flows. To meet these objectives, FAS 161 requires (a) qualitative disclosures about objectives for using derivatives by primary underlying risk exposure and by purpose or strategy, (b) information about the volume of derivative activity, (c) tabular disclosures about balance sheet location and gross fair value amounts of derivative instruments, income statement and other comprehensive income location and amounts of gains and losses on derivative instruments by type of contract, and (d) disclosures about credit risk-related contingent features in derivative agreements. We adopted FAS 161 effective for the fiscal year beginning January 1, 2009. This statement required us to provide expanded disclosures of our interest rate hedge contract and to present certain disclosures in tabular format (See note 2 to the consolidated financial statements).

In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements* (FAS 157). FAS 157 defines fair value, establishes a framework for measuring fair value in accordance with GAAP, and expands disclosures about fair value measurements. On February 12, 2007, the FASB issued FASB Staff Position No. FAS 157-2, *Effective Date of FASB Statement No. 157* (FSP 157-2). FSP 157-2 amends FAS 157 to delay the effective date for all non-financial assets and non-financial liabilities, except for those that are recognized or disclosed at fair value in the financial statements on a recurring basis (i.e. at least annually). FSP 157-2 defers the effective date of FAS 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of FSP 157-2. We do not have significant assets or liabilities recorded at fair value on a recurring basis, and therefore the adoption of this statement for non-financial assets and non-financial liabilities on January 1, 2009 did not have a material impact on our financial statements. However, starting in 2009 we will apply FAS 157 as a part of our fair value allocation to any properties acquired.

In April 2009, the FASB issued FASB Staff Position No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (FSP 107-1). FSP 107-1 amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (FAS 107), to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well in annual statements. Prior to FSP 107-1, disclosures of the

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fair values of our financial instruments were only required for our annual report on 10-K. We adopted FSP 107-1 effective for the quarter ending June 30, 2009. The required disclosures are in note 9 to the consolidated financial statements.

In May 2009, the FASB issued FASB Statement No. 165, *Subsequent Events* (FAS 165). FAS 165 requires disclosure of the date through which subsequent events have been evaluated, as well as whether that date is the date the financial statements were issued. We adopted FAS 165 effective for the quarter ending June 30, 2009. The required disclosure is in note 13 to the consolidated financial statements.

Revenue Recognition

Residential properties (our multifamily segment) are leased under operating leases with terms of generally one year or less, and commercial properties (our office, medical office, retail and industrial segments) are leased under operating leases with average terms of three to seven years. We recognize rental income and rental abatements from our residential and commercial leases when earned on a straight-line basis in accordance with SFAS No. 13, *Accounting for Leases*. Recognition of rental income commences when control of the facility has been given to the tenant. We record a provision for losses on accounts receivable equal to the estimated uncollectible amounts. This estimate is based on our historical experience and a review of the current status of our receivables. Percentage rents, which represent additional rents based on gross tenant sales, are recognized when tenants' sales exceed specified thresholds.

In accordance with SFAS No. 66, *Accounting for Sales of Real Estate*, sales are recognized at closing only when sufficient down payments have been obtained, possession and other attributes of ownership have been transferred to the buyer and we have no significant continuing involvement.

We recognize cost reimbursement income from pass-through expenses on an accrual basis over the periods in which the expenses were incurred. Pass-through expenses are comprised of real estate taxes, operating expenses and common area maintenance costs which are reimbursed by tenants in accordance with specific allowable costs per tenant lease agreements.

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable primarily represents amounts accrued and unpaid from tenants in accordance with the terms of the respective leases, subject to our revenue recognition policy. Receivables are reviewed monthly and reserves are established when, in the opinion of management, collection of the receivable is doubtful. Reserves are established for tenants whose rent payment history or financial condition casts doubt upon the tenant's ability to perform under its lease obligation. When the collection of a receivable is deemed doubtful in the same quarter that the receivable was established, then the allowance for that receivable is recognized as an offset to real estate revenues. When a receivable that was initially established in a prior quarter is deemed doubtful, then the allowance is recognized as an operating expense. In addition to rents due currently, accounts receivable include amounts representing minimal rental income accrued on a straight-line basis to be paid by tenants over the remaining term of their respective leases.

Included in our accounts receivable balance as of June 30, 2009 and December 31, 2008, are notes receivable balances of \$8.3 million and \$8.6 million, respectively.

Noncontrolling Interests in Subsidiaries

We entered into an operating partnership agreement with a member of the entity that previously owned Northern Virginia Industrial Park in conjunction with the acquisition of this property in May 1998. This resulted in a noncontrolling ownership interest in this property based upon defined company ownership units at the date of purchase. The operating partnership agreement was amended and restated in 2002 resulting in a reduced noncontrolling ownership percentage interest. We account for this activity by applying the noncontrolling owner's percentage ownership interest to the net income of the property and reporting such amount in our net income attributable to noncontrolling interests.

In August 2007 we acquired a 0.8 acre parcel of land located at 4661 Kenmore Avenue, Alexandria, Virginia for future medical office development. The acquisition was funded by issuing operating partnership units in our operating partnership, which is a consolidated subsidiary of WRIT. This resulted in a noncontrolling ownership interest in this property based upon defined company operating partnership units at the date of purchase.

Net income from noncontrolling interests was \$51,800 and \$100,700 for the 2009 Quarter and Period, respectively, and \$52,800 and \$110,200 for the 2008 Quarter and Period, respectively. None of the income from noncontrolling interests is attributable to discontinued operations or accumulated other comprehensive income. Quarterly distributions are made to the noncontrolling owners equal to the quarterly dividend per share for each operating partnership unit.

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Income (loss) attributable to the controlling interests from continuing operations was \$6.1 million and \$16.6 million for the 2009 Quarter and Period, respectively, and \$3.7 million and (\$0.1 million) for the 2008 Quarter and Period, respectively.

The operating partnership units could have a dilutive impact on our earnings per share calculation. They are not dilutive for the 2009 Quarter and Period and the 2008 Quarter and Period, and are not included in our earnings per share calculations.

Deferred Financing Costs

External costs associated with the issuance or assumption of mortgages, notes payable and fees associated with the lines of credit are capitalized and amortized using the effective interest rate method or the straight-line method which approximates the effective interest rate method over the term of the related debt. As of June 30, 2009 and December 31, 2008, deferred financing costs of \$19.6 million and \$21.3 million, respectively, net of accumulated amortization of \$9.5 million and \$9.0 million, were included in prepaid expenses and other assets on the balance sheets. The amortization is included in interest expense in the accompanying statements of income. The amortization of debt costs included in interest expense for properties classified as continuing operations totaled \$0.8 million and \$1.7 million for the 2009 Quarter and Period, respectively, and \$0.9 million and \$1.8 million for the 2008 Quarter and Period, respectively.

Deferred Leasing Costs

Costs associated with the successful negotiation of leases, both external commissions and internal direct costs, are capitalized and amortized on a straight-line basis over the terms of the respective leases. If an applicable lease terminates prior to the expiration of its initial lease term, the carrying amount of the costs are written-off to amortization expense. As of June 30, 2009 and December 31, 2008, deferred leasing costs of \$33.6 million and \$31.3 million, respectively, net of accumulated amortization of \$11.6 million and \$10.4 million, were included in prepaid expenses and other assets on the balance sheets. The amortization of deferred leasing costs included in amortization expense for properties classified as continuing operations totaled \$1.1 million and \$2.2 million for the 2009 Quarter and Period, respectively, and \$0.9 million and \$1.8 million for the 2008 Quarter and Period, respectively.

Real Estate and Depreciation

We depreciate buildings on a straight-line basis over estimated useful lives ranging from 28 to 50 years. We capitalize all capital improvement expenditures associated with replacements, improvements or major repairs to real property that extend its useful life and depreciate them using the straight-line method over their estimated useful lives ranging from 3 to 30 years. We also capitalize costs incurred in connection with our development projects, including capitalizing interest and other internal costs during periods in which qualifying expenditures have been made and activities necessary to get the development projects ready for their intended use are in progress. In addition, we capitalize tenant leasehold improvements when certain criteria are met, including when we supervise construction and will own the improvements. We depreciate all tenant improvements over the shorter of the useful life of the improvements or the term of the related tenant lease. Real estate depreciation expense from continuing operations was \$19.0 million and \$37.8 million for the 2009 Quarter and Period, respectively, and \$17.0 million and \$33.6 million for the 2008 Quarter and Period, respectively. Maintenance and repair costs that do not extend an asset's life are charged to expense as incurred.

We capitalize interest costs incurred on borrowing obligations while qualifying assets are being readied for their intended use in accordance with SFAS No. 34, *Capitalization of Interest Cost*. Total interest expense capitalized to real estate assets related to development and major renovation activities was \$0.3 million and \$0.7 million for the 2009 Quarter and Period, respectively, and \$0.7 million and \$1.6 million for the 2008 Quarter and Period, respectively. Interest capitalized is amortized over the useful life of the related underlying assets upon those assets being placed into service.

We recognize impairment losses on long-lived assets used in operations and held for sale, development assets or land held for future development, if indicators of impairment are present and the net undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying amount and estimated undiscounted cash flows associated with future development expenditures. If such carrying amount is in excess of the estimated cash flows from the operation and disposal of the property, we would recognize an impairment loss equivalent to an amount required to adjust the carrying amount to the estimated fair value. The estimated fair value would be calculated in accordance with FAS 157. There were no property impairments recognized during the 2009 and 2008 Quarters and Periods.

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Effective January 1, 2009, we record real estate acquisitions as business combinations in accordance with SFAS No. 141(R), *Business Combinations*. Acquired or assumed assets, including physical assets and in-place leases, and liabilities are recorded based on their fair values. Goodwill is recorded when the purchase price exceeds the fair value of the assets and liabilities acquired. The estimated fair values of the assets and liabilities are determined in accordance with FAS 157. The fair values of acquired buildings are determined on an as-if-vacant basis considering a variety of factors, including the physical condition and quality of the buildings, estimated rental and absorption rates, estimated future cash flows and valuation assumptions consistent with current market conditions. The as-if-vacant fair value is allocated to land, building and tenant improvements based on property tax assessments and other relevant information obtained in connection with the acquisition of the property.

The fair value of in-place leases consists of the following components (a) the estimated cost to us to replace the leases, including foregone rents during the period of finding a new tenant and foregone recovery of tenant pass-throughs (referred to as absorption cost), (b) the estimated cost of tenant improvements, and other direct costs associated with obtaining a new tenant (referred to as tenant origination cost); (c) estimated leasing commissions associated with obtaining a new tenant (referred to as leasing commissions); (d) the above/at/below market cash flow of the leases, determined by comparing the projected cash flows of the leases in place to projected cash flows of comparable market-rate leases (referred to as net lease intangible); and (e) the value, if any, of customer relationships, determined based on our evaluation of the specific characteristics of each tenant's lease and our overall relationship with the tenant (referred to as customer relationship value). We have attributed no value to customer relationship value as of June 30, 2009 or December 31, 2008.

The amounts used to calculate net lease intangibles are discounted using an interest rate which reflects the risks associated with the leases acquired. Tenant origination costs are included in income producing property on our balance sheet and are amortized as depreciation expense on a straight-line basis over the remaining life of the underlying leases. Leasing commissions and absorption costs are classified as other assets and are amortized as amortization expense on a straight-line basis over the remaining life of the underlying leases. Net lease intangible assets are classified as other assets and are amortized on a straight-line basis as a decrease to real estate rental revenue over the remaining term of the underlying leases. Net lease intangible liabilities are classified as other liabilities and are amortized on a straight-line basis as an increase to real estate rental revenue over the remaining term of the underlying leases. Should a tenant terminate its lease, the unamortized portion of the tenant origination cost, leasing commissions, absorption costs and net lease intangible associated with that lease are written off.

Balances, net of accumulated depreciation or amortization, as appropriate, of the components of the fair value of in-place leases at June 30, 2009 and December 31, 2008 are as follows (in millions):

	June 30, 2009			December 31, 2008		
	Gross Value	Carrying Amortization	Accumulated Net	Gross Value	Carrying Amortization	Accumulated Net
Tenant origination costs	\$ 40.5	\$ 18.6	\$ 21.9	\$ 40.9	\$ 16.1	\$ 24.8
Leasing commissions/absorption costs	\$ 50.2	\$ 19.7	\$ 30.5	\$ 50.7	\$ 16.3	\$ 34.4
Below-market ground lease asset	\$ 12.1	\$ 0.3	\$ 11.8	\$ 12.1	\$ 0.2	\$ 11.9
Net lease intangible assets	\$ 9.7	\$ 5.9	\$ 3.8	\$ 9.8	\$ 5.4	\$ 4.4
Net lease intangible liabilities	\$ 32.7	\$ 12.6	\$ 20.1	\$ 33.0	\$ 10.3	\$ 22.7

Amortization of these components combined was \$2.4 million and \$4.8 million for the 2009 Quarter and Period, respectively, and \$2.5 million and \$4.7 million for the 2008 Quarter and Period.

Discontinued Operations

We classify properties as held for sale when they meet the necessary criteria specified by FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and Emerging Issues Task Force Issue No. 03-13, *Applying the Conditions in Paragraph 42 of FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, in Determining Whether to Report Discontinued Operations*. These include: (a) senior management commits to and actively embarks upon a plan to sell the assets, (b) the sale is expected to be completed within one year under terms usual and customary for such sales and (c) actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn. Depreciation on these properties is discontinued, but operating revenues, operating expenses and interest expense continue to be recognized until the date of sale.

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Under SFAS No. 144, revenues and expenses of properties that are either sold or classified as held for sale are presented as discontinued operations for all periods presented in the consolidated statements of income. Interest on debt that can be identified as specifically attributed to these properties is included in discontinued operations. We do not have significant continuing involvement in the operations of any of our disposed properties.

Cash and Cash Equivalents

Cash and cash equivalents include investments readily convertible to known amounts of cash with original maturities of 90 days or less.

Restricted Cash

Restricted cash at June 30, 2009 and December 31, 2008 consisted of \$21.0 million and \$18.8 million, respectively, in funds escrowed for tenant security deposits, real estate tax, insurance and mortgage escrows and escrow deposits required by lenders on certain of our properties to be used for future building renovations or tenant improvements.

Assets and Liabilities Measured at Fair Value

For assets and liabilities measured at fair value on a recurring basis, SFAS No. 157, *Fair Value Measurements*, requires quantitative disclosures about the fair value measurements separately for each major category of assets and liabilities. The only assets or liabilities we had at June 30, 2009 and December 31, 2008 that are recorded at fair value on a recurring basis are the assets held in the Supplemental Executive Retirement Program (SERP) and interest rate hedge contracts. Our valuations related to these items are based on assumptions derived from significant other observable inputs and accordingly fall into Level 2 in the fair value hierarchy. The fair values of these assets and liabilities at June 30, 2009 and December 31, 2008 are as follows (in millions):

	June 30, 2009			December 31, 2008				
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:								
SERP	\$ 0.8	\$	\$ 0.8	\$	\$ 0.6	\$	\$ 0.6	\$
Liabilities:								
Derivatives	\$ 1.8	\$	\$ 1.8	\$	\$ 2.3	\$	\$ 2.3	\$
<i>Derivative Instruments</i>								

In February 2008, we entered into an interest rate swap with a notional amount of \$100 million that qualifies as a cash flow hedge under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133). In May 2009, we entered into a forward interest rate swap with a notional amount of \$100 million that qualifies as a cash flow hedge under FAS 133 (see Note 6 to the consolidated financial statements for further details). We enter into interest rate swaps to manage our exposure to variable rate interest risk. We do not purchase derivatives for speculation. Our cash flow hedges are recorded at fair value. The effective portion of changes in fair value of cash flow hedges is recorded in other comprehensive income. The ineffective portion of changes in fair value of cash flow hedges is recorded in earnings in the period affected. We assess effectiveness of our cash flow hedges both at inception and on an ongoing basis. The hedges were deemed effective for the 2009 and 2008 Quarters and Periods, as applicable.

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The fair value and balance sheet location of the interest rate swaps as of June 30, 2009 and December 31, 2008, are as follows (in millions):

	June 30, 2009 Fair Value	December 31, 2008 Fair Value
Accounts payable and other liabilities	\$ 1.8	\$ 2.3

The interest rate swaps have been effective since inception. The gain or loss on the effective swaps is recognized in other comprehensive income, as follows (in millions):

	Quarters Ended June 30,		Periods Ended June 30,	
	2009	2008	2009	2008
	Fair Value	Fair Value	Fair Value	Fair Value
Change in other comprehensive income (loss)	\$ 0.2	\$ 1.6	\$ 0.5	\$ 0.4

Derivative instruments expose us to credit risk in the event of non-performance by the counterparty under the terms of the interest rate hedge agreement. We believe that we minimize our credit risk on these transactions by dealing with major, creditworthy financial institutions. As part of our on-going control procedures, we monitor the credit ratings of counterparties and our exposure to any single entity, thus minimizing our credit risk concentration.

Stock Based Compensation

We previously maintained a Share Grant Plan and Incentive Stock Option Plans as described in Note 7, and pursuant to those plans we made restricted share grants and granted share options to officers, eligible employees and trustees in 2006 and prior. In March 2007, the WRIT Board of Trustees adopted, and in July 2007 WRIT shareholders approved, the Washington Real Estate Investment Trust 2007 Omnibus Long-Term Incentive Plan (2007 Plan). This plan replaced the Share Grant Plan, which formally expired on December 15, 2007, as well as the Incentive Stock Option Plans. The 2007 Plan provides for the award to WRIT's trustees, officers and non-officer employees of restricted shares, restricted share units, options and other awards up to an aggregate of 2,000,000 shares over the ten year period in which the plan will be in effect. The shares and options granted pursuant to the Share Grant Plan and the Incentive Stock Option Plan were not affected by the adoption of the 2007 Plan.

Under the plans above, officer and non-officer employee share grants vesting over five years vest in annual installments commencing one year after the date of grant, and share grants vesting over three years vest 25% from date of grant in years one and two and 50% in year three. Officer performance share units, granted under an amendment to the Share Grant Plan, cliff vest at the end of a three year performance period. Trustee share grants are fully vested immediately upon date of share grant and are restricted from transferability for the period of the trustee's service.

If an award under the Share Grant Plan is forfeited or an award of options granted under the Incentive Stock Option Plan expires without being exercised, the shares covered by those awards will not be available for issuance under the 2007 Plan. If an award under the 2007 Plan of restricted shares or restricted share units is forfeited or an award of options or any other rights granted under the 2007 Plan expires without being exercised, the shares covered by any such award would again become available for issuance under new awards.

Compensation expense is recognized for share grants over the vesting period equal to the fair market value of the shares on the date of grant. Compensation cost for restricted performance share units is initially measured at fair value at the issuance date as payouts are probable, is remeasured at subsequent reporting dates until all award conditions are established and a grant date has occurred, and is amortized to expense over the service period. Compensation expense for the trustee grants, which fully vest immediately, is fully recognized upon issuance based upon the fair market value of the shares on the date of grant. The unvested portion of officer and non-officer employee share grants is recognized in compensation cost over the vesting period. Compensation cost for awards with market conditions is based on the grant date, as determined using a Monte Carlo simulation, and recognized over the service period, regardless of whether the market conditions are achieved and the awards ultimately vest.

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Unvested shares are forfeited upon an employee's termination except for employees eligible for retirement whose unvested shares fully vest upon retirement. For shares granted to employees who are eligible for retirement or will become eligible for retirement during the vesting period, compensation cost is recognized through the date that the employee is no longer required to provide service to earn the award (e.g. the date the employee is eligible to retire).

As noted above, stock options were historically issued to officers, non-officer key employees and trustees under the Incentive Stock Option Plans. They were last issued to officers in 2002, to non-officer key employees in 2003 and to trustees in 2004. The options vested over a 2-year period in annual installments commencing one year after the date of grant, except for trustee options which vested immediately upon the date of grant. All stock options were issued prior to the adoption of SFAS No. 123(R) and were accounted for in accordance with APB No. 25, whereby if options are priced at fair market value or above at the date of grant and if other requirements are met then the plans are considered fixed and no compensation expense is recognized. Accordingly, we have recognized no compensation cost for stock options.

Earnings per Common Share

We calculate basic and diluted earnings per share in accordance with SFAS No. 128, *Earnings per Share*. Basic earnings per share excludes dilution and is computed by dividing net income attributable to the controlling interest by the weighted-average number of common shares outstanding for the period. During 2009, we adopted FSP EITF 03-6-1, which prescribed that unvested share-based payment awards with non-forfeitable rights to dividends or dividend equivalents be included in the computation of earnings per share pursuant to the two-class method. Our unvested restricted share awards have non-forfeitable rights to dividends. Pursuant to FSP EITF 03-6-1, our unvested restricted share awards are considered participating securities and are included in the computation of our basic and diluted earnings per share if the effect of applying the if-converted method is dilutive. Other sources of potentially dilutive common shares are our operating partnership units, performance share units and senior convertible notes. These were not dilutive for the 2009 and 2008 Quarters, respectively.

The following table sets forth the computation of basic and diluted earnings per share (amounts in thousands; except per share data):

	Quarter Ended June 30, 2009		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic earnings:			
Income from continuing operations	\$ 6,187	56,276	\$ 0.11
Less: Net income attributable to noncontrolling interests	(52)	56,276	
Allocation of undistributed earnings to unvested restricted share awards and units	(22)	56,276	
Income from continuing operations attributable to the controlling interest	6,113	56,276	0.11
Income from discontinued operations, including gain on sale of real estate	6,955	56,276	0.12
Net income attributable to the controlling interests	13,068	56,276	0.23
Effect of dilutive securities:			
Employee stock options		1	
Diluted earnings:			
Income from continuing operations attributable to the controlling interests	6,113	56,277	0.11
Income from discontinued operations attributable to the controlling interests	6,955	56,277	0.12
Net income attributable to the controlling interests	\$ 13,068	56,277	\$ 0.23

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	Quarter Ended June 30, 2008		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic earnings:			
Income from continuing operations	\$ 3,756	47,933	\$ 0.08
Less: Net income attributable to noncontrolling interests	(53)	47,933	
Allocation of undistributed earnings to unvested restricted share awards and units	(43)	47,933	
Income (loss) from continuing operations attributable to the controlling interest	3,660	47,933	0.08
Income from discontinued operations, including gain on sale of real estate	16,247	47,933	0.34
Net income attributable to the controlling interests	19,907	47,933	0.42
Effect of dilutive securities:			
Employee stock options		100	
Diluted earnings:			
Income from continuing operations attributable to the controlling interests	3,660	48,033	0.08
Income from discontinued operations, including gain on sale of real estate	16,247	48,033	0.33
Net income attributable to the controlling interests	\$ 19,907	48,033	\$ 0.41

	Period Ended June 30, 2009		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic earnings:			
Income from continuing operations	\$ 16,670	54,604	\$ 0.30
Less: Net income attributable to noncontrolling interests	(101)	54,604	
Allocation of undistributed earnings to unvested restricted share awards and units	(83)	54,604	
Income from continuing operations attributable to the controlling interest	16,486	54,604	\$ 0.30
Income from discontinued operations, including gain on sale of real estate	7,372	54,604	0.14
Net income attributable to the controlling interests	23,858	54,604	0.44
Effect of dilutive securities:			
Employee stock options		1	
Diluted earnings:			
Income from continuing operations attributable to the controlling interests	16,486	54,605	0.30
Income from discontinued operations, including gain on sale of real estate	7,372	54,605	0.14
Net income attributable to the controlling interests	\$ 23,858	54,605	\$ 0.44

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	Period Ended June 30, 2008		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic earnings:			
Loss from continuing operations	\$ (43)	47,278	\$
Less: Net income attributable to noncontrolling interests	(110)	47,278	
Allocation of undistributed earnings to unvested restricted share awards and units	(9)	47,278	
Income (loss) from continuing operations attributable to the controlling interest	(162)	47,278	
Income from discontinued operations, including gain on sale of real estate	17,379	47,278	0.36
Net income attributable to the controlling interests	17,217	47,278	0.36
Effect of dilutive securities¹:			
Employee stock options			
Diluted earnings:			
Income (loss) from continuing operations attributable to the controlling interests	(162)	47,278	
Income from discontinued operations, including gain on sale of real estate	17,379	47,278	0.36
Net income attributable to the controlling interests	\$ 17,217	47,278	\$ 0.36

¹ The 2008 Period had a loss from continuing operations. Therefore, the diluted earnings per share did not assume the exercise of 99,000 potentially dilutive employee stock options, as the impact would have been antidilutive.

Accounting for Uncertainty in Income Taxes

FASB Interpretation No. 48, *Accounting for Income Taxes* (FIN 48), an interpretation of SFAS No. 109, *Accounting for Income Taxes*, prescribes how we should recognize, measure and present in our financial statements uncertain tax positions that have been taken or are expected to be taken in a tax return. Pursuant to FIN 48, we can recognize a tax benefit only if it is more likely than not that a particular tax position will be sustained upon examination or audit. To the extent that the more likely than not standard has been satisfied, the benefit associated with a tax position is measured as the largest amount that is greater than 50% likely of being recognized upon settlement.

We are subject to U.S. federal income tax as well as income tax of the states of Maryland and Virginia, and the District of Columbia, but as a REIT, we generally are not subject to income tax on our net income distributed as dividends to our shareholders.

Tax returns filed for 2005 through 2008 tax years are subject to examination by taxing authorities. We classify interest and penalties related to uncertain tax positions, if any, in our financial statements as a component of general and administrative expense.

Use of Estimates in the Financial Statements

The preparation of financial statements in conformity with GAAP requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation.

Other Comprehensive Income (Loss)

We recorded other comprehensive loss of \$1.8 million and \$2.3 million as of June 30, 2009 and December 31, 2008, respectively, to account for the change in valuation of an interest rate swap agreement that qualifies as a cash flow hedge under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

Table of Contents**NOTE 3: REAL ESTATE INVESTMENTS***Continuing Operations*

Our real estate investment portfolio, at cost, consists of properties located in Maryland, Washington, D.C. and Virginia as follows (in thousands):

	June 30, 2009	December 31, 2008
Office	\$ 1,021,845	\$ 1,014,771
Medical office	369,566	367,651
Retail	267,361	266,897
Multifamily	318,526	316,837
Industrial/flex	315,980	314,596
	\$ 2,293,278	\$ 2,280,752

The amounts above reflect properties classified as continuing operations, which means they are to be held and used in rental operations (income producing property).

The cost of our real estate portfolio in development is as follows (in thousands):

	June 30, 2009	December 31, 2008
Office	\$ 18,772	\$ 18,453
Medical office	4,992	4,815
Retail	288	239
Multifamily	88	225
Industrial/flex		
	\$ 24,140	\$ 23,732

Our results of operations are dependent on the overall economic health of our markets, tenants and the specific segments in which we own properties. These segments include general purpose office, medical office, retail, multifamily and industrial. All segments are affected by external economic factors, such as inflation, consumer confidence, unemployment rates, etc. as well as changing tenant and consumer requirements. Because the properties are located in the Washington metro region, we are subject to a concentration of credit risk related to these properties.

As of June 30, 2009, no single property or tenant accounted for more than 10% of total assets or total real estate rental revenue.

WRIT did not acquire any properties during the 2009 Period.

Table of Contents*Discontinued Operations*

We dispose of assets (sometimes using tax-deferred exchanges) that no longer meet our long-term strategy or return objectives and where market conditions for sale are favorable. The proceeds from the sales may be reinvested into other properties, used to fund development operations or to support other corporate needs, or distributed to our shareholders. Properties are considered held for sale when they meet the criteria specified by SFAS No. 144 (see Note 2 – Discontinued Operations). Depreciation on these properties is discontinued at that time, but operating revenues, other operating expenses and interest continue to be recognized until the date of sale. We have two properties classified as held for sale or sold, as follows (in thousands):

	June 30, 2009	December 31, 2008
Multifamily	\$	\$ 17,227
Industrial	4,915	4,935
Less accumulated depreciation	(1,077)	(5,754)
	\$ 3,838	\$ 16,408

We sold two properties in 2008. The two sold properties, Sullyfield Center and The Earhart Building, were classified as held for sale in November 2007, and sold on June 6, 2008. They were sold for a contract sales price of \$41.1 million, and we recognized a gain on sale of \$15.3 million, in accordance with SFAS No. 66, *Accounting for Sales of Real Estate*.

We sold one property and classified one property as held for sale in 2009. A multifamily property, Avondale, was sold on May 13, 2009 for a contract sales price of \$19.8 million that resulted in a gain on sale of \$6.7 million. In March, 2009, Charleston Business Center, an industrial property, met the criteria specified in FAS 144 necessary for classification as held for sale and met the criteria specified in EITF 03-13 requiring reporting as discontinued operations. Senior management has committed to, and actively embarked upon, plans to sell the asset, and the sale is expected to be completed within one year under terms usual and customary for such sales, with no indication that the plan will be significantly altered or abandoned. Depreciation on this property has been discontinued as of the date it was classified as held for sale, but operating revenues and other operating expenses continue to be recognized until the date of sale. Under FAS 144, revenues and expenses of properties that are classified as held for sale or sold are treated as discontinued operations for all periods presented in the statements of income.

Operating results of the properties classified as discontinued operations are summarized as follows (in thousands):

	Quarters Ended June 30,		Periods Ended June 30,	
	2009	2008	2009	2008
Revenues	\$ 571	\$ 1,861	\$ 1,499	\$ 3,891
Property expenses	(283)	(686)	(767)	(1,392)
Depreciation and amortization	(7)	(203)	(34)	(395)
	\$ 281	\$ 972	\$ 698	\$ 2,104

Operating income by each property classified as discontinued operations is summarized below (in thousands):

Property	Segment	Quarters Ended		Periods Ended	
		June 30,	June 30,	June 30,	June 30,
		2009	2008	2009	2008
Sullyfield Center	Industrial	\$	\$ 469	\$	\$ 1,065
The Earhart Building	Industrial		170		421
Avondale	Multifamily	80	136	392	247
Charleston	Industrial	201	197	306	371

\$ 281 \$ 972 \$ 698 \$ 2,104

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Subsequent to the end of the 2009 Period, we sold Tech 100, an industrial property, for a contract sales price of \$10.5 million and Brandywine Center, an office property, for \$3.3 million (see Note 13 to the consolidated financial statements). As of June 30, 2009, Tech 100 and Brandywine Center did not meet the criteria specified in FAS 144 necessary for classification as held for sale. Therefore they are classified with continuing operations in these consolidated financial statements and notes thereto (in thousands):

	June 30, 2009	December 31, 2008
Tech 100	9,124	9,106
Brandywine Center	3,050	3,050
Less accumulated depreciation	(4,531)	(4,299)
	\$ 7,643	\$ 7,857

Operating results of Tech 100 and Brandywine are summarized as follows (in thousands):

	Quarters Ended June 30,		Periods Ended June 30,	
	2009	2008	2009	2008
Revenues	\$ 428	\$ 457	\$ 925	\$ 1,132
Property expenses	(162)	(192)	(372)	(386)
Depreciation and amortization	(123)	(119)	(246)	(275)
	\$ 143	\$ 146	\$ 307	\$ 471

Operating income by property sold after the end of the 2009 Quarter is summarized below (in thousands):

Property	Segment	Quarters Ended		Periods Ended	
		June 30,	June 30,	June 30,	June 30,
		2009	2008	2009	2008
Tech 100	Industrial	\$ 116	\$ 83	\$ 238	\$ 332
Brandywine Center	Office	27	63	69	139
		\$ 143	\$ 146	\$ 307	\$ 471

Table of Contents**NOTE 4: MORTGAGE NOTES PAYABLE**

	(in thousands)	
	June 30, 2009	December 31, 2008
On September 27, 1999, we executed a \$50.0 million mortgage note payable secured by Munson Hill Towers, Country Club Towers, Roosevelt Towers, Park Adams Apartments and the Ashby of McLean. The mortgage bears interest at 7.14% per annum and interest only is payable monthly until October 1, 2009, at which time all unpaid principal and interest are payable in full. Subsequent to the end of the 2009 Quarter, on July 1, 2009, we prepaid this mortgage note payable in its entirety (see Note 13 to the consolidated financial statements).	\$ 50,000	\$ 50,000
On October 9, 2003, we assumed a \$36.1 million mortgage note payable and a \$13.7 million mortgage note payable as partial consideration for our acquisition of Prosperity Medical Center. The mortgages bear interest at 5.36% per annum and 5.34% per annum respectively. Principal and interest are payable monthly until May 1, 2013, at which time all unpaid principal and interest are payable in full.	45,439	45,811
On August 12, 2004, we assumed a \$10.1 million mortgage note payable with an estimated fair value* of \$11.2 million, as partial consideration for our acquisition of Shady Grove Medical Village II. The mortgage bears interest at 6.98% per annum. Principal and interest are payable monthly until December 1, 2011, at which time all unpaid principal and interest are payable in full.	9,840	9,992
On December 22, 2004, we assumed a \$15.6 million mortgage note payable with an estimated fair value* of \$17.8 million, and a \$3.9 million mortgage note payable with an estimated fair value* of \$4.2 million as partial consideration for our acquisition of Dulles Business Park. The mortgages bear interest at 7.09% per annum and 5.94% per annum, respectively. Principal and interest are payable monthly until August 10, 2012, at which time all unpaid principal and interest are payable in full.	19,291	19,610
On March 23, 2005, we assumed a \$24.3 million mortgage note payable with an estimated fair value* of \$25.0 million as partial consideration for our acquisition of Frederick Crossing. The mortgage bears interest at 5.95% per annum. Principal and interest are payable monthly until January 1, 2013, at which time all unpaid principal and interest are payable in full.	23,052	23,304
On April 13, 2006, we assumed a \$5.7 million mortgage note payable as partial consideration for the acquisition of 9707 Medical Center Drive. The mortgage bears interest at 5.32% per annum. Principal and interest are payable monthly until July 1, 2028, at which time all unpaid principal and interest are payable in full.	5,201	5,278
On June 22, 2006, we assumed a \$4.9 million mortgage note payable as partial consideration for the acquisition of Plumtree Medical Center. The mortgage bears interest at 5.68% per annum. Principal and interest are payable monthly until March 11, 2013, at which time all unpaid principal and interest are payable in full.	4,642	4,684
On July 12, 2006, we assumed an \$8.8 million mortgage note payable as partial consideration for the acquisition of 15005 Shady Grove Road. The mortgage bears interest at 5.73% per annum. Principal and interest are payable monthly until March 11, 2013, at which time all unpaid principal and interest are payable in full.	8,391	8,468
On August 25, 2006, we assumed a \$34.2 million mortgage note payable as partial consideration for the acquisition of 20-50 West Gude Drive. The mortgage bears interest at 5.86% per annum. Principal and interest are payable monthly until February 11, 2013, at which time all unpaid principal and interest are payable in full.	32,495	32,815
On August 25, 2006, we assumed a \$23.1 million mortgage note payable as partial consideration for the acquisition of The Crescent and The Ridges. The mortgage bears interest at 5.82%** per annum. Principal and interest are payable monthly until August 11, 2033** at which time all unpaid principal and interest are payable in full. The note may be repaid without penalty on August 11, 2010.	22,084	22,277
On June 1, 2007, we assumed a \$21.2 million mortgage note payable as partial consideration for the acquisition of Woodholme Medical Office Building. The mortgage bears interest at 5.29% per annum. Principal and interest are payable monthly until November 1, 2015, at which time all unpaid principal	20,749	20,897

and interest are payable in full.

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On June 1, 2007, we assumed a \$3.1 million mortgage note payable and a \$3.0 million mortgage note payable as partial consideration for our acquisition of the Ashburn Farm Office Park. The mortgages bear interest at 5.56% per annum and 5.69% per annum, respectively. Principal and interest are payable monthly until May 31, 2025 and July 31, 2023, respectively, at which time all unpaid principal and interest are payable in full.	5,184	5,291
On May 29, 2008, we executed three mortgage notes payable totaling \$81.0 million secured by 3801 Connecticut Avenue, Walker House and Bethesda Hill. The mortgages bear interest at 5.71% per annum and interest only is payable monthly until May 31, 2016, at which time all unpaid principal and interest are payable in full.	81,029	81,029
On December 2, 2008, we assumed a \$101.9 million mortgage note payable with an estimated fair value* of \$91.7 million as partial consideration for the acquisition of 2445 M Street. The mortgage bears interest at 5.62% per annum. Interest is payable monthly until January 6, 2017, at which time all unpaid principal and interest are payable in full.	92,457	91,830
On February 17, 2009, we executed a \$37.5 million mortgage note payable secured by Kenmore Apartments. The mortgage bears interest at 5.37% per annum. Principal and interest are payable monthly until March 1, 2019, at which time all unpaid principal and interest are payable in full.	37,384	
	\$ 457,238	\$ 421,286

* The fair value of the mortgage notes payable was estimated upon acquisition by WRIT based upon market information and data, such as dealer quotes for instruments with similar terms and maturities. There is no notation when the fair value at the inception of the mortgage is the same as the carrying value.

** If the loan is not repaid on August 11, 2010, from and after August 11, 2010, the interest rate adjusts to one of the following rates: (i) the greater of (A) 10.82% or (B) the Treasury Rate (determined as of August 11, 2010, and defined as the yield calculated using linear interpolation approximating the period from August 11, 2010 to August 11, 2033 on the basis of Federal Reserve Stat. Release H.15-Selected Interest Rates under the heading U.S. Governmental Security/Treasury Constant Maturities) plus 5%; or (ii) if the Note is an asset of an entity formed for purposes of securitization and pursuant thereto securities rated by a rating agency have been issued, then the rate will equal: the greater of (A) 7.82% or (B) the Treasury Rate plus 2%. Due to the probability that the mortgage will not be paid off on August 11, 2010, the date reflected in the future maturities schedule is August 11, 2033.

Total carrying amount of the above mortgaged properties was \$730.3 million and \$666.0 million at June 30, 2009 and December 31, 2008, respectively. Scheduled principal payments for the remaining six months in 2009 and the remaining years subsequent to December 31, 2009 are as follows (in thousands):

	Principal Payments
2009	\$ 52,188
2010	4,458
2011	13,788
2012	21,823
2013	107,123
Thereafter	265,617
	464,997
Net discounts/premiums	(7,759)
Total	\$ 457,238

NOTE 5: UNSECURED LINES OF CREDIT PAYABLE

As of June 30, 2009, we maintained a \$75.0 million unsecured line of credit maturing in June 2011 (Credit Facility No. 1) and a \$262.0 million unsecured line of credit maturing in November 2010 (Credit Facility No. 2).

Credit Facility No. 1

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We had no balance outstanding as of June 30, 2009 related to Credit Facility No. 1, and \$5.4 million in letters of credit issued, with \$69.6 million unused and available for subsequent acquisitions or capital improvements. We had no balance outstanding under this facility at December 31, 2008. We borrowed \$16.0 million during the 2009 Quarter to fund repurchases of convertible debt. We repaid the \$16.0 million during the 2009 Quarter using proceeds from the May 2009 equity offering. During the 2008 Quarter we had no borrowings and repaid \$37.0 million using proceeds from the June 2008 equity offering.

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Borrowings under the facility bear interest at our option of LIBOR plus a spread based on the credit rating on our publicly issued debt or the higher of SunTrust Bank's prime rate and the Federal Funds Rate in effect plus 0.5%. All outstanding advances are due and payable upon maturity in June, 2011. Interest only payments are due and payable generally on a monthly basis. For the 2009 Quarter and Period, we recognized interest expense (excluding facility fees) of \$5,300, representing an average interest rate of 0.92%. For the 2008 Quarter and Period, we recognized interest expense (excluding facility fees) of \$0.6 million and \$1.4 million, respectively, representing an average interest rate of 5.36% and 5.27%, respectively.

In addition, we pay a facility fee based on the credit rating of our publicly issued debt which currently equals 0.15% per annum of the \$75.0 million committed capacity, without regard to usage. Rates and fees may be adjusted up or down based on changes in our senior unsecured credit ratings. For the 2009 Quarter and Period, we incurred facility fees of \$28,400 and \$56,600, respectively. For the 2008 Quarter and Period, we incurred facility fees of \$28,400 and \$46,300, respectively.

Credit Facility No. 2

We had \$15.0 million outstanding as of June 30, 2009 related to Credit Facility No. 2, and \$0.9 million in letters of credit issued, with \$246.1 million unused and available for subsequent acquisitions or capital improvements. \$67.0 million was outstanding under this facility at December 31, 2008. During the 2009 Quarter, we borrowed \$26.0 million to fund repurchases of convertible debt and repaid \$59.0 million with proceeds from the May 2009 equity offering. During the 2008 Quarter we repaid \$122.5 million using proceeds from the June 2008 offering and new mortgage notes

Borrowings under the facility bear interest at our option of LIBOR plus a spread based on the credit rating on our publicly issued debt or the higher of Wells Fargo Bank's prime rate and the Federal Funds Rate in effect plus 0.5%. All outstanding advances are due and payable upon maturity in November, 2010. Interest only payments are due and payable generally on a monthly basis. For the 2009 Quarter and Period, we recognized interest expense (excluding facility fees) of \$59,900 and \$180,200, respectively, representing an average interest rate of 1.19% and 1.00%, respectively. For the 2008 Quarter and Period, we recognized interest expense (excluding facility fees) of \$1.2 million and \$2.8 million, respectively, representing an average interest rate of 5.58% and 5.33%, respectively.

In addition, we pay a facility fee based on the credit rating of our publicly issued debt which currently equals 0.15% per annum of the \$262.0 million committed capacity, without regard to usage. Rates and fees may be adjusted up or down based on changes in our senior unsecured credit ratings. For the 2009 Quarter and Period, we incurred facility fees of \$98,300 and \$196,100, respectively. For the 2008 Quarter and Period, we incurred facility fees of \$99,300 and \$192,500, respectively.

Credit Facility No. 1 and No. 2 contain certain financial and non-financial covenants, all of which we have met as of June 30, 2009.

NOTE 6: NOTES PAYABLE

On February 20, 1998, we issued \$50.0 million of 7.25% unsecured notes due February 25, 2028 at 98.653% to yield approximately 7.36%.

On March 17, 2003, we issued \$60.0 million of 5.125% unsecured notes due March 2013. The notes bear an effective interest rate of 5.23%. Our total proceeds, net of underwriting fees, were \$59.1 million. We used portions of the proceeds of these notes to repay advances on our lines of credit and to fund general corporate purposes.

On December 11, 2003, we issued \$100.0 million of 5.25% unsecured notes due January 2014. The notes bear an effective interest rate of 5.34%. Our total proceeds, net of underwriting fees, were \$99.3 million. We used portions of the proceeds of these notes to repay advances on our lines of credit.

On April 26, 2005, we issued \$50.0 million of 5.05% unsecured notes due May 1, 2012 and \$50.0 million of 5.35% unsecured notes due May 1, 2015, at effective yields of 5.064% and 5.359% respectively. The net proceeds from the sale of the notes of \$99.1 million were used to repay borrowings under our lines of credit totaling \$90.5 million and the remainder was used for general corporate purposes.

On October 6, 2005, we issued an additional \$100.0 million of the series of 5.35% unsecured notes due May 1, 2015, at an effective yield of 5.49%. \$93.5 million of the \$98.1 million net proceeds from the sale of these notes was used to repay borrowings under our lines of credit and the remainder was used to fund general corporate purposes.

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On June 6, 2006, we issued \$100.0 million of 5.95% unsecured notes due June 15, 2011 at 99.951% of par, resulting in an effective interest rate of 5.96%. Our total proceeds, net of underwriting fees, were \$99.4 million. We used the proceeds of these notes to repay advances on one of our lines of credit.

On July 26, 2006, we issued an additional \$50.0 million of the series of 5.95% unsecured notes due June 15, 2011 at 100.127% of par, resulting in an effective yield of 5.92%. Our total proceeds, net of underwriting fees, were \$50.2 million. We used the proceeds of these notes to repay borrowings under our lines of credit and to fund general corporate purposes.

On September 11, 2006, we issued \$100.0 million of 3.875% convertible notes due September 15, 2026. On September 22, 2006, we issued an additional \$10.0 million of the 3.875% convertible notes due September 15, 2026, upon the exercise by the underwriter of an over-allotment option granted by WRIT. The notes were issued at 99.5% of par. The adoption of FSP 14-1 (see Note 2 to the consolidated financial statements) resulted in a discount on the 3.875% convertible notes that is amortized as an increase to interest expense over the expected life of the debt. This increases the effective interest rate on the 3.875% convertible notes to 5.875%. Our total proceeds, net of underwriting fees, were \$106.7 million. We used the proceeds of these notes to repay borrowings under our lines of credit and to fund general corporate purposes.

On January 22, 2007, we issued an additional \$135.0 million of the 3.875% convertible notes due September 15, 2026. On January 30, 2007, we issued an additional \$15.0 million of the 3.875% convertible notes due September 15, 2026, upon the exercise by the underwriter of an over-allotment option granted by WRIT. The notes were issued at 100.5% of par. The adoption of FSP 14-1 (see Note 2 to the consolidated financial statements) resulted in a discount on the 3.875% convertible notes that is amortized as an increase to interest expense over the expected life of the debt. This increases the effective interest rate on the 3.875% convertible notes to 5.875%. Our total proceeds, net of underwriting fees, were \$146.0 million. We used the proceeds of these notes to fund the acquisition of 270 Technology Park and a portion of the acquisition of Monument II, to repay borrowings under our lines of credit and to fund general corporate purposes.

The convertible notes are convertible into our common shares at the option of the holder, under specific circumstances or on or after July 15, 2026, at an initial exchange rate of 20.090 common shares per \$1,000 principal amount of notes. This is equivalent to an initial conversion price of \$49.78 per common share, which represents a 22% premium over the \$40.80 closing price of our common shares at the time the September 2006 transaction was priced and a 21% premium over the \$41.17 closing price of our common shares at the time the January 2007 transaction was priced. Holders may convert their notes into our common shares prior to the maturity date based on the applicable conversion rate during any fiscal quarter if the closing price of our common shares for at least 20 trading days in the 30 consecutive trading day period ending on the last trading day of the immediate preceding fiscal quarter is more than 130% of the conversion price per common share on the last day of such preceding fiscal quarter. The initial conversion rate is subject to adjustment in certain circumstances including an adjustment to the rate if the quarterly dividend rate to common shareholders is in excess of \$0.4125 per share. In addition, the conversion rate will be adjusted if we make distributions of cash or other consideration by us or any of our subsidiaries in respect of a tender offer or exchange offer for our common shares, to the extent such cash and the value of any such other consideration per common share validly tendered or exchanged exceeds the closing price of our common shares as defined in the note offering. Upon an exchange of notes, we will settle any amounts up to the principal amount of the notes in cash and the remaining exchange value, if any, will be settled, at our option, in cash, common shares or a combination thereof. The convertible notes could have a dilutive impact on our earnings per share calculation in the future. However, these convertible notes are not dilutive for the 2009 and 2008 Quarters, and are not included in our earnings per share calculations.

On or after September 20, 2011, we may redeem the convertible notes at a redemption price equal to the principal amount of the convertible notes plus any accrued and unpaid interest, if any, up to, but excluding, the purchase date. In addition, on September 15, 2011, September 15, 2016 and September 15, 2021 or following the occurrence of certain change in control transactions prior to September 15, 2011, holders of these notes may require us to repurchase the convertible notes for an amount equal to the principal amount of the convertible notes plus any accrued and unpaid interest thereon.

During the fourth quarter of 2008, we repurchased \$16.0 million of the convertible notes at 75.0% of par, resulting in a gain on extinguishment of debt of \$2.9 million. During the first quarter of 2009, we repurchased \$48.6 million of the convertible notes at 80.0% to 84.0% of par, resulting in a gain on extinguishment of debt of \$5.8 million. During the 2009 Quarter, we repurchased \$40.8 million of the convertible notes at 84.0% to 92.0% of par, resulting in a gain on extinguishment of debt of \$1.2 million. No repurchases were made during the 2008 Quarter or Period. As of June 30, 2009, the amount outstanding on the convertible notes is \$154.6 million.

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On January 1, 2009 we adopted the convertible debt FSP (see Notes 2 and 11 to the consolidated financial statements), which resulted in the reclassification of \$21.0 million of our convertible notes original carrying amount into shareholders equity. The amortization of the resulting discount on the convertible notes is recognized as interest expense. The effective interest rate on the liability component of the convertible notes was 5.875% for the 2009 and 2008 Quarters and Periods. The interest expense recognized relating to the contractual interest coupon was \$1.6 million and \$3.8 million for the 2009 Quarter and Period, respectively. The additional interest expense recognized relating to the amortization of the discount was \$0.7 million and \$1.7 million for the 2009 Quarter and Period, respectively. The interest expense recognized relating to the contractual interest coupon was \$2.5 million and \$5.0 million for the 2008 Quarter and Period, respectively. The additional interest expense recognized relating to the amortization of the discount was \$1.1 million and \$2.1 million for the 2008 Quarter and Period, respectively. The carrying amount of the equity component as of June 30, 2009 and December 31, 2008 is \$21.0 million. The net carrying amount of the principal is as follows (in thousands):

	June 30, 2009	December 31, 2008
Principal, gross	\$ 154,635	\$ 244,000
Unamortized discount	(6,315)	(12,047)
Principal, net	\$ 148,320	\$ 231,953

The remaining discount is being amortized through September, 2011, on the effective interest method.

During the first quarter of 2008, we repaid the \$60 million outstanding principal balance under our 6.74% 10-year Mandatory Par Put Remarketed Securities (MOPPRS) notes. The total aggregate consideration paid to repurchase the notes was \$70.8 million, which amount included the \$8.7 million remarketing option value paid to the remarketing dealer and accrued interest paid to the holders. The loss on extinguishment of debt was \$8.4 million, net of unamortized loan premium costs, upon settlement of these securities.

On February 21, 2008, we entered into a \$100 million unsecured term loan (the Term Loan) with Wells Fargo Bank, National Association. The Term Loan had a maturity date of February 19, 2010 and bore interest at our option of LIBOR plus 1.50% or Wells Fargo s prime rate.

On May 7, 2009, we entered into an agreement to modify the Term Loan with Wells Fargo, National Association to extend the maturity date from February 19, 2010 to November 1, 2011. This agreement also increased the interest rate on the Term Loan from LIBOR plus 1.50% to LIBOR plus 2.75%. To hedge our exposure to interest rate fluctuations on the Term Loan, we previously had entered into an interest rate swap on a notional amount of \$100 million through the original maturity date of February 19, 2010. This interest rate swap had the effect of fixing the LIBOR portion of the interest rate on the term loan at 2.95% through February 2010. The current interest rate, taking into account the swap, is 5.70% (2.95% plus 275 basis points). On May 6, 2009, we entered into a forward interest rate swap on a notional amount of \$100 million for the period from February 20, 2010 through the maturity date of November 1, 2011. This forward interest rate swap has the effect of fixing the LIBOR portion of the interest rate on the term loan at 2.10% from February 20, 2010 through November 1, 2011. The interest rate for that time period, taking into account the forward interest rate swap, will be 4.85% (2.10% plus 275 basis points). The forward interest rate swap agreement will settle contemporaneously with the maturity of the loan. These swaps qualify as a cash flow hedges as discussed in Note 2.

The following is a summary of our unsecured note borrowings (in thousands):

	June 30, 2009	December 31, 2008
5.70% term loan due 2011	\$ 100,000	\$ 100,000
5.95% notes due 2011	150,000	150,000
5.05% notes due 2012	50,000	50,000
5.125% notes due 2013	60,000	60,000
5.25% notes due 2014	100,000	100,000
5.35% notes due 2015	150,000	150,000
3.875% notes due 2026	154,635	244,000
7.25% notes due 2028	50,000	50,000
Discount on notes issued	(7,532)	(13,352)
Premium on notes issued	25	31

Total	\$ 807,128	\$ 890,679
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The required principal payments excluding the effects of note discounts or premium for the remaining six months in 2009 and the remaining years subsequent to December 31, 2009 are as follows (in thousands):

2009	\$
2010	
2011 ⁽¹⁾	404,635
2012	50,000
2013	60,000
Thereafter	300,000
	\$ 814,635

- (1) We reflect the 3.875% convertible notes as maturing in 2011 on this schedule due to the fact that we may redeem them at a redemption price equal to the principal amount of the notes plus any accrued and unpaid interest, if any, up to, but excluding, the purchase date on or after September 20, 2011. In addition, on September 15, 2011, September 15, 2016 and September 15, 2021 or following the occurrence of certain change in control transactions prior to September 15, 2011, holders of these notes may require us to repurchase the notes for an amount equal to the principal amount of the notes plus any accrued and unpaid interest thereon.

Interest on these notes is payable semi-annually. These notes contain certain financial and non-financial covenants, all of which we have met as of June 30, 2009.

The covenants under our line of credit agreements require us to insure our properties against loss or damage in amounts customarily maintained by similar businesses or as they may be required by applicable law. The covenants for the notes require us to keep all of our insurable properties insured against loss or damage at least equal to their then full insurable value. We have an insurance policy which has no terrorism exclusion, except for nuclear acts of terrorism and non-certified chemical and biological acts of terrorism. Our financial condition and results of operations are subject to the risks associated with acts of terrorism and the potential for uninsured losses as the result of any such acts. Effective November 26, 2002, under this existing coverage, any losses caused by certified acts of terrorism would be partially reimbursed by the United States under a formula established by federal law. Under this formula the United States pays 85% of covered terrorism losses exceeding the statutorily established deductible paid by the insurance provider, and insurers pay 10% until aggregate insured losses from all insurers reach \$100 billion in a calendar year. If the aggregate amount of insured losses under this program exceeds \$100 billion during the applicable period for all insured and insurers combined, then each insurance provider will not be liable for payment of any amount which exceeds the aggregate amount of \$100 billion. On December 26, 2007, the Terrorism Risk Insurance Program Reauthorization Act of 2007 was signed into law and extends the program through December 31, 2014.

NOTE 7: SHARE OPTIONS AND GRANTS*Options*

In March 2007, the WRIT Board of Trustees adopted, and in July 2007 WRIT shareholders approved, the Washington Real Estate Investment Trust 2007 Omnibus Long-Term Incentive Plan (2007 Plan). This plan replaced the Share Grant Plan, which expired on December 15, 2007, as well as the 2001 Stock Option Plan and Stock Option Plan for Trustees. The shares and options granted pursuant to the above plans are not affected by the adoption of the 2007 Plan. However, if an award under the Share Grant Plan is forfeited or an award of options granted under the Option Plans expires without being exercised, the shares covered by those awards will not be available for issuance under the 2007 Plan.

The 2007 Plan provides for the award to WRIT s trustees, officers and non-officer employees of restricted shares, restricted share units, options and other awards up to an aggregate of 2,000,000 shares over the ten year period in which the plan will be in effect. If an award under the 2007 Plan of restricted shares or restricted share units is forfeited or an award of options or any other rights granted under the 2007 Plan expires without being exercised, the shares covered by any such award would again become available for issuance under new awards.

The previous Option Plans provided for the grant of qualified and non-qualified options. Options granted under the plans were granted with exercise prices equal to the market price on the date of grant, vested 50% after year one and 50% after year two and expire ten years following the date of grant. Options granted to trustees were granted with exercise prices equal to the market price on the date of grant and were fully

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vested on the grant date. As discussed in Note 2, option awards were accounted for in accordance with APB No. 25, and we have recognized no compensation cost for stock options. The last option awards to officers were in 2002, to non-officer key employees in 2003 and to trustees in 2004. The following chart details the previously issued and currently outstanding and exercisable stock options:

	2009	
	Shares	Wtd Avg Ex Price
Outstanding at January 1	317,000	\$ 25.31
Granted		
Exercised		
Expired/Forfeited		
Outstanding at June 30	317,000	\$ 25.31
Exercisable at June 30	317,000	\$ 25.31

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The 317,000 options outstanding at June 30, 2009, all of which are exercisable, have exercise prices between \$14.47 and \$33.09, with a weighted-average exercise price of \$25.31 and a weighted average remaining contractual life of 3.0 years. The aggregate intrinsic value of outstanding exercisable shares at June 30, 2009 and December 31, 2008 was zero and \$0.9 million, respectively. The aggregate intrinsic value of options exercised in the 2008 Period was \$1.1 million. There were no options forfeited in the 2009 and 2008 Quarters or Periods.

Share Grants, Performance Share Units and Restricted Share Units

As discussed in Note 2 to the consolidated financial statements, we previously maintained a Share Grant Plan for officers, trustees and other members of management. In 2004 and 2005, awards were granted to officers and other members of management in the form of restricted shares, with a value equal to various percentages of a participant's salary based upon WRIT's performance compared to an appropriate benchmark target, with minimum and maximum thresholds. The awards were valued based on market value at the date of grant. Shares vest ratably over a five year period from the date of grant.

Beginning in 2005, annual long-term incentive compensation for trustees was changed from options of 2,000 shares plus 400 restricted shares to \$30,000 in restricted shares. In May 2007, the value of the restricted shares awarded to trustees was increased to \$55,000. These shares vest immediately and are restricted from sale for the period of the trustee's service.

The 2007 Plan provides for the granting of restricted share units to officers and other members of management and performance share units to officers, based upon various percentages of their salaries and their positions with WRIT. For officers, one-third of the award is in the form of restricted share units that vest 20% per year based upon continued employment and two-thirds of the award is in the form of performance share units. For other members of management, 100% of the award is in the form of restricted share units that vest 20% per year from date of grant based on performance targets.

With respect to the performance share units, performance targets will be set annually based on appropriate benchmarks with minimum and maximum payout thresholds. The grants and each award are based on cumulative performance over three years, and performance share units cliff vest at the end of the three year period. These performance share units are based on three-year cumulative performance targets set at the beginning of each year, as such, the grant date does not occur until all such targets are set and thus the significant terms of the award are known. Because payouts are probable, WRIT estimates the compensation expense at each reporting period based on the current fair market value of the probable award, until the vesting occurs and as progress towards meeting target is known, and recognizes this expense ratably over the three-year period. \$128,000 and \$154,000 were recognized during the 2008 Quarter and Period, respectively, related to the 2006 performance share units. The estimated expense related to the 2007 performance share units at the end of the three-year period is approximately \$602,000 of which \$73,000 and (\$334,000) were recognized during the 2009 Quarter and Period, respectively, with minimal expense recognized during the 2008 Quarter and Period. The estimated expense related to the 2008 performance share units at the end of the three-year period is approximately \$1.1 million of which \$194,000 and \$330,000 were recognized during the 2009 Quarter and Period, respectively, and \$105,000 and \$269,000 were recognized during the 2008 Quarter and period, respectively. The estimated expense related to the 2009 performance share units at the end of the three-year period is approximately \$2.4 million of which \$227,000 and \$404,000 were recognized during the 2009 Quarter and Period, respectively. Participants who terminate prior to the end of the three-year performance period forfeit their entire portion of the award.

Under the 2007 Plan described in Note 2 to the consolidated financial statements, elected deferrals of short term incentive awards by officers are converted into restricted share units which vest immediately on the grant date and WRIT will match 25% of the deferred short term incentive in restricted share units, which vest at the end of three years. Dividends on these restricted share units are paid in the form of restricted share units valued based on the

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market value of WRIT's stock on the date dividends are paid. WRIT granted 876 and 4,783 restricted share units to officers in 2008 and 2007, respectively, pursuant to elective short term incentive deferrals. During 2008, WRIT granted 263 restricted share units on dividends. In 2009, WRIT granted 267 restricted share units on dividends.

There were 24,344 restricted share units awarded to the prior CEO in the second quarter of 2007, and 38,228 restricted share units awarded to officers and other members of management in December 2007. There were 47,865 restricted share units awarded to officers and other members of management in 2008. Performance and restricted share units awarded were initially valued at a weighted average price per share based upon the market value on the date of grant, as follows:

	Shares	Wtd Avg Grant Price
2007	67,355	\$ 32.85
2008	49,004	\$ 26.16
2009	267	\$ 19.52

There were no shares granted during 2008. During 2007 we issued 15,962 share grants to the prior CEO at a price of \$37.59 per share based on the market value on the date of grant. They vested and were expensed immediately upon date of grant.

In August 2008 as the result of an award modification per the terms of the departing Chief Financial Officer's termination agreement, 7,820 share grants issued between 2004 and 2006 were remeasured under FAS 123(R) based on the market value of WRIT's stock at the time of the award modification. The modification accelerated the vesting of the 7,820 share grants to be fully vested by February 28, 2009. In addition, 4,560 restricted share units awarded to the departing Chief Financial Officer in 2006 and 2007 were revalued based on the market value of WRIT's stock at the time of the award modification. The modification also accelerated the vesting of the 4,560 restricted share units to be fully vested by February 28, 2009.

The following are tables of activity for the period ended June 30, 2009 related to our share grants and restricted share unit grants.

Share Grants

	Shares	2009 Wtd Avg Grant Price
Vested at January 1	312,006	\$ 29.21
Unvested at January 1	34,849	\$ 35.04
Granted		
Vested during year	(30,412)	\$ 35.33
Expired/Forfeited		
Unvested at June 30	4,437	\$ 32.98
Vested at June 30	342,418	\$ 29.76

The total fair value of shares vested during the period ending June 30, 2009 was \$0.6 million. As of June 30, 2009, the total compensation cost related to non-vested share awards not yet recognized was \$0.1 million, which is expected to be recognized over a weighted average period of 14 months on a straight-line basis.

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	2009	
	Shares	Wtd Avg Grant Price
Vested at January 1	28,914	\$ 35.00
Unvested at January 1	106,562	\$ 30.63
Granted	267	\$ 19.52
Vested during year	(16,919)	\$ 34.77
Expired/Forfeited	(211)	\$ 28.87
Unvested at June 30	89,699	\$ 29.82
Vested at June 30	45,833	\$ 34.90

The value of unvested restricted share units at June 30, 2009 was \$2.5 million, which is expected to be recognized as compensation cost over a weighted average period of 42 months on a straight-line basis.

Total compensation expense recognized for share based awards, including share grants and restricted share units, in the 2009 Quarter and Period was \$0.4 million and \$1.1 million, respectively and \$0.5 million and \$1.0 million for the 2008 Quarter and Period, respectively. The expense related to the 2009 Period includes \$0.1 million related to the accelerated vesting of the departed Chief Financial Officer's share grant awards as required by SFAS No. 123R - Share Based Payments.

NOTE 8: OTHER BENEFIT PLANS

We have a Retirement Savings Plan (the 401K Plan), which permits all eligible employees to defer a portion of their compensation in accordance with the Internal Revenue Code. Under the 401K Plan, WRIT may make discretionary contributions on behalf of eligible employees. WRIT made contributions to the 401K plan of \$0.1 million and \$0.2 million for the 2009 Quarter and Period, respectively, and \$0.1 million and \$0.2 million for the 2008 Quarter and Period, respectively.

We have adopted a non-qualified deferred compensation plan for the officers and members of the Board of Trustees. The plan allows for a deferral of a percentage of annual cash compensation and trustee fees. The plan is unfunded and payments are to be made out of our general assets. The deferred compensation liability was \$0.9 million and \$0.8 million at June 30, 2009 and December 31, 2008, respectively.

We established a Supplemental Executive Retirement Plan (SERP) effective July 1, 2002 for the benefit of our prior CEO. Under this plan, upon the prior CEO's termination of employment from WRIT for any reason other than death, permanent and total disability, or discharge for cause, he is entitled to receive an annual benefit equal to his accrued benefit times his vested interest. We accounted for this plan in accordance with SFAS No. 87, *Employers' Accounting for Pensions*, whereby we accrued benefit cost in an amount that resulted in an accrued balance at the end of the prior CEO's employment in June 2007 which was not less than the present value of the estimated benefit payments to be made. At June 30, 2009 and December 31, 2008, the accrued benefit liability was \$1.7 million and \$1.9 million, respectively. For the 2009 Quarter and Period, we recognized current service cost of \$31,000 and \$62,000, respectively. For the 2008 Quarter and Period, we recognized current service cost of \$33,000 and \$66,000, respectively. On December 31, 2006, WRIT adopted the recognition and disclosure provisions of SFAS No. 158. SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans-an Amendment of FASB Statements No. 87, 88, 106, and 132(r)* (FAS 158), required WRIT to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of its pension plan in the December 31, 2006 statement of financial position, with a corresponding adjustment to accumulated other comprehensive income, net of tax. Because the prior CEO's SERP is unfunded, the adoption of FAS 158 did not have an effect on WRIT's consolidated financial condition at December 31, 2006, or for any prior period presented and it will not affect WRIT's operating results in future periods. WRIT currently has an investment in corporate owned life insurance intended to meet the SERP benefit liability since the prior CEO's retirement. Benefit payments to the prior CEO began in 2008.

In November 2005, the Board of Trustees approved the establishment of a SERP for the benefit of the officers, other than the prior CEO. This is a defined contribution plan under which, upon a participant's termination of employment from WRIT for any reason other than death, discharge for cause or total and permanent disability, the participant will be entitled to receive a benefit equal to the participant's accrued benefit times the participant's vested interest, offset by the corresponding change in the liability. We account for this plan in accordance with

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EITF 97-14, *Accounting for Deferred Compensation Arrangements Where Amounts Earned are Held in a Rabbi Trust and Invested* and SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, whereby the investments are reported at fair value, and unrealized holding gains and losses are included in earnings. For the 2009 Quarter and Period, we recognized current service cost of \$50,000 and \$111,000, respectively. For the 2008 Quarter and Period, we recognized current service cost of \$76,000 and \$161,000, respectively.

NOTE 9: FAIR VALUE OF FINANCIAL INSTRUMENTS

FSP 107-1 extends the requirements of FAS 107 to disclose the fair value of financial instruments in interim periods. The following disclosures of estimated fair value were determined by management using available market information and established valuation methodologies, including discounted cash flow. Many of these estimates involve significant judgment. The estimated fair value disclosed may not necessarily be indicative of the amounts we could realize on disposition of the financial instruments. The use of different market assumptions or estimation methodologies could have an effect on the estimated fair value amounts. In addition, fair value estimates are made at a point in time and thus, estimates of fair value subsequent to June 30, 2009 may differ significantly from the amounts presented.

Below is a summary of significant methodologies used in estimating fair values and a schedule of fair values at June 30, 2009.

Cash and Cash Equivalents

Cash and cash equivalents includes cash and commercial paper with original maturities of less than 90 days, which are valued at the carrying value, which approximates fair value due to the short maturity of these instruments.

Notes Receivable

The fair value of the notes is estimated based on quotes for debt with similar terms and characteristics or a discounted cash flow methodology using market discount rates if reliable quotes are not available.

Derivatives

The company reports its interest rate swap at fair value in accordance with SFAS No. 133, and thus the carrying value is the fair value.

Mortgage Notes Payable

Mortgage notes payable consist of instruments in which certain of our real estate assets are used for collateral. The fair value of the mortgage notes payable is estimated based primarily upon lender quotes for instruments with similar terms and maturities.

Lines of Credit Payable

Lines of credit payable consist of bank facilities which we use for various purposes including working capital, acquisition funding or capital improvements. The lines of credit advances are priced at a specified rate plus a spread. The carrying value of the lines of credit payable is estimated to be market value given the adjustable rate of these borrowings.

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The fair value of these securities is estimated based primarily on lender quotes for securities with similar terms and characteristics.

(in thousands)	As of June 30, 2009		As of December 31, 2008	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Cash and cash equivalents, including restricted cash	\$ 79,484	\$ 79,484	\$ 30,697	\$ 30,697
2445 M Street note receivable	\$ 6,831	\$ 8,104	\$ 7,331	\$ 7,331
Interest rate hedge liability	\$ 1,808	\$ 1,808	\$ 2,335	\$ 2,335
Mortgage notes payable	\$ 457,238	\$ 445,000	\$ 421,286	\$ 408,089
Lines of credit payable	\$ 15,000	\$ 15,000	\$ 67,000	\$ 67,000
Notes payable	\$ 807,128	\$ 750,639	\$ 890,679	\$ 712,763

NOTE 10: SEGMENT INFORMATION

We have five reportable segments: office, medical office, retail, multifamily and industrial/flex properties. Office buildings provide office space for various types of businesses and professions. Medical office buildings provide offices and facilities for a variety of medical services. Retail centers are typically neighborhood grocery store or drug store anchored retail centers. Multifamily properties provide rental housing for individuals and families. Industrial/flex centers are used for flex-office, warehousing, services and distribution type facilities.

Real estate rental revenue as a percentage of the total for each of the five reportable operating segments is as follows:

	Quarters Ended June 30,		Periods Ended June 30,	
	2009	2008	2009	2008
Office	44%	42%	44%	42%
Medical office	15%	16%	15%	16%
Retail	13%	15%	13%	15%
Multifamily	15%	13%	15%	12%
Industrial	13%	14%	13%	15%

The percentage of total income producing real estate assets, at cost, for each of the five reportable operating segments is as follows:

	June 30, 2009	December 31, 2008
Office	44%	44%
Medical office	16%	16%
Retail	12%	12%
Multifamily	14%	14%
Industrial	14%	14%

The accounting policies of each of the segments are the same as those described in Note 2. We evaluate performance based upon operating income from the combined properties in each segment. Our reportable operating segments are consolidations of similar properties. SFAS No.131, *Disclosures about Segments of an Enterprise and Related Information*, requires that segment disclosures present the measure(s) used by the chief operating decision maker for purposes of assessing segments performance. Net operating income is a key measurement of our segment profit and loss. Net operating income is defined as segment real estate rental revenue less segment real estate expenses.

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The following table presents real estate rental revenue and net operating income for the 2009 and 2008 Quarters and Periods from these segments, and reconciles net operating income of reportable segments to net income as reported (in thousands):

	Quarter Ended June 30, 2009						Consolidated
	Office	Medical Office	Retail	Multifamily	Industrial/Flex	Corporate and Other	
Real estate rental revenue	\$ 33,986	\$ 11,033	\$ 10,233	\$ 11,605	\$ 9,895	\$	\$ 76,752
Real estate expenses	12,124	3,566	2,565	4,696	2,639		25,590
Net operating income	\$ 21,862	\$ 7,467	\$ 7,668	\$ 6,909	\$ 7,256	\$	\$ 51,162
Depreciation and amortization							(23,501)
Interest expense							(19,316)
General and administrative							(3,716)
Other income							339
Gain on extinguishment of debt, net							1,219
Gain on sale of real estate							6,674
Income from discontinued operations							281
Net income							13,142
Less: Net income attributable to noncontrolling interests							(52)
Net income attributable to the controlling interests							\$ 13,090
Capital expenditures	\$ 5,296	\$ 1,278	\$ 455	\$ 1,064	\$ 625	\$ 67	\$ 8,785
Total assets	\$ 939,784	\$ 342,693	\$ 227,252	\$ 246,385	\$ 264,135	\$ 90,563	\$ 2,110,812

	Quarter Ended June 30, 2008						Consolidated
	Office	Medical Office	Retail	Multifamily	Industrial/Flex	Corporate and Other	
Real estate rental revenue	\$ 28,716	\$ 10,869	\$ 10,341	\$ 8,789	\$ 10,024	\$	\$ 68,739
Real estate expenses	9,810	3,439	2,411	4,130	2,520		22,310
Net operating income	\$ 18,906	\$ 7,430	\$ 7,930	\$ 4,659	\$ 7,504	\$	\$ 46,429
Depreciation and amortization							(20,995)
Interest expense							(18,840)
General and administrative							(3,058)
Other income							220
Gain on sale of real estate							15,275
Income from discontinued operations							972
Net income							20,003
Less: Net income attributable to noncontrolling interests							(53)
Net income attributable to the controlling interests							\$ 19,950
Capital expenditures	\$ 5,840	\$ 2,113	\$ 1,291	\$ 1,621	\$ 1,830	\$ 181	\$ 12,876

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Total assets	\$ 761,747	\$ 349,493	\$ 233,775	\$ 203,789	\$ 272,041	\$ 82,908	\$ 1,903,753
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	Period Ended June 30, 2009						Corporate and Other	Consolidated
	Office	Medical Office	Retail	Multifamily	Industrial/ Flex			
Real estate rental revenue	\$ 68,395	\$ 22,518	\$ 20,813	\$ 22,774	\$ 20,112	\$	\$ 154,612	
Real estate expenses	24,843	7,499	5,438	9,585	5,629		52,994	
Net operating income	\$ 43,552	\$ 15,019	\$ 15,375	\$ 13,189	\$ 14,483	\$	\$ 101,618	
Depreciation and amortization							(46,776)	
Interest expense							(38,997)	
General and administrative							(6,898)	
Other income							659	
Gain on extinguishment of debt, net							7,064	
Gain on sale of real estate							6,674	
Income from discontinued operations							698	
Net income							24,042	
Less: Net income attributable to noncontrolling interests							(101)	
Net income attributable to the controlling interests							\$ 23,941	
Capital expenditures	\$ 7,485	\$ 2,157	\$ 504	\$ 1,578	\$ 1,532	\$ 141	\$ 13,397	

	Period Ended June 30, 2008						Corporate and Other	Consolidated
	Office	Medical Office	Retail	Multifamily	Industrial/ Flex			
Real estate rental revenue	\$ 58,417	\$ 21,603	\$ 20,987	\$ 16,921	\$ 20,157	\$	\$ 138,085	
Real estate expenses	20,355	6,949	4,683	7,971	5,030		44,988	
Net operating income	\$ 38,062	\$ 14,654	\$ 16,304	\$ 8,950	\$ 15,127	\$	\$ 93,097	
Depreciation and amortization							(41,328)	
Interest expense							(37,740)	
General and administrative							(6,081)	
Other income							458	
Loss on extinguishment of debt							(8,449)	
Gain on sale of real estate							15,275	
Income from discontinued operations							2,104	
Net income							17,336	
Less: Net income attributable to noncontrolling interests							(110)	
Net income attributable to the controlling interests							\$ 17,226	
Capital expenditures	\$ 7,913	\$ 3,074	\$ 1,656	\$ 2,951	\$ 2,422	\$ 224	\$ 18,240	

NOTE 11: CHANGE IN METHOD OF ACCOUNTING FOR CONVERTIBLE DEBT

On May 9, 2008, the FASB issued FASB Staff Position APB 14-1 (FSP 14-1). This guidance clarifies the accounting for convertible debt instruments that may be settled in cash (including partial cash settlement) upon conversion. We adopted FSP 14-1 effective for the fiscal year beginning January 1, 2009. FSP 14-1 required retrospective application, and has been applied to all periods presented in these consolidated financial statements. This guidance significantly impacted the accounting of our convertible debt by requiring bifurcation of a component of the debt, classification of that component in stockholders' equity, and then accretion of the resulting discount on the debt to result in interest expense

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equal to our nonconvertible debt borrowing rate. The adoption of FSP 14-1 impacted operating results with higher interest expense and lower gain on extinguishment of the convertible debt. The effective interest rate on the liability component of the convertible notes is 5.875% for the 2009 and 2008 Quarters and Periods.

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The following financial statement line items were affected by this accounting change for the periods indicated (in thousands, except for per share amounts):

Consolidated statements of income:

	For the Quarter Ended June 30, 2009		
	As computed		
	prior to FSP 14-1	As reported under FSP 14-1	Effect of Change
Interest expense	\$ 18,401	\$ 19,316	\$ (915)
Gain on extinguishment of debt	\$ 2,731	\$ 1,219	\$ (1,512)
Income from continuing operations	\$ 8,614	\$ 6,187	\$ (2,427)
Net income attributable to the controlling interests	\$ 15,517	\$ 13,090	\$ (2,427)
Earnings per share, diluted	\$ 0.27	\$ 0.23	\$ (0.04)

	For the Quarter Ended June 30, 2008		
	As computed		
	prior to FSP 14-1	As reported under FSP 14-1	Effect of Change
Interest expense	\$ 17,582	\$ 18,840	\$ (1,258)
Income from continuing operations	\$ 5,014	\$ 3,756	\$ (1,258)
Net income attributable to the controlling interest	\$ 21,208	\$ 19,950	\$ (1,258)
Earnings per share, diluted	\$ 0.44	\$ 0.41	\$ (0.03)

	For the Period Ended June 30, 2009		
	As computed		
	prior to FSP 14-1	As reported under FSP 14-1	Effect of Change
Interest expense	\$ 36,888	\$ 38,997	\$ (2,109)
Gain on extinguishment of debt	\$ 10,082	\$ 7,064	\$ (3,018)
Income from continuing operations	\$ 21,797	\$ 16,670	\$ (5,127)
Net income attributable to the controlling interests	\$ 29,068	\$ 23,941	\$ (5,127)
Earnings per share, diluted	\$ 0.53	\$ 0.44	\$ (0.09)

	For the Period Ended June 30, 2008		
	As computed		
	prior to FSP 14-1	As reported under FSP 14-1	Effect of Change
Interest expense	\$ 35,246	\$ 37,740	\$ (2,494)
Income (loss) from continuing operations	\$ 2,451	\$ (43)	\$ (2,494)
Net income attributable to the controlling interest	\$ 19,720	\$ 17,226	\$ (2,494)
Earnings per share, diluted	\$ 0.41	\$ 0.36	\$ (0.05)

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Consolidated balance sheets:

	As of June 30, 2009		
	As computed prior to FSP 14-1	As reported under FSP 14-1	Effect of Change
Income producing property	\$ 1,852,385	\$ 1,852,995	\$ 610
Development in progress	\$ 24,005	\$ 24,140	\$ 135
Prepaid expenses and other assets	\$ 102,920	\$ 100,835	\$ (2,085)
Total assets	\$ 2,112,152	\$ 2,110,812	\$ (1,340)
Notes payable	\$ 813,582	\$ 807,128	\$ (6,454)
Total liabilities	\$ 1,376,511	\$ 1,370,057	\$ (6,454)
Additional paid in capital	\$ 880,569	\$ 901,603	\$ 21,034
Distributions in excess of net income	\$ (147,505)	\$ (163,425)	\$ (15,920)
Total equity	\$ 735,641	\$ 740,755	\$ 5,114
Total liabilities and equity	\$ 2,112,152	\$ 2,110,812	\$ (1,340)

	As of December 31, 2008		
	As computed prior to FSP 14-1	As reported under FSP 14-1	Effect of Change
Income producing property	\$ 1,865,611	\$ 1,866,221	\$ 610
Development in progress	\$ 23,630	\$ 23,732	\$ 102
Prepaid expenses and other assets	\$ 115,295	\$ 112,599	\$ (2,696)
Total assets	\$ 2,111,391	\$ 2,109,407	\$ (1,984)
Notes payable	\$ 902,900	\$ 890,679	\$ (12,221)
Total liabilities	\$ 1,481,203	\$ 1,468,982	\$ (12,221)
Additional paid in capital	\$ 756,341	\$ 777,375	\$ 21,034
Distributions in excess of net income	\$ (128,139)	\$ (138,936)	\$ (10,797)
Total equity	\$ 630,188	\$ 640,425	\$ 10,237
Total liabilities and equity	\$ 2,111,391	\$ 2,109,407	\$ (1,984)

NOTE 12: SHAREHOLDERS' EQUITY

During the 2009 Quarter, we completed a public offering of 5.25 million common shares priced at \$21.40 per share, raising \$107.5 million in net proceeds. The net proceeds were used to repay borrowing under our unsecured lines of credit and for general corporate purposes.

During the third quarter of 2008, we entered into a sales agency financing agreement with BNY Mellon Capital Markets, LLC relating to the issuance and sale of up to \$150.0 million of our common shares from time to time over a period of no more than 36 months. Sales of our common shares are made at market prices prevailing at the time of sale. Net proceeds for the sale of common shares under this program are used for the repayment of borrowings under our lines of credit, acquisitions, and general corporate purposes. During the 2009 Period, we issued 558,268 million common shares under this program, at a weighted average price of \$26.47 raising \$14.6 million in net proceeds. During 2008, we issued 1.1 million common shares at a weighted average price of \$36.15 under this program, raising \$40.7 million in net proceeds.

We have a dividend reinvestment program, whereby shareholders may use their dividends and optional cash payments to purchase common shares. The common shares sold under this program may either be common shares issued by us or common shares purchased in the open market. Net proceeds under this program are used for general corporate purposes. No common shares were issued under this program during the 2009 and 2008 Quarters. During 2008, 125,348 common shares were issued at a weighted average price of \$32.75 per share, raising \$4.1 million in net proceeds.

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NOTE 13: SUBSEQUENT EVENTS

On July 1, 2009, we prepaid the \$50 million mortgage note that was to mature in October 2009. This prepayment unencumbered five multifamily properties in Virginia: Munson Hill Towers, Country Club Towers, Roosevelt Towers, Park Adams Apartments and The Ashby at McLean. There was no penalty for prepayment of this mortgage note.

Subsequent to the end of the 2009 Quarter, we completed the sale of Tech 100, an industrial property, for a contract sales price of \$10.5 million and an estimated gain on disposal of \$4.2 million.

Subsequent to the end of the 2009 Quarter, we completed the sale of Brandywine Center, an office property, for a contract sales price of \$3.3 million and an estimated gain on disposal of \$1.0 million.

Subsequent to the end of the 2009 Quarter, we executed repurchases totaling \$2.1 million of the face value of our 3.875% convertible notes at 94.875% of par.

Subsequent events have been evaluated through August 7, 2009, the date of issuance for these consolidated financial statements and notes thereto.

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

The following discussion should be read in conjunction with our Consolidated Financial Statements and the notes thereto appearing in Item 1 of this report and the more detailed information contained in our Annual Report on Form 10-K for the year ended December 31, 2008 filed with the Securities and Exchange Commission on March 2, 2009, as well as our Current Report on Form 8-K filed with the Securities and Exchange Commission on July 10, 2009.

We refer to the three months ended June 30, 2009 and June 30, 2008 as the 2009 Quarter and the 2008 Quarter, respectively, and the six months ended June 30, 2009 and June 30, 2008 as the 2009 Period and the 2008 Period, respectively.

Forward-Looking Statements

We claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 for the foregoing statements. The following important factors, in addition to those discussed elsewhere in our 2008 Annual Report on Form 10-K under the caption Risk Factors and elsewhere in that report, could affect our future results and could cause those results to differ materially from those expressed in the forward-looking statements: (a) the effect of the current credit and financial market conditions; (b) the availability and cost of capital; (c) fluctuations in interest rates; (d) the economic health of our tenants; (e) the timing and pricing of lease transactions; (f) the economic health of the greater Washington metro region, or other markets we may enter; (g) the effects of changes in Federal government spending; (h) the supply of competing properties; (i) consumer confidence; (j) unemployment rates; (k) consumer tastes and preferences; (l) our future capital requirements; (m) inflation; (n) compliance with applicable laws, including those concerning the environment and access by persons with disabilities; (o) governmental or regulatory actions and initiatives; (p) changes in general economic and business conditions; (q) terrorist attacks or actions; (r) acts of war; (s) weather conditions; (t) the effects of changes in capital available to the technology and biotechnology sectors of the economy; (u) the impact of newly adopted accounting principles; and (v) other factors discussed under the caption Risk Factors. We undertake no obligation to update our forward-looking statements or risk factors to reflect new information, future events, or otherwise.

Overview

Our revenues are derived primarily from the ownership and operation of income-producing properties in the greater Washington metro region. As of June 30, 2009, we owned a diversified portfolio of 92 properties, consisting of 28 office properties, 22 industrial/flex properties, 17 medical office properties, 14 retail centers, and 11 multifamily properties, encompassing in the aggregate 13.3 million net rentable square feet, and land for development. Subsequent to the end of the 2009 Quarter, we completed the sales of Tech 100, a 166,000 square foot industrial property, and Brandywine Center, a 35,000 square foot office property. We have a fundamental strategy of regional focus, diversification by property type and conservative capital management.

When evaluating our financial condition and operating performance, we focus on the following financial and non-financial indicators, discussed in further detail herein:

Net operating income (NOI) by segment, calculated as real estate rental revenue less real estate expenses excluding depreciation and amortization and general and administrative expenses. NOI is a non-GAAP supplemental measure to net income.

Funds from operations (FFO), calculated as set forth below under the caption Funds from Operations. FFO is a non-GAAP supplemental measure to net income.

Economic occupancy (occupancy), calculated as actual real estate rental revenue recognized for the period indicated as a percentage of gross potential real estate rental revenue for that period. Percentage rents and expense reimbursements are not considered in computing economic occupancy percentages.

Leased percentage, calculated as the percentage of available physical net rentable area leased for our commercial segments and percentage of apartments leased for our multifamily segment.

Rental rates.

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Leasing activity, including new leases, renewals and expirations.

Our results of operations in the 2009 Quarter were primarily impacted by acquisitions in 2008, development properties placed into service, dispositions and the performance of our core portfolio. We completed acquisitions and dispositions totaling \$257.4 million and \$41.1 million, respectively, during 2008. We placed into service from development at the end of 2007 and during 2008 two multifamily properties and one office property. The performance of our core portfolio, consisting of properties owned for the entirety of the 2009 and 2008 Quarters, declined compared to the 2008 Quarter, primarily due to lower occupancy and higher bad debt expense.

We summarize below our significant transactions during the 2009 and 2008 Periods:

2009 Period

The completion of a public offering of 5.25 million common shares priced at \$21.40 per share, raising \$107.5 million in net proceeds.

The disposition of one multifamily property, Avondale, for a contract sales price of \$19.75 million and a gain on sale of \$6.7 million.

The execution of an agreement to modify our \$100.0 million unsecured term loan with Wells Fargo Bank, National Association to extend the maturity date from February 19, 2010 to November 1, 2011. This agreement also increased the interest rate on the term loan from LIBOR plus 150 basis points to LIBOR plus 275 basis points.

The issuance of 0.6 million common shares at a weighted average price of \$26.47 under our sales agency financing agreement, raising \$14.6 million in net proceeds.

The execution of one mortgage note of approximately \$37.5 million at a fixed rate of 5.37%, secured by the Kenmore Apartments.

The repurchase of \$89.4 million of our 3.875% convertible notes at 80% to 92% of par, resulting in a gain on extinguishment of debt of \$7.1 million.

The execution of new leases for 793,800 square feet of commercial space, with an average rental rate increase of 13.2% over expiring leases.

2008 Period

The acquisition of one medical office building for \$6.5 million, adding approximately 36,000 square feet which was 100% leased at the end of the 2008 Period. The sellers of this property agreed to lease 37% of the building's space for a period of 12 to 18 months.

The sale of two industrial properties for a contract sales price of \$41.1 million, resulting in a gain on sale of \$15.3 million.

The completion of a public offering of 2.6 million common shares priced at \$34.80 per share, raising \$86.7 million in net proceeds.

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The execution of three mortgage loans totaling approximately \$81 million at a fixed rate of 5.71%, secured by three multifamily properties.

The repayment of the \$60 million outstanding principal balance under 6.74% 10-year Mandatory Par Put Remarketed Securities (MOPPRS) notes. The total aggregate consideration paid to repurchase the notes was \$70.8 million, which amount included the \$8.7 million remarketing option value paid to the remarketing dealer and accrued interest paid to the holders. The loss on extinguishment of debt was \$8.4 million, net of unamortized loan premium costs, upon settlement of these securities. WRIT refinanced the repurchase of these notes, and refinanced a portion of line outstandings, by issuing a \$100 million 2-year term loan.

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The exercise of the right to increase the capacity of the unsecured revolving credit facility with a syndicate of banks led by Wells Fargo Bank, National Association from \$200 million to \$262 million.

The execution of new leases for 470,000 square feet of commercial space, with an average rental rate increase of 18.0% over expiring leases.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate these estimates, including those related to estimated useful lives of real estate assets, estimated fair value of acquired leases, cost reimbursement income, bad debts, contingencies and litigation. We base the estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. There can be no assurance that actual results will not differ from those estimates.

We believe the following critical accounting policies reflect the significant judgments and estimates used in the preparation of our consolidated financial statements. Our significant accounting policies are also described in Note 2 to the consolidated financial statements contained in this Form 10-Q.

Revenue Recognition

Residential properties (our multifamily segment) are leased under operating leases with terms of generally one year or less, and commercial properties (our office, medical office, retail and industrial segments) are leased under operating leases with average terms of three to seven years. We recognize rental income and rental abatements from our residential and commercial leases when earned on a straight-line basis in accordance with SFAS No. 13, *Accounting for Leases*. Recognition of rental income commences when control of the facility has been given to the tenant. We record a provision for losses on accounts receivable equal to the estimated uncollectible amounts. This estimate is based on our historical experience and a review of the current status of our receivables. Percentage rents, which represent additional rents based on gross tenant sales, are recognized when tenants' sales exceed specified thresholds.

In accordance with SFAS No. 66, *Accounting for Sales of Real Estate*, sales are recognized at closing only when sufficient down payments have been obtained, possession and other attributes of ownership have been transferred to the buyer and we have no significant continuing involvement.

We recognize cost reimbursement income from pass-through expenses on an accrual basis over the periods in which the expenses were incurred. Pass-through expenses are comprised of real estate taxes, operating expenses and common area maintenance costs which are reimbursed by tenants in accordance with specific allowable costs per tenant lease agreements.

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable primarily represents amounts accrued and unpaid from tenants in accordance with the terms of the respective leases, subject to our revenue recognition policy. Receivables are reviewed monthly and reserves are established when, in the opinion of management, collection of the receivable is doubtful. Reserves are established for tenants whose rent payment history or financial condition casts doubt upon the tenant's ability to perform under its lease obligation. When the collection of a receivable is deemed doubtful in the same quarter that the receivable was established, then the allowance for that receivable is recognized as an offset to real estate revenues. When a receivable that was initially established in a prior quarter is deemed doubtful, then the allowance is recognized as an operating expense. In addition to rents due currently, accounts receivable include amounts representing minimal rental income accrued on a straight-line basis to be paid by tenants over the remaining term of their respective leases.

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Included in our accounts receivable balance as of June 30, 2009 and December 31, 2008, are notes receivable balances of \$8.3 million and \$8.6 million, respectively.

Table of Contents*Real Estate and Depreciation*

We depreciate buildings on a straight-line basis over estimated useful lives ranging from 28 to 50 years. We capitalize all capital improvement expenditures associated with replacements, improvements or major repairs to real property that extend its useful life and depreciate them using the straight-line method over their estimated useful lives ranging from 3 to 30 years. We also capitalize costs incurred in connection with our development projects, including capitalizing interest and other internal costs during periods in which qualifying expenditures have been made and activities necessary to get the development projects ready for their intended use are in progress. In addition, we capitalize tenant leasehold improvements when certain criteria are met, including when we supervise construction and will own the improvements. We depreciate all tenant improvements over the shorter of the useful life of the improvements or the term of the related tenant lease. Real estate depreciation expense from continuing operations was \$19.0 million and \$37.8 million for the 2009 Quarter and Period, respectively, and \$17.0 million and \$33.6 million for the 2008 Quarter and Period, respectively. Maintenance and repair costs that do not extend an asset's life are charged to expense as incurred.

We capitalize interest costs incurred on borrowing obligations while qualifying assets are being readied for their intended use in accordance with SFAS No. 34, *Capitalization of Interest Cost*. Total interest expense capitalized to real estate assets related to development and major renovation activities was \$0.3 million and \$0.7 million for the 2009 Quarter and Period, respectively, and \$0.7 million and \$1.6 million for the 2008 Quarter and Period, respectively. Interest capitalized is amortized over the useful life of the related underlying assets upon those assets being placed into service.

We recognize impairment losses on long-lived assets used in operations and held for sale, development assets or land held for future development, if indicators of impairment are present and the net undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying amount and estimated undiscounted cash flows associated with future development expenditures. If such carrying amount is in excess of the estimated cash flows from the operation and disposal of the property, we would recognize an impairment loss equivalent to an amount required to adjust the carrying amount to the estimated fair value. The estimated fair value would be calculated in accordance with FAS 157. There were no property impairments recognized during the 2009 and 2008 Quarters and Periods.

Effective January 1, 2009, we record real estate acquisitions as business combinations in accordance with SFAS No. 141(R), *Business Combinations*. Acquired or assumed assets, including physical assets and in-place leases, and liabilities are recorded based on their fair values. Goodwill is recorded when the purchase price exceeds the fair value of the assets and liabilities acquired. The estimated fair values of the assets and liabilities are determined in accordance with FAS 157. The fair values of acquired buildings are determined on an as-if-vacant basis considering a variety of factors, including the physical condition and quality of the buildings, estimated rental and absorption rates, estimated future cash flows and valuation assumptions consistent with current market conditions. The as-if-vacant fair value is allocated to land, building and tenant improvements based on property tax assessments and other relevant information obtained in connection with the acquisition of the property.

The fair value of in-place leases consists of the following components: (a) the estimated cost to us to replace the leases, including foregone rents during the period of finding a new tenant and foregone recovery of tenant pass-throughs (referred to as absorption cost); (b) the estimated cost of tenant improvements, and other direct costs associated with obtaining a new tenant (referred to as tenant origination cost); (c) estimated leasing commissions associated with obtaining a new tenant (referred to as leasing commissions); (d) the above/at/below market cash flow of the leases, determined by comparing the projected cash flows of the leases in place to projected cash flows of comparable market-rate leases (referred to as net lease intangible); and (e) the value, if any, of customer relationships, determined based on our evaluation of the specific characteristics of each tenant's lease and our overall relationship with the tenant (referred to as customer relationship value). We have attributed no value to customer relationship value as of June 30, 2009 or December 31, 2008.

The amounts used to calculate net lease intangibles are discounted using an interest rate which reflects the risks associated with the leases acquired. Tenant origination costs are included in income producing property on our balance sheet and are amortized as depreciation expense on a straight-line basis over the remaining life of the underlying leases. Leasing commissions and absorption costs are classified as other assets and are amortized as amortization expense on a straight-line basis over the remaining life of the underlying leases. Net lease intangible assets are classified as other assets and are amortized on a straight-line basis as a decrease to real estate rental revenue over the remaining term of the underlying leases. Net lease intangible liabilities are classified as other liabilities and are amortized on a straight-line basis as an increase to real estate rental revenue over the remaining term of the underlying leases. Should a tenant terminate its lease, the unamortized portion of the tenant origination cost, leasing commissions, absorption costs and net lease intangible associated with that lease are written off.

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We believe that we qualify as a real estate investment trust (REIT) under Sections 856-860 of the Internal Revenue Code and intend to continue to qualify as such. To maintain our status as a REIT, we are required to distribute 90% of our ordinary taxable income to our shareholders. When selling properties, we have the option of (a) reinvesting the sale price of properties sold, allowing for a deferral of income taxes on the sale, (b) paying out capital gains to the shareholders with no tax to WRIT or (c) treating the capital gains as having been distributed to the shareholders, paying the tax on the gain deemed distributed and allocating the tax paid as a credit to the shareholders. In June 2008, two industrial properties, Sullyfield Center and The Earhart Building, were sold for a gain of \$15.3 million. The proceeds from the sale were treated as a distribution to shareholders. In May 2009, a multifamily property, Avondale, was sold for a gain of \$6.7 million. It is anticipated that the proceeds from the gain will be treated as a distribution to shareholders. Generally, no provisions for income taxes are necessary except for taxes on undistributed REIT taxable income and taxes on the income generated by our taxable REIT subsidiaries (TRS). A TRS is subject to corporate federal and state income tax on its taxable income at regular statutory rates. There were no income tax provisions or material deferred income tax items for our TRS for the six month periods ended June 30, 2009 and 2008.

Results of Operations

The discussion that follows is based on our consolidated results of operations for the 2009 and 2008 Quarters. The ability to compare one period to another may be significantly affected by acquisitions completed and dispositions made during those periods.

For purposes of evaluating comparative operating performance, we categorize our properties as core , non-core or discontinued operations. A core property is one that was owned for the entirety of the periods being evaluated and is included in continuing operations. A non-core property is one that was acquired or placed into service during either of the periods being evaluated and is included in continuing operations. Results for properties sold or held for sale during any of the periods evaluated are classified as discontinued operations. No properties were acquired during the 2009 Period, and four properties were acquired during or subsequent to the 2008 Period. Also classified as non-core are three development properties placed into service in 2008 and 2007. One property was sold and one property was classified as held for sale during the 2009 Period, and two properties were sold during 2008. These held for sale and sold properties are classified as discontinued operations for the 2009 and 2008 Quarters and Periods.

To provide more insight into our operating results, our discussion is divided into two main sections: (a) the consolidated results of operations section, in which we provide an overview analysis of results on a consolidated basis, and (b) the net operating income (NOI) section, in which we provide a detailed analysis of core versus non-core NOI results by segment.

Consolidated Results of Operations

Real Estate Rental Revenue

Real estate rental revenue for properties classified as continuing operations is summarized as follows (all data in thousands except percentage amounts):

	Quarters Ended June 30,				Periods Ended June 30,			
	2009	2008	Change		2009	2008	Change	
			\$	%			\$	%
Minimum base rent	\$ 66,753	\$ 59,918	\$ 6,835	11.4%	\$ 133,041	\$ 119,530	\$ 13,511	11.3%
Recoveries from tenants	8,925	7,797	1,128	14.5%	19,436	15,597	3,839	24.6%
Provisions for doubtful accounts	(1,684)	(1,385)	(299)	21.6%	(3,141)	(2,141)	(1,000)	46.7%
Lease termination fees	272	386	(114)	(29.5)%	460	720	(260)	(36.1)%
Parking and other tenant charges	2,486	2,023	463	22.9%	4,816	4,379	437	10.0%
	\$ 76,752	\$ 68,739	\$ 8,013	11.7%	\$ 154,612	\$ 138,085	\$ 16,527	12.0%

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Real estate rental revenue is comprised of (a) minimum base rent, which includes rental revenues recognized on a straight-line basis, (b) revenue from the recovery of operating expenses from our tenants, (c) provisions for doubtful accounts, which includes provisions for straight-line receivables, (d) revenue from the collection of lease termination fees and (e) parking and other tenant charges such as percentage rents.

Minimum Base Rent: Minimum base rent increased by \$6.8 million in the 2009 Quarter as compared to the 2008 Quarter due primarily to non-core properties (\$6.4 million), combined with a \$0.4 million increase in minimum base rent from core properties due to higher rental rates in all segments, offset by higher vacancy in all segments.

Minimum base rent increased by \$13.5 million in the 2009 Period as compared to the 2008 Period due primarily to non-core properties (\$13.0 million), combined with a \$0.5 million increase in minimum base rent from core properties due to higher rental rates in all segments, offset by higher vacancy in all segments.

Recoveries from Tenants: Recoveries from tenants increased by \$1.1 million in the 2009 Quarter as compared to the 2008 Quarter due primarily to non-core properties (\$1.5 million), combined with a \$0.4 million decrease in recoveries from tenants from core properties primarily due to lower common area maintenance reimbursements (\$1.0 million) offset by higher real estate tax reimbursements (\$0.5 million).

Recoveries from tenants increased by \$3.8 million in the 2009 Period as compared to the 2008 Period due primarily to non-core properties (\$3.2 million), combined with a \$0.6 million increase in recoveries from tenants from core properties primarily due to higher real estate tax reimbursements (\$0.8 million) and electricity reimbursements (\$0.4 million), offset by lower common area maintenance reimbursements (\$0.7 million).

Provisions for Doubtful Accounts: Provisions for doubtful accounts increased by \$0.3 million in the 2009 Quarter as compared to the 2008 Quarter, primarily in the retail segment (\$0.2 million).

Provisions for doubtful accounts increased by \$1.0 million in the 2009 Period as compared to the 2008 Period, primarily in the office (\$0.8 million) and retail (\$0.4 million) segments. The increase in provisions for doubtful accounts for both the 2009 Quarter and Period reflects the impact of the national economic recession.

Lease Termination Fees: Lease termination fees were relatively flat, decreasing by \$0.1 million in the 2009 Quarter as compared to the 2008 Quarter.

Lease termination fees decreased by \$0.3 million in the 2009 Period as compared to the 2008 Period, primarily in the office segment (\$0.3 million).

Parking and Other Tenant Charges: Parking and other tenant charges increased by \$0.5 million in the 2009 Quarter as compared to the 2008 Quarter due primarily to non-core properties (\$0.3 million), combined with a \$0.2 million increase from core properties.

Parking and other tenant charges increased by \$0.4 million in the 2009 Period as compared to the 2008 Period due primarily to non-core properties (\$0.5 million), offset by a \$0.1 million decrease in core properties.

A summary of economic occupancy for properties classified as continuing operations by segment follows:

	Quarters Ended June 30,			Periods Ended June 30,		
	2009	2008	Change	2009	2008	Change
Office	93.0%	94.1%	(1.1)%	92.8%	94.8%	(2.0)%
Medical Office	95.9%	97.2%	(1.3)%	96.2%	97.5%	(1.3)%
Retail	95.0%	95.1%	(0.1)%	95.1%	95.2%	(0.1)%
Multifamily	90.6%	80.1%	10.5%	89.0%	79.4%	9.6%
Industrial	90.2%	93.2%	(3.0)%	90.4%	93.9%	(3.5)%
Total	92.9%	92.3%	0.6%	92.6%	92.7%	(0.1)%

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Economic occupancy represents actual real estate rental revenue recognized for the period indicated as a percentage of gross potential real estate rental revenue for that period. Percentage rents and expense reimbursements are not considered in computing economic occupancy percentages.

Our overall economic occupancy increased to 92.9% in the 2009 Quarter from 92.3% in the 2008 Quarter, driven by higher occupancy in the multifamily segment, which increased to 90.6% in the 2009 Quarter from 80.1% in the 2008 Quarter, driven by the lease-up during 2008 and 2009 of our development properties, Bennett Park and Clayborne Apartments. This was partially offset by higher vacancy in the commercial segments.

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Our overall economic occupancy slightly decreased to 92.6% in the 2009 Period from 92.7% in the 2008 Period, driven by higher vacancy in the office, medical office and industrial segments. This decrease was substantially offset by the multifamily segment, which increased to 89.0% in the 2009 Period from 79.4% in the 2008 Period, driven by the lease-up during 2008 and 2009 of our development properties, Bennett Park and Clayborne Apartments.

A detailed discussion of occupancy by sector can be found in the NOI section.

Real Estate Expenses

Real estate expenses are summarized as follows (all data in thousands except percentage amounts):

	Quarters Ended June 30,				Periods Ended June 30,			
	2009	2008	\$	%	2009	2008	\$	%
Property operating expenses	\$ 17,294	\$ 15,528	\$ 1,766	11.4%	\$ 36,574	\$ 31,696	\$ 4,878	15.4%
Real estate taxes	8,296	6,782	1,514	22.3%	16,420	13,292	3,128	23.5%
	\$ 25,590	\$ 22,310	\$ 3,280	14.7%	\$ 52,994	\$ 44,988	\$ 8,006	17.8%

Real estate expenses as a percentage of revenue were 33.3% and 32.5% for the 2009 and 2008 Quarters, respectively, and 34.3% and 32.6% for the 2009 and 2008 Periods, respectively.

Property Operating Expenses: Property operating expenses include utilities, repairs and maintenance, property administration and management, operating services, common area maintenance and other operating expenses.

Property operating expenses increased \$1.8 million in the 2009 Quarter as compared to the 2008 Quarter due primarily to non-core properties (\$1.4 million), combined with a \$0.5 million increase in property operating expenses from core properties driven by write-offs of tenant receivables (\$0.6 million).

Property operating expenses increased \$4.9 million in the 2009 Period as compared to the 2008 Period due primarily to non-core properties (\$3.2 million), combined with a \$1.8 million increase in property operating expenses from core properties driven by higher utilities costs (\$1.0 million) caused by higher electricity rates, and write-offs of tenant receivables (\$0.8 million).

Real Estate Taxes: Real estate taxes increased \$1.5 million in the 2009 Quarter as compared to the 2008 Quarter due to the non-core properties (\$0.9 million), combined with a (\$0.6 million) increase in real estate taxes from core properties due primarily to higher rates and assessments across the portfolio.

Real estate taxes increased \$3.1 million in the 2009 Period as compared to the 2008 Period due to the non-core properties (\$1.9 million), combined with a (\$1.2 million) increase in real estate taxes from core properties due primarily to higher rates and assessments across the portfolio.

Other Operating Expenses

Other operating expenses are summarized as follows (all data in thousands except percentage amounts):

	Quarters Ended June 30,				Periods Ended June 30,			
	2009	2008	\$	%	2009	2008	\$	%
Depreciation and amortization	\$ 23,501	\$ 20,995	\$ 2,506	11.9%	\$ 46,776	\$ 41,328	\$ 5,448	13.2%
Interest expense	19,316	18,840	476	2.5%	38,997	37,740	1,257	3.3%
General and administrative	3,716	3,058	658	21.5%	6,898	6,081	817	13.4%

\$ 46,533 \$ 42,893 \$ 3,640 8.5% \$ 92,671 \$ 85,149 \$ 7,522 8.8%

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Depreciation and Amortization: Depreciation and amortization expense increased by \$2.5 million and \$5.4 million in the 2009 Quarter and Period, respectively, due primarily to properties acquired or placed into service during 2008 of \$340.3 million.

Interest Expense: Interest expense increased \$0.5 million in the 2009 Quarter compared to the 2008 Quarter, reflecting a \$3.0 million increase in mortgage interest due to entering into new mortgage notes during 2009 and 2008, as well as assuming a mortgage with the 2445 M Street acquisition in 2008. Also, capitalized interest decreased by \$0.4 million due to placing development projects into service at the end of 2007 and during 2008. These increases were offset by lower interest on the unsecured lines of credit (\$1.8 million) due to paydowns and lower interest rates, and lower interest on notes payable due to buybacks of the convertible notes during 2008 and 2009. The proceeds of the new mortgage notes were used to pay down floating rate credit facility debt and to repurchase a portion of the convertible notes.

Interest expense increased \$1.3 million in the 2009 Period compared to the 2008 Period, driven by the same factors that caused the quarterly increase, as described in the preceding paragraph.

A summary of interest expense by debt type for the 2009 and 2008 Quarters and Periods appears below (in millions, except percentage amounts):

	Quarters Ended June 30,				Periods Ended June 30,			
	2009	2008	Change		2009	2008	Change	
			\$	%			\$	%
Notes payable	\$ 12.1	\$ 13.2	\$ (1.1)	(8.3)%	\$ 25.0	\$ 26.6	\$ (1.6)	(6.0)%
Mortgages	7.2	4.2	3.0	71.4%	14.0	7.9	6.1	77.2%
Lines of credit/short-term note payable	0.3	2.1	(1.8)	(85.7)%	0.7	4.8	(4.1)	(85.4)%
Capitalized interest	(0.3)	(0.7)	0.4	57.1%	(0.7)	(1.6)	0.9	56.3%
Total	\$ 19.3	\$ 18.8	\$ 0.5	2.7%	\$ 39.0	\$ 37.7	\$ 1.3	3.4%

General and Administrative Expense: General and administrative expense increased by \$0.7 million and \$0.8 million in the 2009 Quarter and Period, respectively. The increases were driven primarily by higher share based compensation expense and the expensing of pre-acquisition costs. Pre-acquisition costs were capitalized prior to the January 1, 2009 adoption of SFAS No. 141(R), *Business Combinations* (see Note 2 to the consolidated financial statements). In addition, general and administrative expenses for the 2009 Quarter and Period include a \$0.2 million accrual for the outcome of a dispute related to the pending acquisition of a medical office property in Lansdowne, Virginia.

Discontinued Operations

We dispose of assets (sometimes using tax-deferred exchanges) that are inconsistent with our long-term strategic or return objectives and where market conditions for sale are favorable. The proceeds from the sales are reinvested into other properties, used to fund development operations, used to otherwise support corporate needs or are distributed to our shareholders.

Avondale, a multifamily property, was classified as held for sale in September, 2008 and sold in May, 2009 for a contract sales price of \$19.75 million that resulted in a gain on sale of \$6.7 million. We classified Charleston Business Center, an industrial property, as held for sale in March, 2009. We classify properties as held for sale when they meet the criteria specified in SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Senior management has committed to, and actively embarked upon, a plan to sell the assets, and the sales are expected to be completed within one year under terms usual and customary for such sales, with no indication that the plans will be significantly altered or abandoned. Depreciation on these properties was discontinued at the time they were classified as held for sale, but operating revenues and other operating expenses continue to be recognized until the dates of sale. Under SFAS No. 144, revenues and expenses of properties that are classified as held for sale or sold are treated as discontinued operations for all periods presented in the consolidated statements of income.

We sold two industrial properties in 2008. Sullyfield Center and the Earhart Building were classified as held for sale in November 2007 and sold in June 2008. They were sold for a contract sales price of \$41.1 million, and we recognized a gain on sale of \$15.3 million.

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Operating results of the properties classified as discontinued operations are summarized as follows (in thousands, except for percentages):

	Quarters Ended June 30,				Periods Ended June 30,			
	2009	2008	Change		2009	2008	Change	
			\$	%			\$	%
Revenues	\$ 571	\$ 1,861	\$ (1,290)	(69.3)%	\$ 1,499	\$ 3,891	\$ (2,392)	(61.5)%
Property expenses	(283)	(686)	403	58.7%	(767)	(1,392)	625	44.9%
Depreciation and amortization	(7)	(203)	196	96.5%	(34)	(395)	361	91.4%
Total	\$ 281	\$ 972	\$ (691)	71.1%	\$ 698	\$ 2,104	\$ (1,406)	66.8%

Income from operations of properties sold or held for sale decreased by \$0.7 million and \$1.4 million for the 2009 Quarter and Period, respectively, due to the sale of Avondale in May 2009, and the sale of Sullyfield Center and the Earhart Building in June 2008.

Net Operating Income

NOI, defined as real estate rental revenue less real estate expenses excluding depreciation and amortization and general and administrative expenses, is the primary performance measure we use to assess the results of our operations at the property level. We provide NOI as a supplement to net income calculated in accordance with GAAP. NOI does not represent net income calculated in accordance with GAAP. As such, it should not be considered an alternative to net income as an indication of our operating performance. A reconciliation of NOI to net income follows.

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2009 Quarter Compared to 2008 Quarter

The following tables of selected operating data provide the basis for our discussion of NOI in the 2009 Quarter compared to the 2008 Quarter. All amounts are in thousands except percentage amounts.

	2009	Quarters Ended June 30, 2008		% Change
		\$ Change		
Real Estate Rental Revenue				
Core	\$ 67,885	\$ 67,987	\$ (102)	(0.2)%
Non-core ⁽¹⁾	8,867	752	8,115	
Total real estate rental revenue	\$ 76,752	\$ 68,739	\$ 8,013	11.7%
Real Estate Expenses				
Core	\$ 22,263	\$ 21,306	\$ 957	4.5%
Non-core ⁽¹⁾	3,327	1,004	2,323	231.4%
Total real estate expenses	\$ 25,590	\$ 22,310	\$ 3,280	14.7%
NOI				
Core	\$ 45,622	\$ 46,681	\$ (1,059)	(2.3)%
Non-core ⁽¹⁾	5,540	(252)	5,792	
Total NOI	\$ 51,162	\$ 46,429	\$ 4,733	10.2%
Reconciliation to Net Income				
NOI	\$ 51,162	\$ 46,429		
Other income	339	220		
Interest expense	(19,316)	(18,840)		
Depreciation and amortization	(23,501)	(20,995)		
General and administrative expenses	(3,716)	(3,058)		
Gain on extinguishment of debt	1,219			
Gain on sale of real estate	6,674	15,275		
Discontinued operations ⁽²⁾	281	972		
Net income	13,142	20,003		
Less: Net income attributable to noncontrolling interests	(52)	(53)		
Net income attributable to the controlling interest	\$ 13,090	\$ 19,950		

Economic Occupancy	Quarters Ended June 30,	
	2009	2008
Core	93.1%	94.5%
Non-core ⁽¹⁾	91.0%	30.6%
Total	92.9%	92.3%

(1) Non-core properties include:
In development Bennett Park, Clayborne Apartments and Dulles Station, Phase I

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2008 acquisitions Sterling Medical Office Building, Kenmore Apartments and 2445 M Street

(2) Discontinued operations include gain on disposals and income from operations for:

2008 dispositions Sullyfield Center and The Earhart Building

2009 disposition Avondale

2009 held for sale Charleston

Real estate rental revenue in the 2009 Quarter increased by \$8.0 million as compared to the 2008 Quarter due to the acquisition or placing into service of two office properties, one medical office property and three multifamily properties, which added approximately 1.1 million square feet of net rentable space. These acquisition and

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development properties contributed \$8.1 million of the increase. Real estate rental revenue from the core properties decreased by \$0.1 million primarily due to lower core occupancy (\$1.0 million) and higher bad debt (\$0.3 million), offset by higher rental rates (\$1.3 million).

Real estate expenses increased by \$3.3 million in the 2009 Quarter as compared to the 2008 Quarter due primarily to acquisition and development properties, which contributed \$2.3 million of the increase. Real estate expenses from core properties increased by \$1.0 million due primarily to higher real estate taxes (\$0.6 million) and write-offs of tenant receivables (\$0.6 million).

Core economic occupancy decreased to 93.1% in the 2009 Quarter from 94.5% in the 2008 Quarter due to lower core economic occupancy in all segments. Non-core economic occupancy increased to 91.0% in the 2009 Quarter from 30.6% in the 2008 Quarter, driven by the lease-up of our development properties in the multifamily segment. During the 2009 Quarter, 65.9% of the commercial square footage expiring was renewed as compared to 45.9% in the 2008 Quarter. During the 2009 Quarter, 558,900 commercial square feet were leased at an average rental rate of \$29.71 per square foot, an increase of 13.8%, with average tenant improvements and leasing costs of \$14.99 per square foot.

An analysis of NOI by segment follows.

Table of Contents*Office Segment:*

	2009	Quarters Ended June 30,		% Change
		2008	\$ Change	
Real Estate Rental Revenue				
Core	\$ 28,619	\$ 28,716	\$ (97)	(0.3)%
Non-core ⁽¹⁾	5,367		5,367	
Total real estate rental revenue	\$ 33,986	\$ 28,716	\$ 5,270	18.4%
Real Estate Expenses				
Core	\$ 10,341	\$ 9,649	\$ 692	7.2%
Non-core ⁽¹⁾	1,783	161	1,622	
Total real estate expenses	\$ 12,124	\$ 9,810	\$ 2,314	23.6%
NOI				
Core	\$ 18,278	\$ 19,067	\$ (789)	(4.1)%
Non-core ⁽¹⁾	3,584	(161)	3,745	
Total NOI	\$ 21,862	\$ 18,906	\$ 2,956	15.6%

Economic Occupancy	Quarters Ended June 30,	
	2009	2008
Core	92.6%	94.1%
Non-core ⁽¹⁾	95.3%	
Total	93.0%	94.1%

(1) Non-core properties include:
In development Dulles Station, Phase I

2008 acquisition 2445 M Street

Real estate rental revenue in the office segment increased by \$5.3 million in the 2009 Quarter as compared to the 2008 Quarter due to acquisition and development properties, which contributed \$5.4 million. Real estate rental revenue from core properties decreased by \$0.1 million primarily due to lower core occupancy (\$0.5 million) and lower lease termination fees (\$0.3 million), partially offset by higher rental rates (\$0.7 million).

Real estate expenses in the office segment increased by \$2.3 million in the 2009 Quarter as compared to the 2008 Quarter due primarily to acquisition and development properties, which contributed \$1.6 million of the increase. Real estate expenses from core properties increased by \$0.7 million primarily due to write-offs of tenant receivables (\$0.6 million) and higher real estate taxes (\$0.2 million) caused by higher rates and assessments.

Core economic occupancy decreased to 92.6% in 2009 Quarter from 94.1% in the 2008 Quarter, driven by higher vacancy at One Central Plaza, 51 Monroe Street and 1220 19th Street. These were partially offset by higher economic occupancy at 600 Jefferson Plaza. Non-core economic occupancy of 95.3% reflects the lease-up of Dulles Station, Phase I and the 2008 acquisition of the fully occupied 2445 M Street. During the 2009 Quarter, 54.3% of the square footage that expired was renewed compared to 25.3% in the 2008 Quarter. During the 2009 Quarter, we executed new leases for 306,500 square feet of office space at an average rental rate of \$41.03 per square foot, an increase of 17.6% over expiring leases, with average tenant improvements and leasing costs of \$21.20 per square foot. Of the 306,500 square feet renewed,

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approximately 150,000 square feet is due to the renewal of The International Bank for Reconstruction and Development, one of the two development institutions that make up the World Bank, at 1776 G Street in Washington, DC.

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	2009	Quarters Ended June 30,		% Change
		2008	\$ Change	
Real Estate Rental Revenue				
Core	\$ 10,880	\$ 10,798	\$ 82	0.8%
Non-core ⁽¹⁾	153	71	82	115.5%
Total real estate rental revenue	\$ 11,033	\$ 10,869	\$ 164	1.5%
Real Estate Expenses				
Core	\$ 3,469	\$ 3,408	\$ 61	1.8%
Non-core ⁽¹⁾	97	31	66	212.9%
Total real estate expenses	\$ 3,566	\$ 3,439	\$ 127	3.7%
NOI				
Core	\$ 7,411	\$ 7,390	\$ 21	0.3%
Non-core ⁽¹⁾	56	40	16	40.0%
Total NOI	\$ 7,467	\$ 7,430	\$ 37	0.5%

Economic Occupancy	Quarters Ended June 30,	
	2009	2008
Core	96.4%	97.6%
Non-core ⁽¹⁾	71.8%	60.8%
Total	95.9%	97.2%

(1) Non-core properties include:
2008 acquisition Sterling Medical Office Building

Real estate rental revenue in the medical office segment increased by \$0.2 million in the 2009 Quarter as compared to the 2008 Quarter due primarily to higher rental rates (\$0.3 million), offset by lower expense reimbursements (\$0.1 million) and lower occupancy (\$0.1 million). The acquired property contributed \$0.1 million to the increase.

Real estate expenses in the medical office segment increased by \$0.1 million in the 2009 Quarter as compared to the 2008 Quarter due primarily to higher real estate taxes (\$0.1 million) caused by higher rates and assessments. The acquired property contributed \$0.1 million to the increase.

Core economic occupancy decreased to 96.4% in the 2009 Quarter from 97.6% in the 2008 Quarter, driven by higher vacancy at 8301 Arlington Boulevard. Non-core economic occupancy reflects the vacant space at Sterling Medical Office Building. The sellers of Sterling Medical Office Building are reimbursing us for its vacant space for a period of 12-18 months from the acquisition date. During the 2009 Quarter, 76.1% of the square footage that expired was renewed compared to 67.7% in the 2008 Quarter. During the 2009 Quarter, we executed new leases for 56,800 square feet of medical office space at an average rental rate of \$34.02, an increase of 7.8% over expiring leases, with average tenant improvements and leasing costs of \$14.21 per square foot.

Table of Contents*Retail Segment:*

	2009	Quarters Ended June 30,		% Change
		2008	\$ Change	
Real Estate Rental Revenue				
Total	\$ 10,233	\$ 10,341	\$ (108)	(1.0)%
Real Estate Expenses				
Total	\$ 2,565	\$ 2,411	\$ 154	6.4%
NOI				
Total	\$ 7,668	\$ 7,930	\$ (262)	(3.3)%

Economic Occupancy	Quarters Ended June 30,	
	2009	2008
Core	95.0%	95.1%

Real estate rental revenue in the retail segment decreased by \$0.1 million in the 2009 Quarter as compared to the 2008 Quarter due to higher bad debt (\$0.2 million), partially offset by higher percentage rent (\$0.1 million).

Real estate expenses in the retail segment increased by \$0.2 million in the 2009 Quarter as compared to the 2008 Quarter due to higher legal costs (\$0.2 million) and real estate taxes (\$0.1 million), offset by recoveries of previously estimated tenant credit losses (\$0.1 million).

Economic occupancy slightly decreased to 95.0% in the 2009 Quarter from 95.1% in the 2008 Quarter, due to the closure of Circuit City at the Centre at Hagerstown, offset by higher occupancy at Foxchase Shopping Center. During the 2009 Quarter, 55.9% of the square footage that expired was renewed compared to 69.0% in the 2008 Quarter. During the 2009 Quarter, we executed new leases for 21,300 square feet of retail space at an average rental rate of \$32.90, an increase of 4.9% from expiring leases, with average tenant improvements and leasing costs of \$4.88 per square foot.

Table of Contents*Multifamily Segment:*

	Quarters Ended June 30,			
	2009	2008	\$ Change	% Change
Real Estate Rental Revenue				
Core	\$ 8,258	\$ 8,108	\$ 150	1.9%
Non-core ⁽¹⁾	3,347	681	2,666	391.5%
Total real estate rental revenue	\$ 11,605	\$ 8,789	\$ 2,816	32.0%
Real Estate Expenses				
Core	\$ 3,249	\$ 3,318	\$ (69)	(2.1)%
Non-core ⁽¹⁾	1,447	812	635	78.2%
Total real estate expenses	\$ 4,696	\$ 4,130	\$ 566	13.7%
NOI				
Core	\$ 5,009	\$ 4,790	\$ 219	4.6%
Non-core ⁽¹⁾	1,900	(131)	2,031	
Total NOI	\$ 6,909	\$ 4,659	\$ 2,250	48.3%

Economic Occupancy	Quarters Ended June 30,	
	2009	2008
Core	92.2%	93.3%
Non-core ⁽¹⁾	86.9%	29.1%
Total	90.6%	80.1%

(1) Non-core properties include:

2008 in development Clayborne Apartments

2007 in development Bennett Park

2008 acquisition Kenmore Apartments

Real estate rental revenue in the multifamily segment increased by \$2.8 million in the 2009 Quarter as compared to the 2008 Quarter due primarily to acquisition and development properties placed into service, which contributed \$2.7 million of the increase. Real estate rental revenue from core properties increased by \$0.2 million due to higher rental rates (\$0.1 million) and lower rent abatement (\$0.1 million), partially offset by lower occupancy (\$0.1 million).

Real estate expenses in the multifamily segment increased by \$0.6 million in the 2009 Quarter as compared to the 2008 Quarter due primarily to acquisition and development properties placed into service, which contributed all of the increase. Real estate expenses from core properties were flat.

Core economic occupancy decreased to 92.2% in the 2009 Quarter from 93.3% in the 2008 Quarter driven by lower occupancy at Bethesda Hill Apartments. Non-core economic occupancy increased to 86.9% from 29.1%, reflecting the lease-up of Bennett Park and Clayborne Apartments.

Table of Contents*Industrial Segment:*

	2009	Quarters Ended June 30,		
		2008	\$ Change	% Change
Real Estate Rental Revenue				
Total	\$ 9,895	\$ 10,024	\$ (129)	(1.3)%
Real Estate Expenses				
Total	\$ 2,639	\$ 2,520	\$ 119	4.7%
NOI				
Total	\$ 7,256	\$ 7,504	\$ (248)	(3.3)%

Economic Occupancy	2009	2008
Core	90.2%	93.2%

Real estate rental revenue in the industrial segment decreased by \$0.1 million in the 2009 Quarter as compared to the 2008 Quarter due to higher vacancy (\$0.3 million), offset by higher rental rates (\$0.2 million).

Real estate expenses in the industrial segment increased by \$0.1 million in the 2009 Quarter as compared to the 2008 Quarter due primarily to write-offs of tenant receivables (\$0.1 million).

Core economic occupancy decreased to 90.2% in the 2009 Quarter from 93.2% in the 2008 Quarter, driven by higher vacancy at NVIP I & II, 270 Tech Park and Ammendale Technology Park. During the 2009 Quarter, 78.2% of the square footage that expired was renewed compared to 64.6% in the 2008 Quarter. During the 2009 Quarter, we executed new leases for 174,200 square feet of industrial space at an average rental rate of \$8.01, a decrease of 3.1% over expiring leases, with average tenant improvements and leasing costs of \$5.54 per square foot.

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2009 Period Compared to 2008 Period

The following tables of selected operating data provide the basis for our discussion of NOI in the 2009 Period compared to the 2008 Period. All amounts are in thousands except percentage amounts.

	2009	Periods Ended June 30, 2008	\$ Change	% Change
Real Estate Rental Revenue				
Core	\$ 136,255	\$ 136,491	\$ (236)	(0.2)%
Non-core ⁽¹⁾	18,357	1,594	16,763	
Total real estate rental revenue	\$ 154,612	\$ 138,085	\$ 16,527	12.0%
Real Estate Expenses				
Core	\$ 46,003	\$ 43,082	\$ 2,921	6.8%
Non-core ⁽¹⁾	6,991	1,906	5,085	266.8%
Total real estate expenses	\$ 52,994	\$ 44,988	\$ 8,006	17.8%
NOI				
Core	\$ 90,252	\$ 93,409	\$ (3,157)	(3.4)%
Non-core ⁽¹⁾	11,366	(312)	11,678	
Total NOI	\$ 101,618	\$ 93,097	\$ 8,521	9.2%
Reconciliation to Net Income				
NOI	\$ 101,618	\$ 93,097		
Other income	659	458		
Interest expense	(38,997)	(37,740)		
Depreciation and amortization	(46,776)	(41,328)		
General and administrative expenses	(6,898)	(6,081)		
Gain (loss) on extinguishment of debt	7,064	(8,449)		
Gain on sale of real estate	6,674	15,275		
Discontinued operations ⁽²⁾	698	2,104		
Net income	24,042	17,336		
Less: Net income attributable to noncontrolling interests	(101)	(110)		
Net income attributable to the controlling interest	\$ 23,941	\$ 17,226		

Economic Occupancy	Periods Ended June 30,	
	2009	2008
Core	93.1%	95.0%
Non-core ⁽¹⁾	89.2%	30.1%
Total	92.6%	92.7%

(1) Non-core properties include:
2008 in development Clayborne Apartments and Dulles Station, Phase I

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2007 in development Bennett Park

2008 acquisitions 6100 Columbia Park Road, Sterling Medical Office Building, Kenmore Apartments and 2445 M Street

(2) Discontinued operations include gain on disposals and income from operations for:
2008 dispositions Sullyfield Center and The Earhart Building

2009 disposition Avondale

2009 held for sale Charleston

Real estate rental revenue in the 2009 Period increased by \$16.5 million as compared to the 2008 Period due to the acquisition or placing into service of two office properties, one medical office property, three multifamily properties

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and one industrial property, which added approximately 1.3 million square feet of net rentable space. These acquisition and development properties contributed all of the increase. Real estate rental revenue from the core properties decreased by \$0.2 million primarily due to lower core occupancy (\$2.6 million), higher bad debt (\$1.0 million) and lower lease termination fees (\$0.3 million), offset by higher rental rates (\$2.9 million) and expense reimbursements (\$0.6 million).

Real estate expenses increased by \$8.0 million in the 2009 Period as compared to the 2008 Period due primarily to acquisition and development properties, which contributed \$5.1 million of the increase. Real estate expenses from core properties increased by \$2.9 million due primarily to higher real estate taxes (\$1.2 million) caused by higher rates and assessments, higher utilities costs (\$1.0 million) due to higher electricity rates and write-offs of tenant receivables (\$0.8 million).

Core economic occupancy decreased to 93.1% in the 2009 Period from 95.0% in the 2008 Period due to lower core economic occupancy in all segments. Non-core economic occupancy increased to 89.2% in the 2009 Period from 30.1% in the 2008 Period, driven by the lease-up of our development properties placed into service in the multifamily and office segments. During the 2009 Period, 71.9% of the commercial square footage expiring was renewed as compared to 51.4% in the 2008 Period. During the 2009 Period, 793,800 commercial square feet were leased at an average rental rate of \$26.12 per square foot, an increase of 13.2%, with average tenant improvements and leasing costs of \$13.18 per square foot.

An analysis of NOI by segment follows.

Table of Contents*Office Segment:*

	2009	2008	Periods Ended June 30, \$ Change	% Change
Real Estate Rental Revenue				
Core	\$ 57,585	\$ 58,417	\$ (832)	(1.4)%
Non-core ⁽¹⁾	10,810		10,810	
Total real estate rental revenue	\$ 68,395	\$ 58,417	\$ 9,978	17.1%
Real Estate Expenses				
Core	\$ 21,188	\$ 20,045	\$ 1,143	5.7%
Non-core ⁽¹⁾	3,655	310	3,345	
Total real estate expenses	\$ 24,843	\$ 20,355	\$ 4,488	22.0%
NOI				
Core	\$ 36,397	\$ 38,372	\$ (1,975)	(5.1)%
Non-core ⁽¹⁾	7,155	(310)	7,465	
Total NOI	\$ 43,552	\$ 38,062	\$ 5,490	14.4%

Economic Occupancy	Periods Ended June 30,	
	2009	2008
Core	92.4%	94.8%
Non-core ⁽¹⁾	95.3%	
Total	92.8%	94.8%

(1) Non-core properties include:
In development Dulles Station, Phase I

2008 acquisition 2445 M Street

Real estate rental revenue in the office segment increased by \$10.0 million in the 2009 Period as compared to the 2008 Period due to acquisition and development properties, which contributed \$10.8 million. Real estate rental revenue from core properties decreased by \$0.8 million primarily due to lower core occupancy (\$1.4 million), higher bad debt (\$0.8 million) and lower lease termination fees (\$0.3 million), partially offset by higher rental rates (\$1.5 million).

Real estate expenses in the office segment increased by \$4.5 million in the 2009 Period as compared to the 2008 Period due primarily to acquisition and development properties, which contributed \$3.3 million of the increase. Real estate expenses from core properties increased by \$1.1 million primarily due to write-offs of tenant receivables (\$0.6 million), higher real estate taxes (\$0.3 million) caused by higher rates and assessments, as well as higher utilities expense (\$0.5 million) caused by higher electricity rates.

Core economic occupancy decreased to 92.4% in 2009 Period from 94.8% in the 2008 Period, driven by higher vacancy at One Central Plaza, 51 Monroe Street and 1220 19th Street. These were partially offset by higher economic occupancy at West Gude Drive and 6565 Arlington Boulevard. Non-core economic occupancy of 95.3% reflects the lease-up of Dulles Station, Phase I and the 2008 acquisition of the fully occupied 2445 M Street. During the 2009 Period, 68.8% of the square footage that expired was renewed compared to 22.9% in the 2008 Period. During the 2009 Period, we executed new leases for 373,800 square feet of office space at an average rental rate of \$39.22 per square foot, an increase of 16.9% over expiring leases, with average tenant improvements and leasing costs of \$22.20 per square foot. Of the 373,800 square

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feet renewed, approximately 150,000 square feet is due to the renewal of The International Bank for Reconstruction and Development, one of the two development institutions that make up the World Bank, at 1776 G Street in Washington, DC.

Table of Contents*Medical Office Segment:*

	2009	Periods Ended June 30, 2008	\$ Change	% Change
Real Estate Rental Revenue				
Core	\$ 22,206	\$ 21,532	\$ 674	3.1%
Non-core ⁽¹⁾	312	71	241	339.4%
Total real estate rental revenue	\$ 22,518	\$ 21,603	\$ 915	4.2%
Real Estate Expenses				
Core	\$ 7,311	\$ 6,917	\$ 394	5.7%
Non-core ⁽¹⁾	188	32	156	487.5%
Total real estate expenses	\$ 7,499	\$ 6,949	\$ 550	7.9%
NOI				
Core	\$ 14,895	\$ 14,615	\$ 280	1.9%
Non-core ⁽¹⁾	124	39	85	217.9%
Total NOI	\$ 15,019	\$ 14,654	\$ 365	2.5%

Economic Occupancy	Periods Ended June 30,	
	2009	2008
Core	96.7%	97.7%
Non-core ⁽¹⁾	71.7%	60.8%
Total	96.2%	97.5%

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⁽¹⁾ Non-core properties include:
2008 acquisition Sterling Medical Office Building

Real estate rental revenue in the medical office segment increased by \$0.9 million in the 2009 Period as compared to the 2008 Period due primarily to higher rental rates (\$0.5 million), real estate tax reimbursements (\$0.2 million) and lower bad debt (\$0.2 million), offset by higher vacancy (\$0.2 million). The acquired property contributed \$0.2 million to the increase.

Real estate expenses in the medical office segment increased by \$0.6 million in the 2009 Period as compared to the 2008 Period due primarily to write-offs of tenant receivables (\$0.1 million), higher utilities costs (\$0.1 million) and higher real estate taxes (\$0.2 million) caused by higher rates and assessments. The acquired property contributed \$0.2 million to the increase.

Core economic occupancy decreased to 96.7% in the 2009 Period from 97.7% in the 2008 Period, driven by higher vacancy at 8301 Arlington Boulevard and Woodburn I & II. Non-core economic occupancy reflects the vacant space at Sterling Medical Office Building. The sellers of Sterling Medical Office Building are reimbursing us for its vacant space for a period of 12-18 months from the acquisition date. During the 2009 Period, 67.8% of the square footage that expired was renewed compared to 70.5% in the 2008 Period. During the 2009 Period, we executed new leases for 67,500 square feet of medical office space at an average rental rate of \$34.19, an increase of 8.1% over expiring leases, with average tenant improvements and leasing costs of \$13.57 per square foot.

Table of Contents*Retail Segment:*

	2009	Periods Ended June 30,		% Change
		2008	\$ Change	
Real Estate Rental Revenue				
Total	\$ 20,813	\$ 20,987	\$ (174)	(0.8)%
Real Estate Expenses				
Total	\$ 5,438	\$ 4,683	\$ 755	16.1%
NOI				
Total	\$ 15,375	\$ 16,304	\$ (929)	(5.7)%

Economic Occupancy	Periods Ended June 30,	
	2009	2008
Core	95.1%	95.2%

Real estate rental revenue in the retail segment decreased by \$0.2 million in the 2009 Period as compared to the 2008 Period due to lower percentage rent (\$0.2 million) and higher bad debt (\$0.4 million), partially offset by higher rental rates (\$0.3 million) and reimbursements (\$0.2 million).

Real estate expenses in the retail segment increased by \$0.8 million in the 2009 Period as compared to the 2008 Period due to higher legal costs (\$0.3 million), common area maintenance (\$0.1 million) and real estate taxes (\$0.3 million).

Economic occupancy slightly decreased to 95.1% in the 2009 Period from 95.2% in the 2008 Period, due to the closure of Circuit City at the Centre at Hagerstown as well as higher vacancy at Montrose Shopping Center, offset by higher occupancy at Foxchase Shopping Center. During the 2009 Period, 69.4% of the square footage that expired was renewed compared to 83.9% in the 2008 Period. During the 2009 Period, we executed new leases for 38,500 square feet of retail space at an average rental rate of \$26.08, an increase of 1.6% from expiring leases, with average tenant improvements and leasing costs of \$4.60 per square foot.

Table of Contents*Multifamily Segment:*

	2009	Periods Ended June 30, 2008	\$ Change	% Change
Real Estate Rental Revenue				
Core	\$ 16,322	\$ 15,861	\$ 461	2.9%
Non-core ⁽¹⁾	6,452	1,060	5,392	508.7%
Total real estate rental revenue	\$ 22,774	\$ 16,921	\$ 5,853	34.6%
Real Estate Expenses				
Core	\$ 6,653	\$ 6,552	\$ 101	1.5%
Non-core ⁽¹⁾	2,932	1,419	1,513	106.6%
Total real estate expenses	\$ 9,585	\$ 7,971	\$ 1,614	20.2%
NOI				
Core	\$ 9,669	\$ 9,309	\$ 360	3.9%
Non-core ⁽¹⁾	3,520	(359)	3,879	
Total NOI	\$ 13,189	\$ 8,950	\$ 4,239	47.4%

Economic Occupancy	Periods Ended June 30,	
	2009	2008
Core	91.9%	93.1%
Non-core ⁽¹⁾	82.0%	23.8%
Total	89.0%	79.4%

(1) Non-core properties include:
In development Bennett Park and Clayborne Apartments

2008 acquisition Kenmore Apartments

Real estate rental revenue in the multifamily segment increased by \$5.9 million in the 2009 Period as compared to the 2008 Period due primarily to acquisition and development properties, which contributed \$5.4 million of the increase. Real estate rental revenue from core properties increased by \$0.5 million due to higher rental rates (\$0.3 million), expense reimbursements (\$0.2 million) and lower rent abatements (\$0.1 million), partially offset by lower occupancy (\$0.2 million).

Real estate expenses in the multifamily segment increased by \$1.6 million in the 2009 Period as compared to the 2008 Period due primarily to acquisition and development properties, which contributed \$1.5 million of the increase. Real estate expenses from core properties increased by \$0.1 million primarily due to higher utilities costs (\$0.1 million) and higher real estate taxes (\$0.1 million), offset by lower administrative costs (\$0.1 million).

Core economic occupancy decreased to 91.9% in the 2009 Period from 93.1% in the 2008 Period, driven by lower occupancy at Munson Hill Towers and Walker House. Non-core economic occupancy increased to 82.0% from 23.8%, reflecting the lease-up of Bennett Park and Clayborne Apartments.

Table of Contents*Industrial Segment:*

	2009	Periods Ended June 30,		% Change
		2008	\$ Change	
Real Estate Rental Revenue				
Core	\$ 19,329	\$ 19,694	\$ (365)	(1.9)%
Non-core ⁽¹⁾	783	463	320	69.1%
Total real estate rental revenue	\$ 20,112	\$ 20,157	\$ (45)	(0.2)%
Real Estate Expenses				
Core	\$ 5,413	\$ 4,885	\$ 528	10.8%
Non-core ⁽¹⁾	216	145	71	49.0%
Total real estate expenses	\$ 5,629	\$ 5,030	\$ 599	11.9%
NOI				
Core	\$ 13,916	\$ 14,809	\$ (893)	(6.0)%
Non-core ⁽¹⁾	567	318	249	78.3%
Total NOI	\$ 14,483	\$ 15,127	\$ (644)	(4.3)%

Economic Occupancy	2009	2008
Core	90.1%	94.0%
Non-core ⁽¹⁾	100.0%	86.2%
Total	90.4%	93.9%

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⁽¹⁾ Non-core properties include:
2008 acquisition 6100 Columbia Park Road

Real estate rental revenue in the industrial segment was flat, as an increase of \$0.3 million from non-core properties was offset by a decrease of \$0.3 million from core properties. The decrease from core properties is due to higher vacancy (\$0.7 million) and bad debt (\$0.1 million), offset by higher rental rates (\$0.3 million).

Real estate expenses in the industrial segment increased by \$0.6 million in the 2009 Period as compared to the 2008 Period due primarily to higher common area maintenance (\$0.2 million), write-offs of tenant receivables (\$0.1 million) and real estate taxes (\$0.3 million). The acquisition property contributed \$0.1 million to the increase.

Core economic occupancy decreased to 90.1% in the 2009 Period from 94.0% in the 2008 Period, driven by higher vacancy at 8900 Telegraph Road, Ammendale Technology Park and NVIP I & II. Non-core economic occupancy increased to 100.0% from 86.2% due to fully leasing 6100 Columbia Park Drive. During the 2009 Period, 76.8% of the square footage that expired was renewed compared to 58.2% in the 2008 Period. During the 2009 Period, we executed new leases for 314,100 square feet of industrial space at an average rental rate of \$8.82, an increase of 4.4% over expiring leases, with average tenant improvements and leasing costs of \$3.40 per square foot.

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Liquidity and Capital Resources

Capital Structure

We manage our capital structure to reflect a long-term investment approach, generally seeking to match the cash flow of our assets with a mix of equity and various debt instruments. We expect that our capital structure will allow us to obtain additional capital from diverse sources that could include additional equity offerings of common shares, public and private secured and unsecured debt financings, and possible asset dispositions. Our ability to raise funds through the sale of debt and equity securities is dependent on, among other things, general economic conditions, general market conditions for REITs, our operating performance, our debt rating and the current trading price of our common shares. We analyze which source of capital we believe to be most advantageous to us at any particular point in time. However, the capital markets may not consistently be available on terms that we consider attractive. In particular, as a result of the current economic downturn and turmoil in the capital markets, unsecured notes financings for REITs are currently less available than in past years and long-term credit has become more costly. We cannot predict how long these conditions will continue or if they will decline further.

We currently expect that our potential sources of liquidity for acquisitions, development, expansion and renovation of properties, and operating and administrative expenses, will include:

Cash flow from operations;

Borrowings under our unsecured credit facilities or other short-term facilities;

Issuances of our equity securities and/or common units in our operating partnership;

Proceeds from long-term secured or unsecured debt financings;

Investment from joint venture partners; and

Net proceeds from the sale of assets.

During 2009, we expect that we will have modest capital requirements, including the following items. There can be no assurance that our capital requirements will not be materially higher or lower than these expectations.

Funding dividends on our common shares and distributions to third party unit holders;

Approximately \$30.0 - \$40.0 million to invest in our existing portfolio of operating assets, including approximately \$15.0 - \$20.0 million to fund tenant-related capital requirements and leasing commissions;

Approximately \$15.0 million to fund first generation tenant-related capital requirements and leasing commissions;

Approximately \$2.5 million to invest in our development projects; and

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Approximately \$19.5 - \$50.0 million to fund our expected property acquisitions.

We believe that we will generate sufficient cash flow from operations and have access to the capital resources necessary to fund our requirements. However, as a result of general market conditions in the greater Washington metro region, economic downturns affecting the ability to attract and retain tenants, unfavorable fluctuations in interest rates or our share price, unfavorable changes in the supply of competing properties, or our properties not performing as expected, we may not generate sufficient cash flow from operations or otherwise have access to capital on favorable terms, or at all. If we are unable to obtain capital from other sources, we may not be able to pay the dividend required to maintain our status as a REIT, make required principal and interest payments, make strategic acquisitions or make necessary routine capital improvements or undertake re-development opportunities with respect to our existing portfolio of operating assets. In addition, if a property is mortgaged to secure payment of indebtedness and we are unable to meet mortgage payments, the holder of the mortgage could foreclose on the property, resulting in loss of income and asset value.

Table of Contents*Debt Financing*

We generally use secured or unsecured, corporate-level debt, including mortgages, unsecured notes and our unsecured credit facilities, to meet our borrowing needs. Long-term, we generally use fixed rate debt instruments in order to match the returns from our real estate assets. We also utilize variable rate debt for short-term financing purposes. At times, our mix of variable and fixed rate debt may not suit our needs. At those times, we may use derivative financial instruments including interest rate swaps and caps, forward interest rate options or interest rate options in order to assist us in managing our debt mix. We may either hedge our variable rate debt to give it an effective fixed interest rate or hedge fixed rate debt to give it an effective variable interest rate.

Typically we have obtained the ratings of two credit rating agencies in the underwriting of our unsecured debt. As of June 30, 2009, Standard & Poor's had assigned its BBB+ rating with a stable outlook, and Moody's Investor Service has assigned its Baa1 rating with a stable outlook, to our unsecured debt offerings. A downgrade in rating by either of these rating agencies could result from, among other things, a change in our financial position. Any such downgrade could adversely affect our ability to obtain future financing or could increase the interest rates on our existing debt. However, we have no debt instruments under which the principal maturity would be accelerated upon a downward change in our debt rating. A rating is not a recommendation to buy, sell or hold securities, and each rating is subject to revision or withdrawal at any time by the assigning rating organization.

Our total debt at June 30, 2009 is summarized as follows (in thousands):

	Total Debt
Fixed rate mortgages	\$ 457,238
Unsecured credit facilities	15,000
Unsecured notes payable	807,128
	\$ 1,279,366

If principal amounts due at maturity cannot be refinanced, extended or paid with proceeds of other capital transactions, such as new equity capital, our cash flow may be insufficient to repay all maturing debt. Prevailing interest rates or other factors at the time of a refinancing, such as possible reluctance of lenders to make commercial real estate loans, may result in higher interest rates and increased interest expense.

Mortgage Debt

At June 30, 2009, our \$457.2 million in fixed rate mortgages, which includes a net \$7.8 million in unamortized discounts due to fair value adjustments, bore an effective weighted average fair value interest rate of 6.0% and had a weighted average maturity of 6.6 years. We may either initiate secured mortgage debt or assume mortgage debt from time-to-time in conjunction with property acquisitions.

On February 17, 2009, we executed a mortgage note of \$37.5 million at a fixed rate of 5.37% for a term of ten years, supported by Kenmore Apartments. The proceeds from the note were used to pay down borrowings under our lines of credit and to repurchase a portion of our convertible notes.

Subsequent to the end of the 2009 Quarter, on July 1, 2009, we used a portion of the proceeds of the May 2009 equity offering to prepay the \$50 million mortgage that was to mature in October, 2009.

Unsecured Credit Facilities

Our primary source of liquidity is our two revolving credit facilities. We can borrow up to \$337.0 million under these lines, which bear interest at an adjustable spread over LIBOR based on our public debt rating.

Credit Facility No. 1 is a four-year, \$75.0 million unsecured credit facility expiring in June 2011. We had \$5.4 million in letters of credit issued as of June 30, 2009, related to Credit Facility No. 1. Borrowings under the facility bear interest at our option of LIBOR plus a spread based on the credit rating on our publicly issued debt or the higher of SunTrust Bank's prime rate and the Federal Funds Rate in effect plus 0.5%. All outstanding advances are due and payable upon maturity in June 2011. Interest only payments are due and payable generally on a monthly basis. In addition, we pay a facility fee based on the credit rating of our publicly issued debt which currently equals 0.15% per annum of the \$75.0

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million committed capacity, without regard to usage. Rates and fees may be adjusted up or down based on changes in our senior unsecured credit ratings.

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Credit Facility No. 2 is a four-year \$262.0 million unsecured credit facility expiring in November 2010, with a one year extension option. We had \$15.0 million outstanding and \$0.9 million in letters of credit issued as of June 30, 2009, related to Credit Facility No. 2. Advances under this agreement bear interest at our option of LIBOR plus a spread based on the credit rating of our publicly issued debt or the higher of Wells Fargo Bank's prime rate and the Federal Funds Rate in effect on that day plus 0.5%. All outstanding advances are due and payable upon maturity in November 2010. Interest only payments are due and payable generally on a monthly basis. Credit Facility No. 2 requires us to pay the lender a facility fee on the total commitment of 0.15% per annum. These fees are payable quarterly.

Our unsecured credit facilities contain financial and other covenants with which we must comply. Some of these covenants include:

A minimum tangible net worth;

A maximum ratio of total liabilities to gross asset value, calculated using an estimate of fair market value of our assets;

A maximum ratio of secured indebtedness to gross asset value, calculated using an estimate of fair market value of our assets;

A minimum ratio of annual EBITDA (earnings before interest, taxes, depreciation and amortization) to fixed charges, including interest expense;

A minimum ratio of unencumbered asset value, calculated using a fair value of our assets, to unsecured indebtedness;

A minimum ratio of net operating income from our unencumbered properties to unsecured interest expense; and

A maximum ratio of permitted investments to gross asset value, calculated using an estimate of fair market value of our assets.

Failure to comply with any of the covenants under our unsecured credit facilities or other debt instruments could result in a default under one or more of our debt instruments. This could cause our lenders to accelerate the timing of payments and would therefore have a material adverse effect on our business, operations, financial condition and liquidity.

As of June 30, 2009, we were in compliance with our loan covenants. However, our ability to draw on our unsecured credit facilities or incur other unsecured debt in the future could be restricted by the loan covenants.

We anticipate that in the near term we may rely to a greater extent upon our unsecured credit facilities and potentially maintain balances on our unsecured credit facilities for longer periods than has been our historical practice. To the extent that we maintain larger balances on our unsecured credit facilities or maintain balances on our unsecured credit facilities for longer periods, adverse fluctuations in interest rates could have a material adverse effect on earnings.

Unsecured Notes

We generally issue senior unsecured notes to fund our real estate assets long-term. In issuing future senior unsecured notes, we intend to ladder the maturities of our debt to mitigate exposure to interest rate risk in future years.

Depending upon market conditions, opportunities to issue unsecured notes on attractive terms may not be available. In particular, as noted above, current access to unsecured notes financings for REITs are currently less available and long-term credit has become more expensive, as a result of the current economic downturn and turmoil in the credit markets. Accordingly, as noted above we anticipate that in the near term we may rely to a greater extent upon our unsecured credit facilities and potentially maintain balances on our unsecured credit facilities for longer periods than has been our historical practice. To the extent that we maintain larger balances on our unsecured credit facilities or maintain balances on our unsecured credit facilities for longer periods, adverse fluctuations in interest rates could have a material adverse effect on

earnings.

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Our unsecured fixed-rate notes payable have maturities ranging from February 2010 through February 2028, as follows (in thousands):

	June 30, 2009
	Note Principal
5.70% notes due 2011	\$ 100,000
5.95% notes due 2011	150,000
5.05% notes due 2012	50,000
5.125% notes due 2013	60,000
5.25% notes due 2014	100,000
5.35% notes due 2015	150,000
3.875% notes due 2026 ⁽¹⁾	154,635
7.25% notes due 2028	50,000
	\$ 814,635

- (1) On or after September 20, 2011, we may redeem the convertible notes at a redemption price equal to the principal amount of the notes plus any accrued and unpaid interest, if any, up to, but excluding, the purchase date. In addition, on September 15, 2011, September 15, 2016 and September 15, 2021 or following the occurrence of certain change in control transactions prior to September 15, 2011, holders of these notes may require us to repurchase the notes for an amount equal to the principal amount of the notes plus any accrued and unpaid interest thereon.

Our unsecured notes contain covenants with which we must comply. These include:

Limits on our total indebtedness;

Limits on our secured indebtedness;

Limits on our required debt service payments; and

Maintenance of a minimum level of unencumbered assets.

Failure to comply with any of the covenants under our unsecured notes could result in a default under one or more of our debt instruments. This could cause our debt holders to accelerate the timing of payments and would therefore have a material adverse effect on our business, operations, financial condition and liquidity.

As of June 30, 2009, we were in compliance with our unsecured notes covenants.

During the 2009 Period, we repurchased \$89.4 million of our 3.875% convertible notes at 80.0% to 92.0% of par. We may from time to time seek to repurchase and cancel our outstanding notes through open market purchases, privately negotiated transactions or otherwise. Such repurchases, if any, will depend on prevailing market conditions, our liquidity requirements, contractual restrictions and other factors. The amounts involved may be material.

During the 2009 Quarter we entered into an agreement to modify our \$100 million unsecured term loan with Wells Fargo to extend the maturity date from February 19, 2010 to November 1, 2011. This agreement also increased the interest rate on the term loan from LIBOR plus 150 basis points to LIBOR plus 275 basis points. We previously had an interest rate swap agreement in place through the term loan's original maturity date of February 19, 2010. This interest rate swap effectively fixes the interest rate on the modified term loan at 5.70%. On May 6, 2009, we also entered into a forward interest rate swap agreement that will effectively fix the modified term loan's interest rate at 4.85% for the period from February 20, 2010 through the maturity date of November 1, 2011. The agreement to modify the term loan also allows us to prepay the loan for

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a fee equal to 1.00% of the prepayment on or before November 30, 2010, and for a fee equal to 0.25% of the prepayment after November 30, 2010 but on or before May 31, 2011. After May 31, 2011 there is no prepayment fee under the terms of the modification agreement. We paid a loan fee equal to 0.5% of the \$100 million principal amount in connection with the modification agreement.

Common Equity

We have authorization for issuance of 100.0 million common shares, of which 58.3 million shares were outstanding at June 30, 2009.

During the third quarter of 2008, we entered into a sales agency financing agreement with BNY Mellon Capital Markets, LLC relating to the issuance and sale of up to \$150.0 million of our common shares from time to time over a period of no more than 36 months. Sales of our common shares are made at market prices prevailing at the time of

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sale. Net proceeds from the sale of common shares under this program are used for the repayment of borrowings under our lines of credit, acquisitions and general corporate purposes. During the first quarter of 2009, we issued 558,268 common shares at a weighted average price of \$26.47 under this program, raising \$14.6 million in net proceeds.

We have a dividend reinvestment program whereby shareholders may use their dividends and optional cash payments to purchase common shares. The common shares sold under this program may be purchased in the open market. No common shares were issued under this program during the 2009 and 2008 Quarters.

During the 2009 Quarter, we completed a public offering of 5.25 million common shares priced at \$21.40 per share, raising \$107.5 million in net proceeds. The net proceeds were used to repay borrowing under our unsecured lines of credit and for general corporate purposes.

Dividends

We pay dividends quarterly. The maintenance of these dividends is subject to various factors, including the discretion of our Board of Trustees, the ability to pay dividends under Maryland law, the availability of cash to make the necessary dividend payments and the effect of REIT distribution requirements, which require at least 90% of our taxable income to be distributed to shareholders. The table below details our dividend and distribution payments for the 2009 and 2008 Quarters (in thousands).

	Quarters Ended June 30,				Periods Ended June 30,			
	2009	2008	Change		2009	2008	Change	
			\$	%			\$	%
Common dividends	\$ 25,343	\$ 21,421	\$ 3,922	18.3%	\$ 48,430	\$ 41,177	\$ 7,253	17.6%
Minority interest distributions	46	48	(2)	(4.2)%	95	95		%
	\$ 25,389	\$ 21,469	\$ 3,920	18.3%	\$ 48,525	\$ 41,272	\$ 7,253	17.6%

Dividends paid for the 2009 Quarter as compared to the 2008 Quarter increased due to our issuance of 5.25 million shares during the 2009 Quarter, 4.325 million shares pursuant to public offerings during 2008 and our issuance of 1.7 million shares under our sales agency financing agreement during 2008 and 2009.

Historical Cash Flows

Consolidated cash flow information is summarized as follows (in millions):

	Periods Ended June 30,			
	2009	2008	Change	
			\$	%
Cash provided by operating activities	\$ 62.4	\$ 58.8	\$ 3.6	6.1%
Cash used in investing activities	\$ 4.8	\$ (48.8)	\$ 53.6	109.8%
Cash provided by financing activities	\$ (20.6)	\$ (18.8)	\$ (1.8)	(9.6)%

Operations generated \$62.4 million of net cash in the 2009 Period compared to \$58.8 million in the 2008 Period. The increase in cash provided by operating activities was due primarily to properties acquired or placed into service during 2008.

Our investing activities generated net cash of \$4.8 million in the 2009 Period and used net cash of \$48.8 million in the 2008 Period. The increase in cash generated by investing activities was primarily due to the fact that there was a property sale for \$19.8 million in the 2009 Period, while the proceeds from property sales during the 2008 Period were placed in a tax free escrow. Also, there were no acquisitions during the 2009 Period, while there were \$17.7 million in acquisitions in the 2008 Period. In addition, cash spent on our development projects decreased to \$1.2 million during the 2009 Period from \$13.7 million during the 2008 Period, as our three major development projects (Bennett Park, Clayborne Apartments and Dulles Station, Phase I) were completed and placed into service during 2007 and 2008.

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Our financing activities used net cash of \$20.6 million in the 2009 Period and \$18.8 million in the 2008 Period. The increase in net cash used by financing activities in the 2009 Period was primarily due to the repurchases of a portion of the 3.875 convertible notes for \$76.9 million, net paydowns of the unsecured lines of credit of \$52.0 million and dividends of \$48.4 million, partially offset by proceeds from equity offerings of \$122.0 million and \$37.5 million in proceeds from a new mortgage note.

Table of Contents**Ratios of Earnings to Fixed Charges and Debt Service Coverage**

The following table sets forth our ratios of earnings to fixed charges and debt service coverage for the periods shown:

	Quarters Ended June 30,		Periods Ended June 30,	
	2009	2008	2009	2008
Earnings to fixed charges	1.3x	1.2x	1.4x	(a)
Debt service coverage	2.4x	2.3x	2.5x	2.1x

(a) Due to WRIT's loss from continuing operations during YTD 2008, the coverage ratio was less than 1:1. WRIT needed to generate additional earnings of \$1,726,000 to achieve a coverage ratio of 1:1. The loss in YTD 2008 included the impact of the loss on extinguishment of debt of \$8,449,000.

We computed the ratio of earnings to fixed charges by dividing earnings by fixed charges. For this purpose, earnings consist of income from continuing operations plus fixed charges, less capitalized interest. Fixed charges consist of interest expense, including amortized costs of debt issuance, and interest costs capitalized.

We computed the debt service coverage ratio by dividing EBITDA (which is earnings before interest income and expense, taxes, depreciation, amortization and gain on sale of real estate) by interest expense and principal amortization.

Both the earnings to fixed charges ratio and the debt service coverage ratio for the 2009 Quarter include the impact of the gain on extinguishment of debt of \$1.2 million. Both of the ratios for the 2009 and 2008 Periods include the impact of the gain (loss) on extinguishment of debt of \$7.1 million and (\$8.4 million), respectively (see Item 2: Overview).

Funds From Operations

FFO is a widely used measure of operating performance for real estate companies. We provide FFO as a supplemental measure to net income calculated in accordance with GAAP. Although FFO is a widely used measure of operating performance for REITs, FFO does not represent net income calculated in accordance with GAAP. As such, it should not be considered an alternative to net income as an indication of our operating performance. In addition, FFO does not represent cash generated from operating activities in accordance with GAAP, nor does it represent cash available to pay distributions and should not be considered as an alternative to cash flow from operating activities, determined in accordance with GAAP, as a measure of our liquidity. The National Association of Real Estate Investment Trusts, Inc. (NAREIT) defines FFO (April, 2002 White Paper) as net income (computed in accordance with GAAP) excluding gains (or losses) from sales of property plus real estate depreciation and amortization. We consider FFO to be a standard supplemental measure for REITs because it facilitates an understanding of the operating performance of our properties without giving effect to real estate depreciation and amortization, which historically assumes that the value of real estate assets diminishes predictably over time. Since real estate values have instead historically risen or fallen with market conditions, we believe that FFO more accurately provides investors an indication of our ability to incur and service debt, make capital expenditures and fund other needs. Our FFO may not be comparable to FFO reported by other REITs. These other REITs may not define the term in accordance with the current NAREIT definition or may interpret the current NAREIT definition differently.

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The following table provides the calculation of our FFO and a reconciliation of FFO to net income for the years presented (in thousands):

	Quarters Ended June 30,		Periods Ended June 30,	
	2009	2008	2009	2008
Net income attributable to the controlling interests	\$ 13,090	\$ 19,950	\$ 23,941	\$ 17,226
Adjustments				
Depreciation and amortization	23,501	20,995	46,776	41,328
Discontinued operations depreciation and amortization	7	203	34	395
Gain on sale of real estate	(6,674)	(15,275)	(6,674)	(15,275)
FFO as defined by NAREIT	\$ 29,924	\$ 25,873	\$ 64,077	\$ 43,674

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ITEM 3: QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

The principal material financial market risk to which we are exposed is interest-rate risk. Our exposure to market risk for changes in interest rates relates primarily to refinancing long-term fixed rate obligations, the opportunity cost of fixed rate obligations in a falling interest rate environment and our variable rate lines of credit. We primarily enter into debt obligations to support general corporate purposes including acquisition of real estate properties, capital improvements and working capital needs.

In February 2008, we entered into an interest rate swap with a notional amount of \$100 million that qualifies as a cash flow hedge under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133). In May 2009, we entered into a forward interest rate swap with a notional amount of \$100 million that qualifies as a cash flow hedge under FAS 133. We enter into interest rate swaps to manage our exposure to variable rate interest risk. We do not purchase derivatives for speculation. Our cash flow hedges are recorded at fair value. The effective portion of changes in fair value of cash flow hedges is recorded in other comprehensive income. The ineffective portion of changes in fair value of cash flow hedges is recorded in earnings in the period affected. We assess effectiveness of our cash flow hedges both at inception and on an ongoing basis.

As the majority of our outstanding debt is long-term, fixed rate debt, our interest rate risk has not changed significantly from what was disclosed in our 2008 Form 10-K and Current Report on Form 8-K filed July 10, 2009. See Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources Debt Financing.

ITEM 4: CONTROLS AND PROCEDURES

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

We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer, Chief Financial Officer and Executive Vice President of Accounting, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by the report. Based on the foregoing, our Chief Executive Officer, Chief Financial Officer and Executive Vice President of Accounting concluded that WRIT's disclosure controls and procedures were effective at the reasonable assurance level.

There have been no changes in WRIT's internal control over financial reporting (as defined by Rule 13a-15(f)) that occurred during the period covered by the report that have materially affected, or are reasonably likely to materially affect, WRIT's internal control over financial reporting.

Table of Contents**PART II****OTHER INFORMATION****ITEM 1: LEGAL PROCEEDINGS**

None.

ITEM 1A: RISK FACTORS

None.

ITEM 2: UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3: DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

At WRIT's annual meeting of Shareholders on May 18, 2009, the following members were elected to the Board of Trustees for a period of three years:

	Affirmative Votes	Negative/Withheld Votes
Mr. John M. Derrick, Jr.	45,643,319	1,306,349
Mr. Charles T. Nason	45,779,992	1,169,677
Mr. Thomas Edgie Russell, III	45,784,143	1,165,525

Mr. Derrick, Mr. Nason and Mr. Russell were elected as Trustees. Trustees, whose term in office continued after the meeting were Mr. Edmund B. Cronin, Jr, Mr. George F. McKenzie, Mr. John P. McDaniel, Mr. Edward S. Civera, Mr. Terence C. Golden and Ms. Wendelin A. White.

The shareholders approved the recommendation of the Trustees to ratify the appointment of Ernst & Young LLP as WRIT's independent registered public accounting firm for 2009. The proposal received the following votes:

Affirmative Votes	Negative Votes	Abstain Votes
46,552,455	233,762	163,451

ITEM 5: OTHER INFORMATION

None.

ITEM 6: EXHIBITS

(a) Exhibits

4. Instruments Defining Rights of Security Holders

(rr) First Amendment to Term Loan Agreement dated as of May 7, 2009, by and between WRIT and Wells Fargo Bank, National Association

12. Computation of Ratio of Earnings to Fixed Charges

31. Rule 13a-14(a)/15(d)-14(a) Certifications

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- (a) Certification Chief Executive Officer
 - (b) Certification Executive Vice President Accounting, Administration and Corporate Secretary
 - (c) Certification Chief Financial Officer
32. Section 1350 Certifications
- (a) Written Statement of Chief Executive Officer and Financial Officers

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SIGNATURES

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

WASHINGTON REAL ESTATE INVESTMENT
TRUST

/s/ George F. McKenzie
George F. McKenzie
President and Chief Executive Officer

/s/ Laura M. Franklin
Laura M. Franklin
Executive Vice President
Accounting, Administration and
Corporate Secretary

/s/ William T. Camp
William T. Camp
Executive Vice President and Chief Financial Officer

DATE: August 7, 2009

ont>

—

29,296

25,526

—

Real estate - residential mortgage

4,603

4,603

—

4,689

4,689

—

Construction - commercial residential

14,086

9,450

—

6,271

4,795

—

76,149

65,106

69,013

60,457

With a related allowance recorded:

Real estate - commercial mortgage

32,770

25,205

7,726

37,132

29,446

10,162

Commercial - secured

33,481

29,189

14,974

27,767

22,626

13,198

Commercial - unsecured

1,236

976

525

1,122

823

455

Real estate - home equity
27,739

23,922

10,826

23,971

19,205

9,511

Real estate - residential mortgage
43,979

37,975

10,195

48,885

41,359

11,897

Construction - commercial residential
6,119

2,883

1,006

10,103

4,206

1,300

Construction - commercial

186

100

36

681

435

145

Construction - other

1,096

1,091

392

1,096

1,096

423

Consumer - direct

24

19

13

21

21

14

Consumer - indirect

14

14

8

19

19

12

146,644

121,374

45,701

150,797

119,236

47,117

Total

\$

222,793

\$
186,480

\$
45,701

\$
219,810

\$
179,693

\$
47,117

As of September 30, 2017 and December 31, 2016, there were \$65.1 million and \$60.5 million, respectively, of impaired loans that did not have a related allowance for loan loss. The estimated fair values of the collateral securing these loans exceeded their carrying amount, or they were previously charged down to realizable collateral values. Accordingly, no specific valuation allowance was considered to be necessary.

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The following table presents average impaired loans by class segment:

	Three months ended September 30				Nine months ended September 30			
	2017		2016		2017		2016	
	Average Recorded Investment(1)	Interest Income	Average Recorded Investment(1)	Interest Income	Average Recorded Investment(1)	Interest Income	Average Recorded Investment(1)	Interest Income
	(in thousands)							
With no related allowance recorded:								
Real estate - commercial mortgage	\$21,698	\$ 72	\$25,048	\$ 78	\$22,770	\$213	\$23,929	219
Commercial - secured	33,044	46	23,836	32	29,309	128	18,400	68
Real estate - residential mortgage	4,616	27	6,151	33	4,645	79	5,826	96
Construction - commercial residential	8,747	5	5,734	10	6,745	11	6,658	45
Construction - commercial	295	—	—	—	298	—	—	—
	68,400	150	60,769	153	63,767	431	54,813	428
With a related allowance recorded:								
Real estate - commercial mortgage	25,910	86	29,139	91	27,518	259	32,310	303
Commercial - secured	24,334	33	21,688	29	23,291	96	26,665	100
Commercial - unsecured	818	1	953	1	806	1	903	3
Real estate - home equity	22,837	150	18,283	76	20,957	362	17,589	203
Real estate - residential mortgage	38,329	225	40,913	221	39,584	680	42,399	683
Construction - commercial residential	5,047	4	4,947	8	5,397	11	5,568	37
Construction - commercial	113	—	476	—	186	—	546	—
Construction - other	1,091	—	756	—	1,094	—	579	—
Consumer - direct	19	—	19	—	19	—	17	1
Consumer - indirect	15	—	11	—	17	—	14	—
Leasing, other and overdrafts	—	—	—	—	356	—	712	—
	118,513	499	117,185	426	119,225	1,409	127,302	1,330
Total	\$186,913	\$ 649	\$177,954	\$ 579	\$182,992	\$1,840	\$182,115	1,758

(1) All impaired loans, excluding accruing TDRs, were non-accrual loans. Interest income recognized for the three and nine months ended September 30, 2017 and 2016 represents amounts earned on accruing TDRs.

Credit Quality Indicators and Non-performing Assets

The following is a summary of the Corporation's internal risk rating categories:

• **Pass:** These loans do not currently pose undue credit risk and can range from the highest to average quality, depending on the degree of potential risk.

• **Special Mention:** These loans constitute an undue and unwarranted credit risk, but not to a point of justifying a classification of substandard. Loans in this category are currently acceptable, but are nevertheless potentially weak.

• **Substandard or Lower:** These loans are inadequately protected by current sound worth and paying capacity of the borrower. There exists a well-defined weakness or weaknesses that jeopardize the normal repayment of the debt.

The following table presents internal credit risk ratings for the indicated loan class segments:

	Pass		Special Mention		Substandard or Lower		Total	
	September 30, 2017	December 31, 2016	September 30, 2017	December 31, 2016	September 30, 2017	December 31, 2016	September 30, 2017	December 31, 2016
	(dollars in thousands)							
Real estate - commercial mortgage	\$6,028,523	\$5,763,122	\$118,947	\$132,484	\$127,670	\$122,976	\$6,275,140	\$6,018,582
Commercial - secured	3,807,138	3,686,152	98,639	128,873	183,181	118,527	4,088,958	3,933,552
Commercial - unsecured	127,561	145,922	3,474	4,481	3,082	3,531	134,117	153,934
Total commercial - industrial, financial and agricultural	3,934,699	3,832,074	102,113	133,354	186,263	122,058	4,223,075	4,087,486
Construction - commercial residential	134,786	113,570	6,746	15,447	14,595	13,172	156,127	142,189
Construction - commercial	743,111	635,963	4,418	3,412	3,869	5,115	751,398	644,490
Total construction (excluding Construction - other)	877,897	749,533	11,164	18,859	18,464	18,287	907,525	786,679
	\$10,841,119	\$10,344,729	\$232,224	\$284,697	\$332,397	\$263,321	\$11,405,740	\$10,892,747
% of Total	95.1	% 95.0	% 2.0	% 2.6	% 2.9	% 2.4	% 100.0	% 100.0

The risk rating process allows management to identify credits that potentially carry more risk in a timely manner and to allocate resources to managing troubled accounts. The Corporation believes that internal risk ratings are the most relevant credit quality indicator for the class segments presented above. The migration of loans through the various internal risk rating categories is a significant component of the allowance for credit loss methodology, which bases the probability of default on this migration. Assigning risk ratings involves judgment. The Corporation's loan review officers provide an independent assessment of risk rating accuracy. Ratings may be changed based on the ongoing monitoring procedures performed by loan officers or credit administration staff, or if specific loan review activities identify a deterioration or an improvement in the loan.

The Corporation does not assign internal risk ratings to smaller balance, homogeneous loans, such as home equity, residential mortgage, construction loans to individuals secured by residential real estate, consumer and lease receivables. For these loans, the most relevant credit quality indicator is delinquency status. The migration of loans through the various delinquency status categories is a significant component of the allowance for credit losses methodology for those loans, which bases the probability of default on this migration.

The following table presents a summary of performing, delinquent and non-performing loans for the indicated loan class segments:

Performing	Delinquent (1)	Non-performing (2)	Total
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	September 30, 2017	December 31, 2016	September 30, 2017	December 31, 2016	September 30, 2017	December 31, 2016	September 30, 2017	December 31, 2016
(dollars in thousands)								
Real estate - home equity	\$ 1,542,289	\$ 1,602,687	\$ 12,955	\$ 9,274	\$ 12,229	\$ 13,154	\$ 1,567,473	\$ 1,625,115
Real estate - residential mortgage	1,845,495	1,557,995	20,769	20,344	21,643	23,655	1,887,907	1,601,994
Construction - other	64,110	55,874	382	—	1,091	1,096	65,583	56,970
Consumer - direct	55,490	93,572	158	1,752	63	1,563	55,711	96,887
Consumer - indirect	243,723	190,656	2,834	3,599	180	328	246,737	194,583
Total consumer	299,213	284,228	2,992	5,351	243	1,891	302,448	291,470
Leasing	256,784	229,591	884	1,068	80	317	257,748	230,976
	\$ 4,007,891	\$ 3,730,375	\$ 37,982	\$ 36,037	\$ 35,286	\$ 40,113	\$ 4,081,159	\$ 3,806,525
% of Total	98.2	% 98.0	% 0.9	% 0.9	% 0.9	% 1.1	% 100.0	% 100.0

(1) Includes all accruing loans 30 days to 89 days past due.

(2) Includes all accruing loans 90 days or more past due and all non-accrual loans.

The following table presents non-performing assets:

	September 30, 2017	December 31, 2016
	(in thousands)	
Non-accrual loans	\$123,345	\$120,133
Loans 90 days or more past due and still accruing	13,124	11,505
Total non-performing loans	136,469	131,638
Other real estate owned (OREO)	10,542	12,815
Total non-performing assets	\$147,011	\$144,453

The following tables present past due status and non-accrual loans by portfolio segment and class segment:

	September 30, 2017			Non- accrual	Total ≥ 90 Days	Total Past Due	Current	Total
	30-59 Days Past Due	60-89 Days Past Due	≥ 90 Days Past Due and Accruing					
	(in thousands)							
Real estate - commercial mortgage	\$10,276	\$2,297	\$2,884	\$31,766	\$34,650	\$47,223	\$6,227,917	\$6,275,140
Commercial - secured	8,382	2,378	1,503	51,787	53,290	64,050	4,024,908	4,088,958
Commercial - unsecured	114	34	—	919	919	1,067	133,050	134,117
Total commercial - industrial, financial and agricultural	8,496	2,412	1,503	52,706	54,209	65,117	4,157,958	4,223,075
Real estate - home equity	11,192	1,763	3,096	9,133	12,229	25,184	1,542,289	1,567,473
Real estate - residential mortgage	15,106	5,663	5,258	16,385	21,643	42,412	1,845,495	1,887,907
Construction - commercial residential	400	18	60	12,164	12,224	12,642	143,485	156,127
Construction - commercial	366	—	—	100	100	466	750,932	751,398
Construction - other	382	—	—	1,091	1,091	1,473	64,110	65,583
Total real estate - construction	1,148	18	60	13,355	13,415	14,581	958,527	973,108
Consumer - direct	118	40	63	—	63	221	55,490	55,711
Consumer - indirect	2,393	441	180	—	180	3,014	243,723	246,737
Total consumer	2,511	481	243	—	243	3,235	299,213	302,448
Leasing, other and overdrafts	764	120	80	—	80	964	256,784	257,748
Total	\$49,493	\$12,754	\$13,124	\$123,345	\$136,469	\$198,716	\$15,288,183	\$15,486,899

	December 31, 2016							Current	Total
	30-59 Days Past Due	60-89 Days Past Due	≥ 90 Days Past Due and Accruing	Non-accrual	Total ≥ 90 Days	Total Past Due			
	(in thousands)								
Real estate - commercial mortgage	\$6,254	\$1,622	\$383	\$38,936	\$39,319	\$47,195	\$5,971,387	\$6,018,582	
Commercial - secured	6,660	2,616	959	41,589	42,548	51,824	3,881,728	3,933,552	
Commercial - unsecured	898	35	152	760	912	1,845	152,089	153,934	
Total commercial - industrial, financial and agricultural	7,558	2,651	1,111	42,349	43,460	53,669	4,033,817	4,087,486	
Real estate - home equity	6,596	2,678	2,543	10,611	13,154	22,428	1,602,687	1,625,115	
Real estate - residential mortgage	15,600	4,744	5,224	18,431	23,655	43,999	1,557,995	1,601,994	
Construction - commercial residential	233	51	36	8,275	8,311	8,595	133,594	142,189	
Construction - commercial	743	—	—	435	435	1,178	643,312	644,490	
Construction - other	—	—	—	1,096	1,096	1,096	55,874	56,970	
Total real estate - construction	976	51	36	9,806	9,842	10,869	832,780	843,649	
Consumer - direct	1,211	541	1,563	—	1,563	3,315	93,572	96,887	
Consumer - indirect	3,200	399	328	—	328	3,927	190,656	194,583	
Total consumer	4,411	940	1,891	—	1,891	7,242	284,228	291,470	
Leasing, other and overdrafts	543	525	317	—	317	1,385	229,591	230,976	
Total	\$41,938	\$13,211	\$11,505	\$120,133	\$131,638	\$186,787	\$14,512,485	\$14,699,272	

The following table presents TDRs, by class segment:

	September 30, 2017	December 31, 2016
	(in thousands)	
Real-estate - residential mortgage	\$26,193	\$27,617
Real-estate - commercial mortgage	14,439	15,957
Real estate - home equity	14,789	8,594
Commercial	7,512	6,627
Construction	169	726
Consumer	33	39
Total accruing TDRs	63,135	59,560
Non-accrual TDRs ⁽¹⁾	28,742	27,850
Total TDRs	\$91,877	\$87,410

(1) Included in non-accrual loans in the preceding table detailing non-performing assets.

As of September 30, 2017 and December 31, 2016, there were \$3.8 million and \$3.6 million of commitments, respectively, to lend additional funds to borrowers whose loans were modified under TDRs.

The following table presents TDRs, by class segment and type of concession for loans that were modified during the three and nine months ended September 30, 2017 and 2016:

	Three months ended September 30 2017		2016		Nine months ended September 30 2017		2016	
	Number of Recorded Loans	Post-Modification Investment (dollars in thousands)	Number of Recorded Loans	Post-Modification Investment (dollars in thousands)	Number of Recorded Loans	Post-Modification Investment (dollars in thousands)	Number of Recorded Loans	Post-Modification Investment (dollars in thousands)
Real estate – residential mortgage:								
Extend maturity with rate concession	2	\$ 468	—	\$ —	2	\$ 468	—	\$ —
Extend maturity without rate concession	2	151	—	—	4	488	2	\$ 315
Bankruptcy	—	—	2	350	2	335	3	723
Real estate - commercial mortgage:								
Extend maturity without rate concession	2	1,247	—	—	6	2,228	—	\$ —
Bankruptcy	—	—	—	—	1	12	—	\$ —
Real estate - home equity:								
Extend maturity without rate concession	14	1,315	24	1,063	47	3,874	63	\$ 3,058
Bankruptcy	6	127	11	563	23	1,643	33	\$ 2,279
Commercial:								
Extend maturity without rate concession	1	160	4	1,826	9	5,853	10	3,802
Bankruptcy	—	—	—	—	1	490	—	—
Commercial – unsecured:								
Extend maturity without rate concession	—	—	—	—	1	33	2	103
Construction - commercial residential:								
Extend maturity without rate concession	—	—	—	—	1	1,204	—	—
Consumer - direct:								
Bankruptcy	—	—	—	—	—	—	1	2
Consumer - indirect:								
Bankruptcy	—	—	1	21	—	—	1	21
Total	27	\$ 3,468	42	\$ 3,823	97	\$ 16,628	115	\$ 10,303

The following table presents TDRs, by class segment, as of September 30, 2017 and 2016, that were modified in the previous 12 months and had a post-modification payment default during the nine months ended September 30, 2017 and 2016. The Corporation defines a payment default as a single missed payment.

	2017	2016
Number of Recorded Investment Loans		
	Number of Recorded Investment Loans	Number of Recorded Investment Loans
	(dollars in thousands)	(dollars in thousands)

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Real estate - residential mortgage	5	\$ 1,321	7	\$ 1,395
Real estate - commercial mortgage	3	653	2	129
Real estate - home equity	27	1,598	29	1,902
Commercial	2	264	6	2,593
Commercial - unsecured	—	—	1	26
Construction - commercial residential	1	1,198	—	—
Construction - other	1	411	—	—
Total	39	\$ 5,445	45	\$ 6,045

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NOTE 6 – Mortgage Servicing Rights

The following table summarizes the changes in mortgage servicing rights ("MSRs"), which are included in other assets on the consolidated balance sheets:

	Three months ended September 30		Nine months ended September 30	
	2017	2016	2017	2016
	(in thousands)			
Amortized cost:				
Balance at beginning of period	\$38,180	\$39,874	\$38,822	\$40,944
Originations of mortgage servicing rights	1,333	1,499	3,719	3,927
Amortization	(1,639)	(2,064)	(4,667)	(5,562)
Balance at end of period	\$37,874	\$39,309	\$37,874	\$39,309
Valuation allowance:				
Balance at beginning of period	\$—	\$(1,721)	\$(1,291)	\$—
(Additions) reductions to valuation allowance	—	(1,280)	1,291	(3,001)
Balance at end of period	\$—	\$(3,001)	\$—	\$(3,001)
Net MSRs at end of period	\$37,874	\$36,308	\$37,874	\$36,308

MSRs represent the economic value of existing contractual rights to service mortgage loans that have been sold. Accordingly, actual and expected prepayments of the underlying mortgage loans can impact the value of MSRs. The Corporation accounts for MSRs at the lower of amortized cost or fair value.

The fair value of MSRs is estimated by discounting the estimated cash flows from servicing income, net of expense, over the expected life of the underlying loans at a discount rate commensurate with the risk associated with these assets. Expected life is based on the contractual terms of the loans, as adjusted for prepayment projections. Based on its fair value analysis, the Corporation determined that no adjustment to the valuation allowance was necessary for the three months ended September 30, 2017, while a reduction of \$1.3 million was required for the nine months ended September 30, 2017. Additions to the valuation allowance of \$1.3 million and \$3.0 million were necessary for the three and nine months ended September 30, 2016, respectively. Additions and reductions to the valuation allowance are recorded as decreases and increases, respectively, to "mortgage banking income" on the consolidated statements of income.

NOTE 7 – Stock-Based Compensation

The Corporation grants equity awards to employees, consisting of stock options, restricted stock, RSUs and PSUs under its Amended and Restated Equity and Cash Incentive Compensation Plan ("Employee Equity Plan"). In addition, employees may purchase stock under the Corporation's Employee Stock Purchase Plan. The fair value of equity awards granted to employees is recognized as compensation expense over the period during which employees are required to provide service in exchange for such awards. Compensation expense for PSUs is also recognized over the period during which employees are required to provide service in exchange for such awards, however, compensation expense may vary based on the expectations for actual performance relative to defined performance measures.

The Corporation also grants equity awards to non-employee members of its board of directors under the 2011 Directors' Equity Participation Plan ("Directors' Plan"). Under the Directors' Plan, the Corporation can grant equity

awards to non-employee holding company and subsidiary bank directors in the form of stock options, restricted stock or common stock.

Equity awards issued under the Employee Equity Plan are generally granted annually and become fully vested over or after a three-year vesting period. The vesting period for non-performance-based awards represents the period during which employees are required to provide service in exchange for such awards. Equity awards under the Directors' Plan generally vest immediately upon grant. Certain events, as defined in the Employee Equity Plan and the Directors' Plan, result in the acceleration of the vesting of equity awards.

The following table presents compensation expense and the related tax benefits for equity awards recognized in the consolidated statements of income:

	Three months ended September 30		Nine months ended September 30	
	2017	2016	2017	2016
	(in thousands)			
Stock-based compensation expense	\$1,570	\$1,552	\$3,339	\$4,808
Tax benefit	(628)	(536)	(3,312)	(1,611)
Stock-based compensation expense, net of tax benefit	\$942	\$1,016	\$27	\$3,197

Stock option fair values are estimated through the use of the Black-Scholes valuation methodology as of the date of grant. Stock options carry terms of up to ten years. Fair values for restricted stock, RSUs and a majority of PSUs are based on the trading price of the Corporation's stock on the date of grant and earn dividends or dividend equivalents during the vesting period, which are forfeitable if the awards do not vest. The fair value of certain PSUs are estimated through the use of the Monte Carlo valuation methodology as of the date of grant.

As of September 30, 2017, the Employee Equity Plan had 11.1 million shares reserved for future grants through 2023, and the Directors' Plan had approximately 360,000 shares reserved for future grants through 2021.

NOTE 8 – Employee Benefit Plans

The net periodic benefit cost for the Corporation's Defined Benefit Pension Plan ("Pension Plan") consisted of the following components:

	Three months ended September 30		Nine months ended September 30	
	2017	2016	2017	2016
	(in thousands)			
Service cost ⁽¹⁾	\$—	\$172	\$—	\$516
Interest cost	830	880	2,490	2,640
Expected return on plan assets	(451)	(580)	(1,353)	(1,739)
Net amortization and deferral	663	605	1,989	1,815
Net periodic benefit cost	\$1,042	\$1,077	\$3,126	\$3,232

(1) The Pension Plan was curtailed effective January 1, 2008. Service cost was related to administrative costs associated with the plan and was not due to the accrual of additional participant benefits.

The net periodic benefit of the Corporation's Postretirement Benefits Plan ("Postretirement Plan") consisted of the following components:

	Three months ended September 30		Nine months ended September 30	
	2017	2016	2017	2016
	(in thousands)			
Interest cost	\$17	\$21	\$51	\$64
Expected return on plan assets	—	—	—	(1)
Net accretion and deferral	(141)	(138)	(423)	(413)
Net periodic benefit	\$(124)	\$(117)	\$(372)	\$(350)

The Corporation recognizes the funded status of its Pension Plan and Postretirement Plan on the consolidated balance sheets and recognizes the change in that funded status through other comprehensive income.

NOTE 9 – Derivative Financial Instruments

The Corporation manages its exposure to certain interest rate and foreign currency risks through the use of derivatives. None of the Corporation's outstanding derivative contracts are designated as hedges, and none are entered into for speculative purposes. Derivative instruments are carried at fair value, with changes in fair values recognized in earnings as components of non-interest income and non-interest expense on the consolidated statements of income.

Derivative contracts create counterparty credit risk with both the Corporation's customers and with institutional derivative counterparties. The Corporation manages counterparty credit risk through its credit approval processes, monitoring procedures and obtaining adequate collateral, when the Corporation determines it is appropriate to do so and in accordance with counterparty contracts.

Mortgage Banking Derivatives

In connection with its mortgage banking activities, the Corporation enters into commitments to originate certain fixed-rate residential mortgage loans for customers, also referred to as interest rate locks. In addition, the Corporation enters into forward commitments for the future sales or purchases of mortgage-backed securities to or from third-party counterparties to hedge the effect of changes in interest rates on the values of both the interest rate locks and mortgage loans held for sale. Forward sales commitments may also be in the form of commitments to sell individual mortgage loans at a fixed price at a future date. The amount necessary to settle each interest rate lock is based on the price that secondary market investors would pay for loans with similar characteristics, including interest rate and term, as of the date fair value is measured. Gross derivative assets and liabilities are recorded in other assets and other liabilities, respectively, on the consolidated balance sheets, and changes in fair values during the period are recorded in mortgage banking income on the consolidated statements of income.

Interest Rate Swaps

The Corporation enters into interest rate swaps with certain qualifying commercial loan customers to meet their interest rate risk management needs. The Corporation simultaneously enters into interest rate swaps with dealer counterparties, with identical notional amounts and terms. The net result of these interest rate swaps is that the customer pays a fixed rate of interest and the Corporation receives a floating rate. These interest rate swaps are derivative financial instruments and the gross fair values are recorded in other assets and other liabilities on the consolidated balance sheets, with changes in fair values during the period recorded in other non-interest expense on the consolidated statements of income. Fulton Bank, N.A. ("Fulton Bank"), the Corporation's largest banking subsidiary, exceeded \$10 billion in total assets as of December 31, 2016 and was required to clear all eligible interest rate swap contracts with a central counterparty, effective January 1, 2017. As a result, Fulton Bank became subject to the regulations of the Commodity Futures Trading Commission ("CFTC").

Foreign Exchange Contracts

The Corporation enters into foreign exchange contracts to accommodate the needs of its customers. Foreign exchange contracts are commitments to buy or sell foreign currency on a future date at a contractual price. The Corporation offsets its foreign exchange contract exposure with customers by entering into contracts with third-party correspondent financial institutions to mitigate its exposure to fluctuations in foreign currency exchange rates. The Corporation also holds certain amounts of foreign currency with international correspondent banks. The Corporation's policy limits the total net foreign currency open positions, which includes all outstanding contracts and foreign account balances, to \$500,000. Gross fair values are recorded in other assets and other liabilities on the consolidated balance sheets, with changes in fair values during the period recorded within other service charges and fees on the consolidated statements of income.

The following table presents a summary of the notional amounts and fair values of derivative financial instruments:

	September 30, 2017		December 31, 2016	
	Notional Amount	Asset (Liability) Fair Value	Notional Amount	Asset (Liability) Fair Value
	(in thousands)			
Interest Rate Locks with Customers				
Positive fair values	\$ 141,250	\$ 1,283	\$ 87,119	\$ 863
Negative fair values	5,530	(16)	18,239	(227)
Net interest rate locks with customers		1,267		636
Forward Commitments				
Positive fair values	27,562	48	70,031	2,223
Negative fair values	77,000	(207)	19,964	(112)
Net forward commitments		(159)		2,111
Interest Rate Swaps with Customers				
Positive fair values	1,329,394	34,028	876,744	24,397
Negative fair values	578,120	(13,682)	583,060	(16,998)
Net interest rate swaps with customers		20,346		7,399
Interest Rate Swaps with Dealer Counterparties				
Positive fair values	578,120	13,682	583,060	16,998
Negative fair values ⁽¹⁾	1,329,394	(27,663)	876,744	(24,397)
Net interest rate swaps with dealer counterparties		(13,981)		(7,399)
Foreign Exchange Contracts with Customers				
Positive fair values	5,912	332	11,674	504
Negative fair values	5,473	(226)	4,659	(221)
Net foreign exchange contracts with customers		106		283
Foreign Exchange Contracts with Correspondent Banks				
Positive fair values	8,978	293	7,040	241
Negative fair values	4,420	(280)	12,869	(447)
Net foreign exchange contracts with correspondent banks		13		(206)
Net derivative fair value asset		\$ 7,592		\$ 2,824

(1) Includes centrally cleared interest rate swaps with a notional amount of \$324.3 million and a fair value of \$0 as of September 30, 2017. Collateral is posted daily through a clearing agent for changes in the fair value.

The following table presents a summary of the fair value gains (losses) on derivative financial instruments:

	Three months ended September 30, 2017		Nine months ended September 30, 2016	
	2017	2016	2017	2016
	(in thousands)			
Interest rate locks with customers	\$(59)	\$ 178	\$ 631	\$ 1,922
Forward commitments	(48)	970	(2,270)	(1,042)
Interest rate swaps with customers	(47)	(1,948)	12,947	48,052
Interest rate swaps with dealer counterparties	1,248	1,948	(6,582)	(48,052)
Foreign exchange contracts with customers	140	47	(177)	502
Foreign exchange contracts with correspondent banks	(111)	(266)	219	(613)
Net fair value gains on derivative financial instruments	\$ 1,123	\$ 929	\$ 4,768	\$ 769

Fair Value Option

U.S. GAAP permits entities to measure many financial instruments and certain other items at fair value and requires certain disclosures for amounts for which the fair value option is applied. The Corporation has elected to measure mortgage loans held

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for sale at fair value to more accurately reflect the financial results of its mortgage banking activities in its consolidated financial statements. Derivative financial instruments related to these activities are also recorded at fair value, as noted above. The Corporation determines fair value for its mortgage loans held for sale based on the price that secondary market investors would pay for loans with similar characteristics, including interest rate and term, as of the date fair value is measured. Changes in fair values during the period are recorded as components of mortgage banking income on the consolidated statements of income. Interest income earned on mortgage loans held for sale is classified in interest income on the consolidated statements of income.

The following table presents a summary of the Corporation's mortgage loans held for sale:

	September 30, 2017	December 31, 2016
	(in thousands)	
Cost	\$22,615	\$ 28,708
Fair value	23,049	28,697

During the three months ended September 30, 2017 and 2016, the Corporation recorded losses related to changes in fair values of mortgage loans held for sale of \$120,000 and \$360,000, respectively. During the nine months ended September 30, 2017 and 2016, the Corporation recorded gains related to changes in fair values of mortgage loans held for sale of \$445,000 and \$504,000, respectively.

Balance Sheet Offsetting

Certain financial assets and liabilities may be eligible for offset on the consolidated balance sheets because they are subject to master netting arrangements or similar agreements. The Corporation elects to not offset certain assets and liabilities subject to such arrangements on the consolidated financial statements.

The Corporation is a party to interest rate swap transactions with financial institution counterparties and customers, disclosed in detail above. Under these agreements, the Corporation has the right to net-settle multiple contracts with the same counterparty in the event of default on, or termination of, any one contract. Cash collateral is posted by the party with a net liability position in accordance with contract thresholds and can be used to settle the fair value of the interest rate swap agreements in the event of default. Collateral is posted daily through a clearing agent for changes in the fair value of centrally cleared derivatives with negative fair values. As a result, the total fair values of interest rate swap derivative assets and derivative liabilities recognized on the consolidated balance sheet are not equal and offsetting.

The Corporation is also a party to foreign currency exchange contracts with financial institution counterparties, under which the Corporation has the right to net-settle multiple contracts with the same counterparty in the event of default on, or termination of, any one contract. As with interest rate swap contracts, collateral is posted by the party with a net liability position in accordance with contract thresholds and can be used to settle the fair value of the foreign currency exchange contracts in the event of default.

The Corporation also enters into agreements with customers in which it sells securities subject to an obligation to repurchase the same or similar securities, referred to as repurchase agreements. Under these agreements, the Corporation may transfer legal control over the assets but still maintain effective control through agreements that both entitle and obligate the Corporation to repurchase the assets. Therefore, repurchase agreements are reported as secured borrowings, classified in short-term borrowings on the consolidated balance sheets, while the securities underlying the repurchase agreements remain classified with investment securities on the consolidated balance sheets. The Corporation has no intention of setting off these amounts. Therefore, these repurchase agreements are not eligible for offset.

The following table presents the Corporation's financial instruments that are eligible for offset, and the effects of offsetting, on the consolidated balance sheets:

	Gross Amounts Recognized on the Consolidated Balance Sheets	Gross Amounts Offset on the Consolidated Financial Instruments	Not Offset Cash Collateral	Net Amount
(in thousands)				
September 30, 2017				
Interest rate swap derivative assets	\$47,710	\$(14,163)	\$—	\$33,547
Foreign exchange derivative assets with correspondent banks	293	(280)	—	13
Total	\$48,003	\$(14,443)	\$—	\$33,560
Interest rate swap derivative liabilities	\$41,345	\$(14,163)	\$(15,520)	\$11,662
Foreign exchange derivative liabilities with correspondent banks	280	(280)	—	—
Total	\$41,625	\$(14,443)	\$(15,520)	\$11,662
December 31, 2016				
Interest rate swap derivative assets	\$41,395	\$(15,117)	\$—	\$26,278
Foreign exchange derivative assets with correspondent banks	241	(241)	—	—
Total	\$41,636	\$(15,358)	\$—	\$26,278
Interest rate swap derivative liabilities	\$41,395	\$(15,117)	\$(4,010)	\$22,268
Foreign exchange derivative liabilities with correspondent banks	447	(241)	(206)	—
Total	\$41,842	\$(15,358)	\$(4,216)	\$22,268

For derivative assets, amounts represent any derivative liability fair values that could be offset in the event of (1) counterparty or customer default. For derivative liabilities, amounts represent any derivative asset fair values that could be offset in the event of counterparty or customer default.

(2) Amounts represent collateral received from the counterparty or (posted by the Corporation).

NOTE 10 – Commitments and Contingencies

Commitments

The Corporation is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers.

Those financial instruments include commitments to extend credit and letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized on the Corporation's consolidated balance sheets. Exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and letters of credit is represented by the outstanding amount of those instruments.

The outstanding amounts of commitments to extend credit and letters of credit were as follows:

September 30 December 31,
2017 2016
(in thousands)

Commitments to extend credit	\$6,418,318	\$ 6,075,567
Standby letters of credit	331,096	356,359
Commercial letters of credit	41,819	38,901

The Corporation records a reserve for unfunded lending commitments, which represents management's estimate of losses associated with unused commitments to extend credit. See Note 5, "Loans and Allowance for Credit Losses," for additional details.

Residential Lending

Residential mortgages originated and sold by the Corporation consist primarily of conforming, prime loans sold to government sponsored agencies, such as the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"). The Corporation also sells certain prime loans it originates to non-government sponsored agency investors.

The Corporation provides customary representations and warranties to government sponsored entities and investors that specify, among other things, that the loans have been underwritten to the standards established by the government sponsored entity or investor. The Corporation may be required to repurchase a loan, or reimburse the government sponsored entity or investor for a credit loss incurred on a loan, if it is determined that the representations and warranties have not been met. Such repurchases or reimbursements generally result from an underwriting or documentation deficiency. As of both September 30, 2017 and December 31, 2016, total outstanding repurchase requests totaled approximately \$543,000.

From 2000 to 2011, the Corporation sold loans to the Federal Home Loan Bank of Pittsburgh under its Mortgage Partnership Finance Program ("MPF Program"). The Corporation provided a "credit enhancement" for residential mortgage loans sold under the MPF Program whereby it would assume credit losses in excess of a defined "First Loss Account," or "FLA" balance, up to specified amounts. The FLA is funded by the Federal Home Loan Bank of Pittsburgh based on a percentage of the outstanding principal balance of loans sold. As of September 30, 2017, the unpaid principal balance of loans sold under the MPF Program was approximately \$89 million. As of September 30, 2017 and December 31, 2016, the reserve for estimated credit losses related to loans sold under the MPF Program was \$1.3 million and \$1.7 million, respectively. Required reserves are calculated based on delinquency status and estimated loss rates established through the Corporation's existing allowance for credit losses methodology for residential mortgage loans.

As of September 30, 2017 and December 31, 2016, the total reserve for losses on residential mortgage loans sold was \$2.1 million and \$2.5 million, respectively, including both reserves for credit losses under the MPF Program and reserves for representation and warranty exposures. Management believes that the reserves recorded as of September 30, 2017 are adequate. However, declines in collateral values, the identification of additional loans to be repurchased, or a deterioration in the credit quality of loans sold under the MPF Program could necessitate additional reserves, established through charges to earnings, in the future.

Legal Proceedings

The Corporation and its subsidiaries are involved in various legal proceedings in the ordinary course of business of the Corporation. The Corporation periodically evaluates the possible impact of pending litigation matters based on, among other factors, the advice of counsel, available insurance coverage and recorded liabilities and reserves for probable legal liabilities and costs. In addition, from time to time, the Corporation is the subject of investigations or other forms of regulatory or governmental inquiry covering a range of possible issues and, in some cases, these may be part of similar reviews of the specified activities of other industry participants. These inquiries could lead to administrative, civil or criminal proceedings, and could possibly result in fines, penalties, restitution or the need to alter the Corporation's business practices, and cause the Corporation to incur additional costs. The Corporation's practice is to cooperate fully with regulatory and governmental investigations.

As of the date of this report, the Corporation believes that any liabilities, individually or in the aggregate, which may result from the final outcomes of pending proceedings will not have a material adverse effect on the financial condition of the Corporation. However, legal proceedings are often unpredictable, and it is possible that the ultimate resolution of any such matters, if unfavorable, may be material to the Corporation's results of operations for any

particular period, depending, in part, upon the size of the loss or liability imposed and the operating results for the applicable period.

BSA/AML Enforcement Orders

The Corporation and each of its bank subsidiaries are subject to regulatory enforcement orders issued during 2014 and 2015 by their respective federal and state bank regulatory agencies relating to identified deficiencies in the Corporation's centralized Bank Secrecy Act and anti-money laundering compliance program (the "BSA/AML Compliance Program"), which was designed to comply with the requirements of the Bank Secrecy Act, the USA Patriot Act of 2001 and related anti-money laundering regulations (collectively, the "BSA/AML Requirements"). The regulatory enforcement orders, which are in the form of consent orders or orders to cease and desist issued upon consent ("Consent Orders"), generally require, among other things, that the Corporation and its bank subsidiaries undertake a number of required actions to strengthen and enhance the BSA/AML Compliance Program, and, in some cases, conduct retrospective reviews of past account activity and transactions, as well as certain reports filed in accordance with the BSA/AML Requirements, to determine whether suspicious activity and certain transactions in currency were properly identified and reported in accordance with the BSA/AML Requirements. The Corporation and its bank subsidiaries have

implemented numerous enhancements to the BSA/AML Compliance Program, completed the retrospective reviews required under the Consent Orders, and continue to strengthen and refine the BSA/AML Compliance Program to achieve a sustainable program in accordance with the BSA/AML Requirements. In addition to requiring strengthening and enhancement of the BSA/AML Compliance Program, while the Consent Orders remain in effect, the Corporation is subject to certain restrictions on expansion activities of the Corporation and its bank subsidiaries. Further, any failure to comply with the requirements of any of the Consent Orders involving the Corporation or its bank subsidiaries could result in further enforcement actions, the imposition of material restrictions on the activities of the Corporation or its bank subsidiaries, or the assessment of fines or penalties.

On October 27, 2017, the Office of the Comptroller of the Currency (the "OCC") terminated the Consent Orders that it issued on July 14, 2014 to three of the Corporation's bank subsidiaries, Fulton Bank, N.A., FNB Bank, N.A. and Swineford National Bank, relating to deficiencies in the BSA/AML Compliance Programs at those bank subsidiaries.

Fair Lending Investigation

During the second quarter of 2015, Fulton Bank, N.A., the Corporation's largest bank subsidiary, received a letter from the U.S. Department of Justice (the "Department") indicating that the Department had initiated an investigation regarding potential violations of fair lending laws (specifically, the Equal Credit Opportunity Act and the Fair Housing Act) by Fulton Bank, N.A. in certain geographies. Fulton Bank, N.A. has been and is cooperating with the Department and responding to the Department's requests for information. During the third quarter of 2016, the Department informed the Corporation, Fulton Bank, N.A., and three of the Corporation's other bank subsidiaries, Fulton Bank of New Jersey, The Columbia Bank and Lafayette Ambassador Bank, that the Department was expanding its investigation of potential lending discrimination on the basis of race and national origin to encompass additional geographies that were not included in the initial letter from the Department. In addition to requesting information concerning the lending activities of these bank subsidiaries, the Department also requested information concerning the Corporation and the residential mortgage lending activities conducted under the Fulton Mortgage Company brand, the trade name used by all of the Corporation's bank subsidiaries for residential mortgage lending. The investigation relates to lending activities during the period January 1, 2009 to the present. The Corporation and the identified bank subsidiaries are cooperating with the Department and responding to the Department's requests for information. The Corporation and its bank subsidiaries are not able at this time to determine the terms on which this investigation will be resolved or the timing of such resolution, or to reliably estimate the amounts of any settlement, fines or other penalties or the cost of any other remedial actions, if enforcement action is taken. In addition, should the investigation result in an enforcement action against the Corporation or its bank subsidiaries, or a settlement with the Department, the ability of the Corporation and its bank subsidiaries to engage in certain expansion or other activities may be restricted.

Agostino, et al. Litigation

Fulton Bank, N.A. (the "Bank"), the Corporation's largest bank subsidiary, and two unrelated, third-party defendants, Ameriprise Financial Services, Inc. ("Ameriprise") and Riverview Bank ("Riverview"), have been named as defendants in a lawsuit brought on behalf of a group of 67 plaintiffs filed on March 31, 2016, in the Court of Common Pleas for Dauphin County, Pennsylvania (Agostino, et al. v. Ameriprise Financial Services, Inc., et al., No. 2016-CV-2048-CV). The plaintiffs in this action, who are individuals, trustees of certain irrevocable trusts, or the executors of the estates of deceased individuals, were clients of Jeffrey M. Mottern, a now-deceased attorney, who is alleged to have operated a fraud scheme over a period of years through the sale of fictitious high-yield investments or by otherwise misappropriating funds entrusted to Mr. Mottern. Mr. Mottern is alleged to have used the proceeds of these activities to engage in speculative securities trading through defendant Ameriprise, which caused significant losses, and for Mr. Mottern's personal expenses. The allegations against the Bank relate to a commercial checking account at the Bank maintained by Mr. Mottern in connection with Mr. Mottern's law practice. The lawsuit alleges that

the Bank is liable to the plaintiffs for failing to properly monitor Mr. Mottern's checking account and detect Mr. Mottern's fraudulent activity, and specifically alleges that the Bank aided and abetted Mr. Mottern's: (1) fraud; (2) breach of fiduciary duty; (3) violations of the Pennsylvania Unfair Trade Practices and Consumer Protection Law; and (4) conversion. Similar claims have been asserted against Ameriprise and Riverview, which allegedly maintained a personal brokerage account and a trust account for client or other third-party funds, respectively, for Mr. Mottern. The lawsuit seeks damages from the defendants, including the Bank, alleged to be in excess of \$11.3 million, treble damages and attorneys' fees with respect to alleged violations of the Pennsylvania Unfair Trade Practices and Consumer Protection Law, punitive damages, plus interest and costs. On April 29, 2016, the Bank filed a Notice of Removal to remove this lawsuit to the United States District Court for the Middle District of Pennsylvania. On May 31, 2016, the plaintiffs filed a motion to remand the lawsuit to the Court of Common Pleas for Dauphin County, Pennsylvania. On October 24, 2016, the District Court granted the plaintiffs' motion and the lawsuit was remanded back to the Court of Common Pleas for Dauphin County. All defendants subsequently filed preliminary objections to the Complaint, including objections that, if granted, would result in dismissal of the case. On May 26, 2017, the Court of Common Pleas for Dauphin County denied all substantive preliminary objections filed by the Bank. On June 23, 2017, the Bank filed its Combined Motion for Partial Reconsideration of the Court's May 26, 2017 Order and Application for Amendment of the Order to Set Forth Expressly the

Statement in Pa.C.S. s. 702(b) (the “Motion”). The Bank also filed its Answer and New Matter (the “Answer”) on June 23, 2017. The plaintiffs subsequently responded to the Motion and the Answer.

In October 2017, the Bank and the plaintiffs agreed to settle the lawsuit. The plaintiffs' Steering Committee, which represents the interests of the 67 plaintiffs, approved the specific terms of the settlement on October 26, 2017 and recommended that each plaintiff execute the settlement agreement. The settlement involves the Bank making an aggregate payment to the plaintiffs' attorney on their behalf, in exchange for the plaintiffs' agreement to dismiss the claims against the Bank and any related matters with prejudice. The material terms of the settlement will become effective upon the dismissal of the claims against the Bank by the court, which the plaintiffs have agreed to pursue. The Corporation's insurance carrier has informed the Corporation that it will reimburse the Corporation for the full amount of the Bank's agreed upon settlement payment, and, as a result, any further financial impact to the Corporation is expected to be immaterial.

NOTE 11 – Fair Value Measurements

FASB ASC Topic 820 establishes a fair value hierarchy for the inputs to valuation techniques used to measure assets and liabilities at fair value using the following three categories (from highest to lowest priority):

Level 1 – Inputs that represent quoted prices for identical instruments in active markets.

Level 2 – Inputs that represent quoted prices for similar instruments in active markets, or quoted prices for identical instruments in non-active markets. Also includes valuation techniques whose inputs are derived principally from observable market data other than quoted prices, such as interest rates or other market-corroborated means.

Level 3 – Inputs that are largely unobservable, as little or no market data exists for the instrument being valued.

The Corporation has categorized all assets and liabilities measured at fair value on both a recurring and nonrecurring basis into the above three levels.

The following tables present summaries of the Corporation's assets and liabilities measured at fair value on a recurring basis and reported on the consolidated balance sheets:

	September 30, 2017			
	Level 1	Level 2	Level 3	Total
	(in thousands)			
Mortgage loans held for sale	\$—	\$23,049	\$—	\$23,049
Available for sale investment securities:				
Equity securities	13,059	—	—	13,059
U.S. Government sponsored agency securities	—	6,015	—	6,015
State and municipal securities	—	413,913	—	413,913
Corporate debt securities	—	89,755	3,222	92,977
Collateralized mortgage obligations	—	593,678	—	593,678
Residential mortgage-backed securities	—	1,182,086	—	1,182,086
Commercial mortgage-backed securities	—	161,632	—	161,632
Auction rate securities	—	—	98,156	98,156
Total available for sale investment securities	13,059	2,447,079	101,378	2,561,516
Other assets	18,742	49,041	—	67,783
Total assets	\$31,801	\$2,519,169	\$101,378	\$2,652,348
Other liabilities	\$18,607	\$41,569	\$—	\$60,176
	December 31, 2016			
	Level 1	Level 2	Level 3	Total
	(in thousands)			
Mortgage loans held for sale	\$—	\$28,697	\$—	\$28,697
Available for sale investment securities:				
Equity securities	24,526	—	—	24,526
U.S. Government sponsored agency securities	—	134	—	134
State and municipal securities	—	391,641	—	391,641
Corporate debt securities	—	106,537	2,872	109,409
Collateralized mortgage obligations	—	593,860	—	593,860
Residential mortgage-backed securities	—	1,317,838	—	1,317,838
Commercial mortgage-backed securities	—	24,563	—	24,563
Auction rate securities	—	—	97,256	97,256
Total available for sale investment securities	24,526	2,434,573	100,128	2,559,227
Other assets	17,111	44,481	—	61,592
Total assets	\$41,637	\$2,507,751	\$100,128	\$2,649,516
Other liabilities	\$17,032	\$41,734	\$—	\$58,766

The valuation techniques used to measure fair value for the items in the preceding tables are as follows:

Mortgage loans held for sale – This category consists of mortgage loans held for sale that the Corporation has elected to measure at fair value. Fair values as of September 30, 2017 and December 31, 2016 were measured based on the price that secondary market investors were offering for loans with similar characteristics. See Note 9, "Derivative Financial Instruments" for details related to the Corporation's election to measure assets and liabilities at fair value.

Available for sale investment securities – Included in this asset category are both equity and debt securities. Level 2 available for sale debt securities are valued by a third-party pricing service commonly used in the banking industry. The pricing service uses pricing models that vary based on asset class and incorporate available market information, including quoted prices of investment securities with similar characteristics. Because many fixed income securities do not trade on a daily basis, pricing models use available information, as applicable, through processes such as benchmark yield curves, benchmarking of like securities, sector groupings, and matrix pricing.

Standard market inputs include: benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data, including market research publications. For certain security types, additional inputs may be used, or some of the standard market inputs may not be applicable.

Management tests the values provided by the pricing service by obtaining securities prices from an alternative third-party source and comparing the results. This test is done for at least 80% of the securities valued by the pricing service. Generally, differences by security in excess of 5% are researched to reconcile the difference.

Equity securities – Equity securities consist of common stocks of financial institutions (\$12.1 million at September 30, 2017 and \$23.5 million at December 31, 2016) and other equity investments (\$1.0 million at September 30, 2017 and December 31, 2016). These Level 1 investments are measured at fair value based on quoted prices for identical securities in active markets.

U.S. Government sponsored agency securities/State and municipal securities/Collateralized mortgage obligations/Residential mortgage-backed securities/Commercial mortgage-backed securities – These debt securities are classified as Level 2 investments. Fair values are determined by a third-party pricing service, as detailed above.

Corporate debt securities – This category consists of subordinated debt issued by financial institutions (\$50.3 million at September 30, 2017 and \$65.2 million at December 31, 2016), single-issuer trust preferred securities issued by financial institutions (\$38.3 million at September 30, 2017 and \$39.8 million at December 31, 2016), pooled trust preferred securities issued by financial institutions (\$422,000 at both September 30, 2017 and December 31, 2016) and other corporate debt issued by non-financial institutions (\$4.0 million at both September 30, 2017 and December 31, 2016).

Level 2 investments include the Corporation's holdings of subordinated debt, other corporate debt issued by non-financial institutions and \$35.5 million and \$37.3 million of single-issuer trust preferred securities held at September 30, 2017 and December 31, 2016, respectively. The fair values for these corporate debt securities are determined by a third-party pricing service, as detailed above.

Level 3 investments include the Corporation's investments in pooled trust preferred securities (\$422,000 at both September 30, 2017 and December 31, 2016) and certain single-issuer trust preferred securities (\$2.8 million at September 30, 2017 and \$2.5 million at December 31, 2016). The fair values of these securities were determined based on quotes provided by third-party brokers who determined fair values based predominantly on internal valuation models which were not indicative prices or binding offers. The Corporation's third-party pricing service cannot derive fair values for these securities primarily due to inactive markets for similar investments. Level 3 values are tested by management primarily through trend analysis, by comparing current values to those reported at the end of the preceding calendar quarter, and determining if they are reasonable based on price and spread movements for this asset class.

Auction rate securities – Due to their illiquidity, ARCs are classified as Level 3 investments and are valued through the use of an expected cash flows model prepared by a third-party valuation expert. The assumptions used in preparing the expected cash flows model include estimates for coupon rates, time to maturity and market rates of return. The most significant unobservable input to the expected cash flows model is an assumed return to market liquidity sometime in the next five years. If the assumed return to market liquidity was lengthened beyond the next five years, this would result in a decrease in the fair value of these ARCs. The Corporation believes that the trusts underlying the

ARCs will self-liquidate as student loans are repaid. Level 3 fair values are tested by management through the performance of a trend analysis of the market price and discount rate.

Changes in the price and discount rates are compared to changes in market data, including bond ratings, parity ratios, balances and delinquency levels.

Other assets – Included in this category are the following:

Level 1 assets include mutual funds that are held in trust for employee deferred compensation plans (\$18.1 million at September 30, 2017 and \$16.4 million at December 31, 2016) and the fair value of foreign currency exchange contracts (\$625,000 at September 30, 2017 and \$745,000 at December 31, 2016). The mutual funds and foreign exchange prices used to measure these items at fair value are based on quoted prices for identical instruments in active markets.

Level 2 assets include the fair value of mortgage banking derivatives in the form of interest rate locks and forward commitments with secondary market investors (\$1.3 million at September 30, 2017 and \$3.1 million at December 31, 2016) and the fair value of interest rate swaps (\$47.7 million at September 30, 2017 and \$41.4 million at December 31, 2016). The fair values of the Corporation's interest rate locks, forward commitments and interest rate swaps represent the amounts that would be required to settle the derivative financial instruments at the balance sheet date. See Note 9, "Derivative Financial Instruments," for additional information.

Other liabilities – Included in this category are the following:

Level 1 liabilities include employee deferred compensation liabilities which represent amounts due to employees under deferred compensation plans (\$18.1 million at September 30, 2017 and \$16.4 million at December 31, 2016) and the fair value of foreign currency exchange contracts (\$506,000 at September 30, 2017 and \$668,000 at December 31, 2016). The fair value of these liabilities are determined in the same manner as the related assets, as described under the heading "Other assets" above.

Level 2 liabilities include the fair value of mortgage banking derivatives in the form of interest rate locks and forward commitments with secondary market investors (\$223,000 at September 30, 2017 and \$339,000 at December 31, 2016) and the fair value of interest rate swaps (\$41.3 million at September 30, 2017 and \$41.4 million at December 31, 2016). The fair values of these liabilities are determined in the same manner as the related assets, as described under the heading "Other assets" above.

The following table presents the changes in the Corporation's available for sale investment securities measured at fair value on a recurring basis using unobservable inputs (Level 3):

	Three months ended September 30, 2017		
	Pooled	Single-issuer	Trust Preferred ARCs
	Securities	Securities	Securities
	(in thousands)		
Balance at June 30, 2017	\$422	\$ 2,775	\$97,923
Unrealized adjustment to fair value ⁽¹⁾	—	(28) 233
Discount accretion ⁽²⁾	—	3	—
Balance at September 30, 2017	\$422	\$ 2,750	\$98,156

	Three months ended September 30, 2016		
Balance at June 30, 2016	\$706	\$ 2,425	\$97,886
Unrealized adjustment to fair value ⁽¹⁾	—	7	(318)
Discount accretion ⁽²⁾	—	3	158
Balance at September 30, 2016	\$706	\$ 2,435	\$97,726

	Nine months ended September 30, 2017		
	Pooled	Single-issuer	Trust Preferred ARCs
	Securities	Securities	Securities
	(in thousands)		
Balance at December 31, 2016	\$422	\$ 2,450	\$97,256
Unrealized adjustment to fair value ⁽¹⁾	—	291	705
Discount accretion ⁽²⁾	—	9	195
Balance at September 30, 2017	\$422	\$ 2,750	\$98,156

	Nine months ended September 30, 2016		
Balance at December 31, 2015	\$706	\$ 2,630	\$98,059
Unrealized adjustment to fair value ⁽¹⁾	—	(204) (668)
Discount accretion ⁽²⁾	—	9	335
Balance at September 30, 2016	\$706	\$ 2,435	\$97,726

Pooled trust preferred securities, single-issuer trust preferred securities and ARCs are classified as available for sale investment securities; as such, the unrealized adjustment to fair value was recorded as an unrealized holding gain (loss) and included as a component of "available for sale investment securities" on the consolidated balance sheets.

(1) Included as a component of "net interest income" on the consolidated statements of income.

Certain assets are not measured at fair value on an ongoing basis, but are subject to fair value measurement in certain circumstances, such as upon their acquisition or when there is evidence of impairment. The following table presents the Corporation's Level 3 financial assets measured at fair value on a nonrecurring basis and reported on the Corporation's consolidated balance sheets:

	September 30, 2017	December 31, 2016
	(in thousands)	
Net loans	\$ 140,779	\$ 132,576
OREO	10,542	12,815
MSRs	37,874	37,532
Total assets	\$ 189,195	\$ 182,923

The valuation techniques used to measure fair value for the items in the table above are as follows:

Net loans – This category consists of loans that were measured for impairment under FASB ASC Section 310-10-35 and have been classified as Level 3 assets. The amount shown is the balance of impaired loans, net of the related allowance for loan losses. See Note 5, "Loans and Allowance for Credit Losses," for additional details.

OREO – This category includes OREO (\$10.5 million at September 30, 2017 and \$12.8 million at December 31, 2016) classified as Level 3 assets. Fair values for OREO were based on estimated selling prices less estimated selling costs for similar assets in active markets.

MSRs – This category includes MSRs (\$37.9 million at September 30, 2017 and \$37.5 million at December 31, 2016), classified as Level 3 assets. MSRs are initially recorded at fair value upon the sale of residential mortgage loans to secondary market investors. MSRs are amortized as a reduction to servicing income over the estimated lives of the underlying loans. MSRs are stratified and evaluated for impairment by comparing each stratum's carrying amount to its estimated fair value. Fair values are determined at the end of each quarter through a discounted cash flows valuation performed by a third-party valuation expert. Significant inputs to the valuation included expected net servicing income, the discount rate and the expected life of the underlying loans. Expected life is based on the contractual terms of the loans, as adjusted for prepayment projections. The weighted average annual constant prepayment rate and the weighted average discount rate used in the September 30, 2017 valuation were 12.4% and 9.5%, respectively. Management tests the reasonableness of the significant inputs to the third-party valuation in comparison to market data.

As required by FASB ASC Section 825-10-50, the following table details the book values and estimated fair values of the Corporation's financial instruments as of September 30, 2017 and December 31, 2016. In addition, a general description of the methods and assumptions used to estimate such fair values is also provided.

	September 30, 2017		December 31, 2016	
	Book Value	Estimated Fair Value	Book Value	Estimated Fair Value
(in thousands)				
FINANCIAL ASSETS				
Cash and due from banks	\$99,803	\$99,803	\$118,763	\$118,763
Interest-bearing deposits with other banks	582,845	582,845	233,763	233,763
Federal Reserve Bank and Federal Home Loan Bank stock	62,951	62,951	57,489	57,489
Loans held for sale ⁽¹⁾	23,049	23,049	28,697	28,697
Available for sale investment securities ⁽¹⁾	2,561,516	2,561,516	2,559,227	2,559,227
Net Loans ⁽¹⁾	15,314,654	15,086,654	14,530,593	14,387,454
Accrued interest receivable	50,082	50,082	46,294	46,294
Other financial assets ⁽¹⁾	219,434	219,434	206,132	206,132
FINANCIAL LIABILITIES				
Demand and savings deposits	\$13,274,319	\$13,274,319	\$12,259,622	\$12,259,622
Brokered Deposits	109,936	109,936	—	—
Time deposits	2,757,525	2,759,913	2,753,242	2,769,757
Short-term borrowings	298,751	298,751	541,317	541,317
Accrued interest payable	10,568	10,568	9,632	9,632
Other financial liabilities ⁽¹⁾	234,160	234,160	216,080	216,080
Federal Home Loan Bank advances and other long-term debt	1,038,159	1,035,053	929,403	928,167

These financial instruments, or certain financial instruments in these categories, are measured at fair value on the (1) Corporation's consolidated balance sheets. Descriptions of the fair value determinations for these financial instruments are disclosed above.

Fair values of financial instruments are significantly affected by the assumptions used, principally the timing of future cash flows and discount rates. Because assumptions are inherently subjective in nature, the estimated fair values cannot be substantiated by comparison to independent market quotes and, in many cases, the estimated fair values could not necessarily be realized in an immediate sale or settlement of the instrument. The aggregate fair value amounts presented do not necessarily represent management's estimate of the underlying value of the Corporation. For short-term financial instruments, defined as those with remaining maturities of 90 days or less, and excluding those recorded at fair value on the Corporation's consolidated balance sheets, book value was considered to be a reasonable estimate of fair value.

The following instruments are predominantly short-term:

Assets	Liabilities
Cash and due from banks	Demand and savings deposits
Interest-bearing deposits with other banks	Short-term borrowings
Accrued interest receivable	Accrued interest payable

Federal Reserve Bank and Federal Home Loan Bank ("FHLB") stock represent restricted investments and are carried at cost on the consolidated balance sheets.

Fair values for loans and time deposits were estimated by discounting future cash flows using the current rates at which similar loans would be made to borrowers and similar deposits would be issued to customers for the same remaining maturities. Fair values estimated in this manner do not fully incorporate an exit price approach to fair value, as defined in FASB ASC Topic 820.

The fair values of FHLB advances and long-term debt were estimated by discounting the remaining contractual cash flows using a rate at which the Corporation could issue debt with similar remaining maturities as of the balance sheet date. These borrowings would be categorized in Level 2 liabilities under FASB ASC Topic 820.

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

Management's Discussion and Analysis of Financial Condition and Results of Operations ("Management's Discussion") relates to Fulton Financial Corporation (the "Corporation"), a financial holding company registered under the Bank Holding Company Act of 1956 and incorporated under the laws of the Commonwealth of Pennsylvania in 1982, and its wholly owned subsidiaries. Management's Discussion should be read in conjunction with the consolidated financial statements and notes presented in this report.

FORWARD-LOOKING STATEMENTS

The Corporation has made, and may continue to make, certain forward-looking statements with respect to its financial condition and results of operations. Do not unduly rely on forward-looking statements. Forward-looking statements can be identified by the use of words such as "may," "should," "will," "could," "estimates," "predicts," "potential," "continue," "anticipates," "believes," "plans," "expects," "future," "intends" and similar expressions which are intended to identify forward-looking statements.

These forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties, some of which are beyond the Corporation's control and ability to predict, that could cause actual results to differ materially from those expressed in the forward-looking statements. The Corporation undertakes no obligation, other than as required by law, to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Many factors could affect future financial results including, without limitation:

- the impact of adverse conditions in the economy and capital markets on the performance of the Corporation's loan portfolio and demand for the Corporation's products and services;
- increases in non-performing assets, which may require the Corporation to increase the allowance for credit losses, charge off loans and incur elevated collection and carrying costs related to such non-performing assets;
- investment securities gains and losses, including other-than-temporary declines in the value of securities which may result in charges to earnings;
- the effects of market interest rates, and the relative balances of interest rate-sensitive assets to interest rate-sensitive liabilities, on net interest margin and net interest income;
- the effects of changes in interest rates on demand for the Corporation's products and services;
- the effects of changes in interest rates or disruptions in liquidity markets on the Corporation's sources of funding;
- the Corporation's ability to manage liquidity, both at the holding company level and at its bank subsidiaries;
- the impact of increased regulatory scrutiny of the banking industry;
- the effects of the increasing amounts of time and expense associated with regulatory compliance and risk management;
- the potential for negative consequences from regulatory violations, investigations and examinations, including potential supervisory actions and the assessment of fines and penalties;
- the additional time, expense and investment required to comply with, and the restrictions on potential growth and investment activities resulting from, the existing enforcement orders applicable to the Corporation and its bank subsidiaries by federal and state bank regulatory agencies requiring improvement in compliance functions and other remedial actions, or any future enforcement orders;
- the Corporation's ability to manage the uncertainty associated with the delay in implementing many of the regulations mandated by the Dodd-Frank Act;
- the effects of, and uncertainty surrounding, potential changes in legislation, regulation and government policy as a result of the recent change in federal administration;
- the effects of actions by the federal government, including those of the Federal Reserve Board and other government agencies, that impact money supply and market interest rates;
- the effects of negative publicity on the Corporation's reputation;

- the effects of adverse outcomes in litigation and governmental or administrative proceedings;
- the potential to incur losses in connection with repurchase and indemnification payments related to sold loans;
- the Corporation's ability to successfully transform its business model;
- the Corporation's ability to achieve its growth plans;
- the effects of competition on deposit rates and growth, loan rates and growth and net interest margin;
- the Corporation's ability to manage the level of non-interest expenses, including salaries and employee benefits expenses, operating risk losses and goodwill impairment;
- the effects of changes in accounting policies, standards, and interpretations on the Corporation's consolidated balance sheets and consolidated statements of income;

the impact of operational risks, including the risk of human error, inadequate or failed internal processes and systems, computer and telecommunications systems failures, faulty or incomplete data and an inadequate risk management framework;

- the impact of failures of third parties upon which the Corporation relies to perform in accordance with contractual arrangements;
- the failure or circumvention of the Corporation's system of internal controls;
- the loss of, or failure to safeguard, confidential or proprietary information;
- the Corporation's failure to identify and to address cyber-security risks, including data breaches or cyberattacks;
- the Corporation's ability to keep pace with technological changes;
- the Corporation's ability to attract and retain talented personnel;
- capital and liquidity strategies, including the Corporation's ability to comply with applicable capital and liquidity requirements, and the Corporation's ability to generate capital internally or raise capital on favorable terms;
- the Corporation's reliance on its subsidiaries for substantially all of its revenues and its ability to pay dividends or other distributions; and
- the effects of any downgrade in the Corporation's credit ratings on its borrowing costs or access to capital markets.

RESULTS OF OPERATIONS

Overview

Fulton Financial Corporation is a financial holding company comprised of six wholly owned bank subsidiaries which provide a full range of retail and commercial financial services through locations in Pennsylvania, Delaware, Maryland, New Jersey and Virginia and eight wholly owned non-bank subsidiaries. The Corporation generates the majority of its revenue through net interest income, or the difference between interest earned on loans, investments and other interest-earning assets, and interest paid on deposits and borrowings. Growth in net interest income is dependent upon balance sheet growth and maintaining or increasing the net interest margin, which is net interest income (fully taxable-equivalent, or "FTE") as a percentage of average interest-earning assets. The Corporation also generates revenue through fees earned on the various services and products offered to its customers and through gains on sales of assets, such as loans, investments, or properties. Offsetting these revenue sources are provisions for credit losses on loans, non-interest expenses and income taxes.

The following table presents a summary of the Corporation's earnings and selected performance ratios:

	As of or for the Three months ended September 30		As of or for the Nine months ended September 30		
	2017	2016	2017	2016	
Net income (in thousands)	\$48,905	\$41,468	\$137,752	\$119,475	
Diluted net income per share	\$0.28	\$0.24	\$0.78	\$0.69	
Return on average assets	0.98	% 0.89	% 0.95	% 0.87	%
Return on average equity	8.76	% 7.78	% 8.45	% 7.64	%
Return on average tangible equity ⁽¹⁾	11.52	% 10.38	% 11.18	% 10.24	%
Net interest margin ⁽²⁾	3.27	% 3.14	% 3.27	% 3.19	%
Efficiency ratio ⁽¹⁾	64.3	% 65.2	% 64.6	% 67.0	%
Non-performing assets to total assets	0.73	% 0.80	% 0.73	% 0.80	%
Annualized net charge-offs to average loans	0.14	% 0.11	% 0.12	% 0.14	%

(1) Ratio represents a financial measure derived by methods other than U.S. Generally Accepted Accounting Principles ("U.S. GAAP"). See reconciliation of this non-U.S. GAAP financial measure to the most comparable U.S. GAAP measure under the heading, "Supplemental Reporting of Non-U.S. GAAP Based Financial Measures"

at the end of this "Overview" section.

(2) Presented on an FTE basis, using a 35% federal tax rate and statutory interest expense disallowances. See also the "Net Interest Income" section of Management's Discussion.

Net income for the three and nine months ended September 30, 2017 increased \$7.4 million, or 17.9%, and \$18.3 million, or 15.3%, respectively, compared to the same periods in 2016.

The following is a summary of financial highlights for the three and nine months ended September 30, 2017:

FTE Net Interest Income and Net Interest Margin - For the three and nine months ended September 30, 2017, FTE net interest income increased \$16.9 million, or 12.5%, and \$39.6 million, or 9.8%, in comparison to the same periods in 2016. These increases were driven by growth in interest-earning assets and improvements in the net interest margin, resulting from increases in yields on interest-earning assets exceeding increases in costs of interest-bearing liabilities. The growth in interest-earning assets accounted for approximately 70% and 87% of the FTE net interest income growth for the three and nine months ended September 30, 2017, respectively, while the increase in net interest margin accounted for the remaining 30% and 13% growth in these periods, respectively.

Asset Quality - The provision for credit losses for the three months ended September 30, 2017 was \$5.1 million, compared to a \$4.1 million provision for the same period in 2016. For the nine months ended September 30, 2017, the provision for credit losses was \$16.6 million, compared to an \$8.2 million provision for the same period in 2016. The increases in the 2017 periods were largely due to growth in the loan portfolio, as credit metrics were generally stable.

Annualized net charge-offs to average loans outstanding were 0.14% for the third quarter of 2017, compared to 0.11% for the third quarter of 2016. For the first nine months of 2017, annualized net charge-offs to average loans outstanding improved to 0.12%, compared to 0.14% for the same period of 2016.

Non-performing assets decreased \$3.1 million, or 2.1%, as of September 30, 2017 in comparison to September 30, 2016 and decreased to 0.73% as a percentage of total assets, compared to 0.80% as of September 30, 2016. The total delinquency rate improved to 1.28% as of September 30, 2017, from 1.38% as of September 30, 2016.

Non-interest Income - For the three and nine months ended September 30, 2017, non-interest income, excluding investment securities gains, increased \$770,000, or 1.6%, and \$7.5 million, or 5.5%, in comparison to the same periods in 2016, respectively. The increases were primarily driven by higher investment management and trust services income and mortgage banking income. Improvements in mortgage banking income were largely due to changes in the MSR valuation allowance. See further discussion under non-interest income in "Results of Operations."

Investment securities gains for the three and nine months ended September 30, 2017 were \$4.6 million and \$7.1 million, respectively, as compared to \$2,000 and \$1.0 million for the same periods in 2016, respectively.

Non-interest Expense - For the three and nine months ended September 30, 2017, non-interest expense increased \$12.3 million, or 10.3%, and \$25.2 million, or 7.0%, respectively, in comparison to the same periods of 2016. The increases were primarily driven by higher salaries and employee benefits, amortization of certain tax credit investments, other outside services and net occupancy expenses. Amortization of certain new tax credit investments was classified in non-interest expense rather than income tax expense in 2017. There was no impact on net income as a result of the different classifications of the amortization for these new tax credit investments as the increases in non-interest expense were offset by decreases in income tax expense.

Supplemental Reporting of Non-U.S. GAAP Based Financial Measures

This Quarterly Report on Form 10-Q contains supplemental financial information, as detailed below, which has been derived by methods other than U.S. GAAP. The Corporation has presented these non-U.S. GAAP financial measures because it believes that these measures provide useful and comparative information to assess trends in the Corporation's results of operations. Presentation of these non-U.S. GAAP financial measures is consistent with how the Corporation evaluates its performance internally, and these non-U.S. GAAP financial measures are frequently used by securities analysts, investors and other interested parties in the evaluation of companies in the Corporation's industry. Management believes that these non-U.S. GAAP financial measures, in addition to U.S. GAAP measures, are also useful to investors to evaluate the Corporation's results. Investors should recognize that the Corporation's presentation of these non-U.S. GAAP financial measures might not be comparable to similarly-titled measures of other companies. These non-U.S. GAAP financial measures should not be considered a substitute for U.S. GAAP basis measures, and the Corporation strongly encourages a review of its consolidated financial statements in their entirety. Following are reconciliations of these non-U.S. GAAP financial measures to the most directly comparable U.S. GAAP measure as of and for the three and nine months ended September 30:

	As of or for the Three months ended September 30		As of or for the Nine months ended September 30		
	2017	2016	2017	2016	
	(dollars in thousands)				
Return on average tangible equity					
Net income - numerator	\$48,905	\$41,468	\$137,752	\$119,475	
Average common shareholders' equity	\$2,215,389	\$2,120,596	\$2,179,316	\$2,089,882	
Less: Average goodwill and intangible assets	(531,556)	(531,556)	(531,556)	(531,556)	
Average tangible shareholders' equity - denominator	\$1,683,833	\$1,589,040	\$1,647,760	\$1,558,326	
Return on average tangible equity, annualized	11.52	% 10.38	% 11.18	% 10.24	%
Efficiency ratio					
Non-interest expense	\$132,157	\$119,848	\$387,127	\$361,898	
Less: Amortization of tax credit investments ⁽¹⁾	(3,503)	—	(7,652)	—	
Numerator	\$128,654	\$119,848	\$379,475	\$361,898	
Net interest income (fully taxable equivalent) ⁽²⁾	\$152,721	\$135,784	\$443,313	\$403,700	
Plus: Total Non-interest income	51,974	48,149	151,018	137,423	
Less: Investment securities gains, net	(4,597)	(2)	(7,139)	(1,025)	
Denominator	\$200,098	\$183,931	\$587,192	\$540,098	
Efficiency ratio	64.3	% 65.2	% 64.6	% 67.0	%

Amortization expense for tax credit investments that are considered to be qualified affordable housing investments under applicable accounting guidance is included in income taxes. Amortization expense for other tax credit investments that are not considered to be affordable housing investments is included in non-interest expense. If amortization expense for all tax credit investments were recorded in income taxes, the effective tax rate for the quarter ended September 30, 2017 would have been 24.8% vs 20.5%.

⁽²⁾ Presented on an FTE basis, using a 35% federal tax rate and statutory interest expense disallowances. See also the "Net Interest Income" section of Management's Discussion.

Quarter Ended September 30, 2017 compared to the Quarter Ended September 30, 2016

Net Interest Income

FTE net interest income increased \$16.9 million, to \$152.7 million, in the third quarter of 2017, from \$135.8 million in the third quarter of 2016. The increase was due to a \$1.3 billion, or 7.8%, increase in interest-earning assets and a 13 basis points, or 4.1%, increase in net interest margin, to 3.27%, for the third quarter of 2017 compared to 3.14% for the third quarter of 2016. The following table provides a comparative average balance sheet and net interest income analysis for those periods. Interest income and yields are presented on an FTE basis, using a 35% federal tax rate and statutory interest expense disallowances. The discussion following this table is based on these FTE amounts.

	Three months ended September 30					
	2017			2016		
	Average Balance	Interest (1)	Yield/Rate	Average Balance	Interest (1)	Yield/Rate
	(dollars in thousands)					
ASSETS						
Interest-earning assets:						
Loans, net of unearned income ⁽²⁾	\$ 15,392,067	\$ 159,454	4.12 %	\$ 14,212,250	\$ 140,434	3.93 %
Taxable investment securities ⁽³⁾	2,115,931	11,423	2.16	2,110,084	10,872	2.06
Tax-exempt investment securities ⁽³⁾	408,594	4,492	4.40	344,231	3,923	4.56
Equity securities ⁽³⁾	8,709	143	6.52	14,209	196	5.50
Total investment securities	2,533,234	16,058	2.53	2,468,524	14,991	2.43
Loans held for sale	22,456	243	4.33	22,593	210	3.72
Other interest-earning assets	590,676	1,667	1.12	501,666	1,051	0.84
Total interest-earning assets	18,538,433	177,422	3.80 %	17,205,033	156,686	3.63 %
Noninterest-earning assets:						
Cash and due from banks	101,643			101,927		
Premises and equipment	220,129			227,906		
Other assets	1,186,622			1,219,844		
Less: Allowance for loan losses	(174,101)			(163,074)		
Total Assets	\$ 19,872,726			\$ 18,591,636		
LIABILITIES AND EQUITY						
Interest-bearing liabilities:						
Demand deposits	\$ 3,943,118	\$ 3,847	0.39 %	\$ 3,602,448	\$ 1,706	0.19 %
Savings and money market deposits	4,603,155	3,962	0.34	4,078,942	2,042	0.20
Brokered deposits	89,767	277	1.23	—	—	—
Time deposits	2,744,532	7,937	1.15	2,814,258	7,562	1.07
Total interest-bearing deposits	11,380,572	16,023	0.56	10,495,648	11,310	0.43
Short-term borrowings	402,341	578	0.57	426,369	254	0.23
FHLB advances and other long-term debt	1,038,062	8,100	3.11	965,228	9,338	3.86
Total interest-bearing liabilities	12,820,975	24,701	0.77 %	11,887,245	20,902	0.70 %
Noninterest-bearing liabilities:						
Demand deposits	4,494,897			4,227,639		
Other	341,465			356,156		
Total Liabilities	17,657,337			16,471,040		
Shareholders' equity	2,215,389			2,120,596		
Total Liabilities and Shareholders' Equity	\$ 19,872,726			\$ 18,591,636		
Net interest income/net interest margin (FTE)		152,721	3.27 %		135,784	3.14 %
Tax equivalent adjustment		(5,912)			(5,219)	
Net interest income		\$ 146,809			\$ 130,565	

- (1) Includes dividends earned on equity securities.
- (2) Includes non-performing loans.
- (3) Balances include amortized historical cost for available for sale securities; the related unrealized holding gains (losses) are included in other assets.

The following table summarizes the changes in FTE interest income and interest expense resulting from changes in average balances (volume) and changes in rates for the three months ended September 30, 2017 in comparison to the three months ended September 30, 2016:

	2017 vs. 2016		
	Increase (Decrease) due to change in		
	Volume	Rate	Net
	(in thousands)		
Interest income on:			
Loans, net of unearned income	\$12,223	\$6,797	\$19,020
Taxable investment securities	30	521	551
Tax-exempt investment securities	714	(145)	569
Equity securities	(86)	33	(53)
Loans held for sale	(1)	34	33
Other interest-earning assets	212	404	616
Total interest income	\$13,092	\$7,644	\$20,736
Interest expense on:			
Demand deposits	\$177	\$1,964	\$2,141
Savings and money market deposits	293	1,627	1,920
Brokered deposits	277	—	277
Time deposits	(186)	561	375
Short-term borrowings	(15)	339	324
FHLB advances and other long-term debt	674	(1,912)	(1,238)
Total interest expense	\$1,220	\$2,579	\$3,799

Note: Changes which are partially attributable to both volume and rate are allocated to the volume and rate components presented above based on the percentage of direct changes that are attributable to each component.

As summarized above, the increase in average interest-earning assets, primarily loans, since the third quarter of 2016 resulted in a \$13.1 million increase in FTE interest income. The 17 basis points increase in the yield on average interest-earning assets resulted in a \$7.6 million increase in FTE interest income. The yield on the loan portfolio increased 19 basis points, or 4.8%, from the third quarter of 2016, the result of federal funds rate increases that occurred in December 2016, March 2017 and June 2017, which primarily impacted variable rate loans and adjustable rate loans that repriced in the first nine months of 2017.

Interest expense increased \$3.8 million primarily due to the 20 and 14 basis points increases in the rate on average interest-bearing demand deposits and savings and money market deposits, as a result of the federal funds rate increases. These basis points increases contributed \$2.0 million and \$1.6 million to the increase in FTE interest expense, respectively. These increases were partially offset by a 75 basis points decrease in the rate on average FHLB advances and other long-term debt, which lowered FTE interest expense by \$1.2 million.

Average loans and average FTE yields, by type, are summarized in the following table:

	Three months ended September 30				Increase (Decrease) in	
	2017		2016		Balance	%
	Balance	Yield	Balance	Yield	\$	%
	(dollars in thousands)					
Real estate – commercial mortgage	\$6,208,630	4.07%	\$5,670,888	3.99%	\$537,742	9.5 %
Commercial – industrial, financial and agricultural	4,257,075	4.08	4,066,275	3.76	190,800	4.7
Real estate – residential mortgage	1,841,559	3.83	1,503,209	3.76	338,350	22.5

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Real estate – home equity	1,569,898	4.48	1,640,913	4.08	(71,015)	(4.3)
Real estate – construction	943,029	4.05	837,920	3.76	105,109	12.5
Consumer	318,546	4.94	281,517	5.31	37,029	13.2
Leasing, other and overdrafts	253,330	4.91	211,528	4.74	41,802	19.8
Total	\$15,392,067	4.12 %	\$14,212,250	3.93 %	\$1,179,817	8.3 %

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Average loans increased \$1.2 billion, or 8.3%, compared to the third quarter of 2016. The increase was driven largely by growth in the commercial mortgage and residential mortgage portfolios, as well as the commercial loan portfolio. The \$537.7 million, or 9.5%, increase in commercial mortgages occurred in both owner-occupied and investment property types and was realized across most geographic markets. The \$338.4 million, or 22.5%, increase in residential mortgages was also experienced across all geographic markets, with the most significant increases occurring in Maryland, Virginia and Pennsylvania. This growth was in part related to new product offerings and marketing efforts targeting specific customer segments, including loans to low- to moderate-income and minority borrowers and loans in low- to moderate-income and majority-minority geographies. The \$190.8 million, or 4.7%, increase in commercial loans was spread across a broad range of industries and concentrated in Pennsylvania.

Average total interest-bearing liabilities increased \$933.7 million, or 7.9%, compared to the third quarter of 2016. Interest expense increased \$3.8 million, or 18.2%, to \$24.7 million in the third quarter of 2017. Average deposits and average interest rates, by type, are summarized in the following table:

	Three months ended September 30				Increase (Decrease)	
	2017		2016		in Balance	
	Balance	Rate	Balance	Rate	\$	%
	(dollars in thousands)					
Noninterest-bearing demand	\$4,494,897	— %	\$4,227,639	— %	\$267,258	6.3 %
Interest-bearing demand	3,943,118	0.39	3,602,448	0.19	340,670	9.5
Savings and money market accounts	4,603,155	0.34	4,078,942	0.20	524,213	12.9
Total demand and savings	13,041,170	0.24	11,909,029	0.13	1,132,141	9.5
Brokered deposits	89,767	1.23	—	—	89,767	N/M
Time deposits	2,744,532	1.15	2,814,258	1.07	(69,726)	(2.5)
Total deposits	\$15,875,469	0.40 %	\$14,723,287	0.31 %	\$1,152,182	7.8 %
N/M - Not meaningful						

The \$1.1 billion, or 9.5%, increase in total demand and savings accounts was primarily due to a \$623.2 million, or 11.3%, increase in personal account balances, a \$276.4 million, or 6.4%, increase in business account balances and a \$221.2 million, or 10.7%, increase in municipal account balances.

During the third quarter of 2017, the Corporation began accepting deposits under an agreement with a non-bank third party pursuant to which excess cash in the accounts of customers of the third party is swept on a collective basis, as frequently as every business day, by the third party, into omnibus deposit accounts maintained by one of the Corporation's subsidiary banks. Under the agreement with the third party, generally, no more than \$250 million of excess cash in accounts of customers of the third party may be swept into the omnibus deposit accounts. The average balance in the omnibus accounts during the third quarter of 2017 was \$89.8 million and is shown as "brokered deposits" in the above table. This source of funding is considered to be both geographically diverse and relatively stable, with balances in the omnibus deposit accounts bearing interest at a rate based on the federal funds rate.

The average cost of total deposits increased 9 basis points to 0.40% in the third quarter of 2017, compared to 0.31% in the third quarter of 2016.

Average borrowings and interest rates, by type, are summarized in the following table:

	Three months ended September 30				Increase (Decrease) in Balance	
	2017		2016		\$	%
	Balance	Rate	Balance	Rate		
	(dollars in thousands)					
Short-term borrowings:						
Customer repurchase agreements and short-term promissory notes	\$256,562	0.19%	\$257,659	0.09%	\$(1,097)	(0.4)%
Federal funds purchased	90,453	1.21	148,546	0.47	(58,093)	(39.1)
Short-term FHLB advances ⁽¹⁾	55,326	1.24	20,163	0.41	35,163	174.4
Total short-term borrowings	402,341	0.57	426,368	0.23	(24,027)	(5.6)
Long-term debt:						
FHLB advances	652,160	2.30	603,285	3.17	48,875	8.1
Other long-term debt	385,902	4.48	361,943	5.01	23,959	6.6
Total long-term debt	1,038,062	3.11	965,228	3.86	72,834	7.5
Total borrowings	\$1,440,403	2.40%	\$1,391,596	2.75%	\$48,807	3.5%

(1) Represents FHLB advances with an original maturity term of less than one year.

Average total short-term borrowings decreased \$24.0 million, or 5.6%, as a portion of these borrowings were repaid with funds provided by the strong growth in deposits during the third quarter of 2017.

The increase of \$48.9 million, or 8.1%, in average long-term FHLB advances provided additional funding to support loan growth. Average long-term debt increased \$72.8 million, or 7.5%, due mainly to the issuance of \$125 million of senior notes in March 2017, partially offset by the repayment of \$100.0 million of 10-year subordinated notes, which matured on May 1, 2017. The 75 basis point, or 19.4%, decrease in the average rate on long-term debt was primarily a result of \$200 million of FHLB advances that were refinanced in December of 2016, which reduced the weighted average rate on these advances from 4.03% to 2.40%.

Provision for Credit Losses

The provision for credit losses was \$5.1 million for the third quarter of 2017, an increase of \$934,000 from the third quarter of 2016, driven mainly by loan growth and the impact of normal changes in the risk characteristics of the loan portfolio.

The provision for credit losses is recognized as an expense in the consolidated statements of income and is the amount necessary to adjust the allowance for credit losses to its appropriate balance, as determined through the Corporation's allowance methodology. The Corporation determines the appropriate level of the allowance for credit losses based on many quantitative and qualitative factors, including, but not limited to: the size and composition of the loan portfolio, changes in risk ratings, changes in collateral values, delinquency levels, historical losses and economic conditions. See the "Financial Condition" section of Management's Discussion under the heading "Provision and Allowance for Credit Losses" for details related to the Corporation's provision and allowance for credit losses.

Non-Interest Income

The following table presents the components of non-interest income:

	Three months		Increase (Decrease)		
	ended September				
	2017	2016	\$	%	
	(dollars in thousands)				
Service charges on deposit accounts:					
Overdraft fees	\$5,844	\$5,770	\$ 74	1.3	%
Cash management fees	3,624	3,605	19	0.5	%
Other	3,554	3,703	(149)	(4.0)	%
Total service charges on deposit accounts	13,022	13,078	(56)	(0.4)	%
Other service charges and fees:					
Merchant fees	4,398	4,220	178	4.2	
Debit card income	2,830	2,718	112	4.1	
Commercial loan interest rate swap fees	1,954	4,359	(2,405)	(55.2)	
Letter of credit fees	1,056	1,078	(22)	(2.0)	
Other	2,013	2,032	(19)	(0.9)	
Total other service charges and fees	12,251	14,407	(2,156)	(15.0)	
Investment management and trust services	12,157	11,425	732	6.4	
Mortgage banking income:					
Gains on sales of mortgage loans	3,560	4,857	(1,297)	(26.7)	
Mortgage servicing income	1,245	(328)	1,573	N/M	
Total mortgage banking income	4,805	4,529	276	6.1	
Credit card income	2,829	2,668	161	6.0	
Other income	2,313	2,040	273	13.4	
Total, excluding investment securities gains, net	47,377	48,147	(770)	(1.6)	
Investment securities gains, net	4,597	2	4,595	N/M	
Total	\$51,974	\$48,149	\$ 3,825	7.9	%

N/M - Not meaningful

Excluding investment securities gains, non-interest income decreased \$770,000, or 1.6%, in the third quarter of 2017 as compared to the same period in 2016. Other service charges and fees decreased \$2.2 million, or 15.0%, primarily due to a \$2.4 million decrease in commercial loan interest rate swap fees, mainly as a result of lower commercial loan originations during the third quarter of 2017.

Investment management and trust services income increased \$732,000, or 6.4%, in the third quarter of 2017 as compared to the same period in 2016, with growth in both trust commissions and brokerage income, due to overall market performance and an increase in assets under management.

Gains on sales of mortgage loans decreased \$1.3 million, or 26.7%, in the third quarter of 2017 compared to the same period in 2016, as both volumes and pricing spreads decreased. Mortgage servicing income increased \$1.6 million as the third quarter of 2016 included an MSR impairment charge of \$1.3 million. Excluding this charge, mortgage servicing income increased \$293,000, or 30.8%. For more information, see Note 6, "Mortgage Servicing Rights," in the Notes to Consolidated Financial Statements for additional details.

Investment securities gains increased \$4.6 million from the third quarter of 2016. The increase resulted from sales of financial institution common stocks. See Note 4, "Investment Securities," in the Notes to Consolidated Financial Statements for additional details.

Non-Interest Expense

The following table presents the components of non-interest expense:

	Three months ended		Increase	
	September 30		\$	%
	2017	2016		
	(dollars in thousands)			
Salaries and employee benefits	\$72,894	\$70,696	\$2,198	3.1 %
Net occupancy expense	12,180	11,782	398	3.4
Data processing and software	10,301	8,727	1,574	18.0
Other outside services	6,582	5,783	799	13.8
Amortization of tax credit investments	3,503	—	3,503	N/M
Professional fees	3,388	2,535	853	33.6
Equipment expense	3,298	3,137	161	5.1
FDIC insurance expense	3,007	1,791	1,216	67.9
Marketing	2,089	1,774	315	17.8
Other	14,915	13,623	1,292	9.5
Total	\$132,157	\$119,848	\$12,309	10.3 %

N/M - Not meaningful

The increase in salaries and employee benefits expense was driven entirely by salaries, reflecting annual merit increases and an increase in staffing levels. Average full-time equivalent employees increased 2.2%, to 3,582 in 2017, as compared to 3,504 in 2016.

Data processing and software expense increased \$1.6 million, or 18.0%, reflecting higher transaction volumes and new processing platforms.

Other outside services increased \$799,000, or 13.8%, largely due to consulting services related to pre-bank consolidation efforts and technology initiatives.

In 2017, amortization of certain new tax credit investments was classified in non-interest expense, rather than income tax expense, as further discussed under income taxes below.

The \$853,000, or 33.6%, increase in professional fees was driven by higher legal expenses. FDIC insurance expense increased \$1.2 million, or 67.9%, reflecting the Corporation's largest banking subsidiary exceeding \$10 billion in assets and becoming subject to the 'large bank' premium assessments and balance sheet growth. Marketing expense increased \$315,000, or 17.8%, compared to the third quarter of 2016, due to an increase in the number of marketing promotions.

Other expenses increased \$1.3 million, or 9.5%, due to higher state taxes resulting from legislated increases in the Pennsylvania bank shares tax rate, and certain sales tax liabilities.

Income Taxes

Income tax expense for the third quarter of 2017 was \$12.6 million, a \$611,000, or 4.6%, decrease from \$13.3 million for the third quarter of 2016.

The Corporation's effective tax rate was 20.5% in the third quarter of 2017, as compared to 24.2% in the third quarter of 2016. The effective tax rate is generally lower than the federal statutory rate of 35% due to tax-exempt interest income earned on loans, investments in tax-free municipal securities, credits earned from community development investments in partnerships that generate tax credits under various federal programs and excess tax benefits realized on stock-based compensation. In 2017, amortization of certain new tax credit investments was included in non-interest expense, rather than as a component of income tax expense. If the amortization had been included as a component of

income tax expense, the effective tax rate for the third quarter of 2017 would have been 24.8%.

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Nine Months Ended September 30, 2017 compared to the Nine Months Ended September 30, 2016

Net Interest Income

FTE net interest income increased \$39.6 million, to \$443.3 million, in the first nine months of 2017, from \$403.7 million in the same period of 2016. The increase was due to a \$1.2 billion, or 7.1%, increase in interest-earning assets and an 8 basis points, or 2.5%, increase in net interest margin, to 3.27%, for the first nine months of 2017 compared to 3.19% for the same period in 2016. The following table provides a comparative average balance sheet and net interest income analysis for those periods. Interest income and yields are presented on an FTE basis, using a 35% federal tax rate and statutory interest expense disallowances. The discussion following this table is based on these FTE amounts.

	Nine months ended September 30					
	2017			2016		
	Average Balance	Interest (1)	Yield/Rate	Average Balance	Interest (1)	Yield/Rate
	(dollars in thousands)					
ASSETS						
Interest-earning assets:						
Loans, net of unearned income ⁽²⁾	\$ 15,127,569	\$ 458,753	4.05 %	\$ 14,011,301	\$ 416,646	3.97 %
Taxable investment securities ⁽³⁾	2,117,127	34,811	2.19	2,139,378	34,034	2.12
Tax-exempt investment securities ⁽³⁾	405,728	13,268	4.36	306,298	10,631	4.63
Equity securities ⁽³⁾	10,391	467	6.01	14,272	599	5.60
Total investment securities	2,533,246	48,546	2.56	2,459,948	45,264	2.45
Loans held for sale	19,378	631	4.34	18,114	529	3.90
Other interest-earning assets	410,250	3,311	1.08	406,163	2,813	0.92
Total interest-earning assets	18,090,443	511,241	3.78 %	16,895,526	465,252	3.68 %
Noninterest-earning assets:						
Cash and due from banks	107,029			100,417		
Premises and equipment	218,700			227,237		
Other assets	1,170,466			1,182,260		
Less: Allowance for loan losses	(172,145)			(164,999)		
Total Assets	\$ 19,414,493			\$ 18,240,441		
LIABILITIES AND EQUITY						
Interest-bearing liabilities:						
Demand deposits	\$ 3,762,439	\$ 8,865	0.32 %	\$ 3,498,659	\$ 4,727	0.18 %
Savings deposits	4,372,453	8,883	0.27	4,000,871	5,732	0.19
Brokered deposits	30,251	277	1.23	—	—	—
Time deposits	2,726,693	22,684	1.11	2,842,011	22,465	1.06
Total interest-bearing deposits	10,891,836	40,709	0.50	10,341,541	32,924	0.43
Short-term borrowings	581,511	2,407	0.55	425,151	739	0.23
FHLB advances and other long-term debt	1,033,159	24,812	3.21	962,997	27,889	3.86
Total interest-bearing liabilities	12,506,506	67,928	0.73 %	11,729,689	61,552	0.70 %
Noninterest-bearing liabilities:						
Demand deposits	4,395,421			4,091,555		
Other	333,250			329,315		
Total Liabilities	17,235,177			16,150,559		
Shareholders' equity	2,179,316			2,089,882		
Total Liabilities and Shareholders' Equity	\$ 19,414,493			\$ 18,240,441		
Net interest income/net interest margin (FTE)		443,313	3.27 %		403,700	3.19 %
Tax equivalent adjustment		(17,362)			(15,165)	
Net interest income		\$ 425,951			\$ 388,535	

- (1) Includes dividends earned on equity securities.
- (2) Includes non-performing loans.
- (3) Balances include amortized historical cost for available for sale securities; the related unrealized holding gains (losses) are included in other assets.

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The following table summarizes the changes in FTE interest income and interest expense resulting from changes in average balances (volume) and changes in rates for the nine months ended September 30, 2017 in comparison to the same period of 2016:

	2017 vs. 2016		
	Increase (Decrease) due to change in		
	Volume	Rate	Net
	(in thousands)		
Interest income on:			
Loans, net of unearned income	\$33,471	\$8,636	\$42,107
Taxable investment securities	(355)	1,132	777
Tax-exempt investment securities	3,277	(640)	2,637
Equity securities	(172)	40	(132)
Loans held for sale	39	63	102
Other interest-earning assets	28	470	498
Total interest income	\$36,288	\$9,701	\$45,989
Interest expense on:			
Demand deposits	\$381	\$3,757	\$4,138
Savings and money market deposits	573	2,578	3,151
Brokered deposits	277	—	277
Time deposits	(939)	1,158	219
Short-term borrowings	349	1,319	1,668
FHLB advances and other long-term debt	1,916	(4,993)	(3,077)
Total interest expense	\$2,557	\$3,819	\$6,376

Note: Changes which are partially attributable to both volume and rate are allocated to the volume and rate components presented above based on the percentage of direct changes that are attributable to each component.

As summarized above, the increase in average interest-earning assets, primarily loans, in comparison to the first nine months of 2016, resulted in a \$36.3 million increase in FTE interest income. The 10 basis points increase in the yield on average interest-earning assets resulted in a \$9.7 million increase in FTE interest income. The yield on the loan portfolio increased 8 basis points, or 2.0%, from the same period of 2016, the result of federal funds rate increases that occurred in December 2016, March 2017 and June 2017, which impacted variable rate loans and adjustable rate loans that repriced in the first nine months of 2017.

Interest expense increased \$6.4 million primarily due to the 14 and 8 basis points increases in the rate on average interest-bearing demand deposits and savings and money market deposits, as a result of the federal funds rate increases. These basis points increases contributed \$3.8 million and \$2.6 million to the increase in FTE interest expense, respectively. In addition, a 32 basis points increase in short-term borrowings contributed \$1.3 million to the increase in FTE interest expense. These increases were partially offset by a 65 basis points decrease in the rate on average FHLB advances and other long-term debt, which lowered FTE interest expense by \$5.0 million.

Average loans and average FTE yields, by type, are summarized in the following table:

	Nine months ended September 30				Increase (Decrease) in Balance	
	2017	2016	2017	2016	\$	%
	Balance	Yield	Balance	Yield		
	(dollars in thousands)					
Real estate – commercial mortgage	\$6,137,824	4.02 %	\$5,572,356	4.01 %	\$565,468	10.1 %
Commercial – industrial, financial and agricultural	4,227,918	3.99	4,080,638	3.79	147,280	3.6
Real estate – residential mortgage	1,729,799	3.79	1,428,430	3.77	301,369	21.1

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Real estate – home equity	1,590,117	4.33	1,656,969	4.09	(66,852) (4.0)
Real estate – construction	894,146	4.00	817,014	3.80	77,132	9.4
Consumer	301,414	5.07	272,402	5.40	29,012	10.7
Leasing, other and overdrafts	246,351	5.00	183,492	6.01	62,859	34.3
Total	\$15,127,569	4.05 %	\$14,011,301	3.97 %	\$1,116,268	8.0 %

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Average loans increased \$1.1 billion, or 8.0%, compared to the first nine months of 2016. The increase was driven largely by growth in the commercial mortgage and residential mortgage portfolios, as well as the commercial loan, construction and leasing portfolios. The \$565.5 million, or 10.1%, increase in commercial mortgages occurred in both owner-occupied and investment property types and was realized in all geographic markets, but predominantly in Pennsylvania, Maryland and Delaware. The \$301.4 million, or 21.1%, increase in residential mortgages was also experienced across all geographic markets, with the most significant increases occurring in Maryland and Virginia. This growth was in part related to new product offerings and marketing efforts targeting specific customer segments, including loans to low- to moderate-income and minority borrowers and loans in low- to moderate-income and majority-minority geographies. The \$147.3 million, or 3.6%, increase in commercial loans was spread across a broad range of industries and concentrated in Pennsylvania.

Average total interest-bearing liabilities for the first nine months of 2017 increased \$776.8 million, or 6.6%, compared to the same period of 2016. Interest expense increased \$6.4 million, or 10.4%, to \$67.9 million in the first nine months of 2017. Average deposits and average interest rates, by type, are summarized in the following table:

	Nine months ended September 30				Increase	
	2017		2016		(Decrease) in	
	Balance	Rate	Balance	Rate	\$	%
	(dollars in thousands)					
Noninterest-bearing demand	\$4,395,421	— %	\$4,091,555	— %	\$303,866	7.4 %
Interest-bearing demand	3,762,439	0.32	3,498,659	0.18	263,780	7.5
Savings	4,372,453	0.27	4,000,871	0.19	371,582	9.3
Total demand and savings	12,530,313	0.19	11,591,085	0.12	939,228	8.1
Brokered deposits	30,251	1.23	—	—	30,251	N/M
Time deposits	2,726,693	1.11	2,842,011	1.06	(115,318)	(4.1)
Total deposits	\$15,287,257	0.36%	\$14,433,096	0.30%	\$854,161	5.9 %

N/M - Not meaningful

The \$939.2 million, or 8.1%, increase in total demand and savings accounts was primarily due to a \$527.5 million, or 9.8%, increase in personal account balances, a \$286.5 million, or 6.8%, increase in business account balances and an \$113.7 million, or 5.8%, increase in municipal account balances.

During the third quarter of 2017, the Corporation began accepting deposits under an agreement with a non-bank third party pursuant to which excess cash in the accounts of customers of the third party is swept on a collective basis, as frequently as every business day, by the third party, into omnibus deposit accounts maintained by one of the Corporation's subsidiary banks. Under the agreement with the third party, generally, no more than \$250 million of excess cash in accounts of customers of the third party may be swept into the omnibus deposit accounts. The average balance in the omnibus accounts during the nine months ended September 30, 2017 was \$30.3 million and is shown as "brokered deposits" in the above table. This source of funding is considered to be both geographically diverse and relatively stable, with balances in the omnibus deposit accounts bearing interest at a rate based on the federal funds rate.

The average cost of total deposits increased 6 basis points to 0.36% in the first nine months of 2017, compared to 0.30% in the same period in 2016.

Average borrowings and interest rates, by type, are summarized in the following table:

	Nine months ended September 30				Increase	
	2017		2016		in Balance	
	Balance	Rate	Balance	Rate	\$	%
(dollars in thousands)						
Short-term borrowings:						
Customer repurchase agreements	\$191,740	0.11%	\$179,892	0.11%	\$11,848	6.6%
Customer short-term promissory notes	79,230	0.13	73,859	0.04	5,371	7.3
Total short-term customer funding	270,970	0.12	253,751	0.09	17,219	6.8
Federal funds purchased	212,885	0.92	156,812	0.44	56,073	35.8
Short-term FHLB advances ⁽¹⁾	97,656	0.94	14,588	0.43	83,068	N/M
Total short-term borrowings	581,511	0.55	425,151	0.23	156,360	36.8
Long-term debt:						
FHLB advances	636,898	2.31	601,120	3.18	35,778	6.0
Other long-term debt	396,261	4.65	361,877	5.00	34,384	9.5
Total long-term debt	1,033,159	3.21	962,997	3.86	70,162	7.3
Total borrowings	\$1,614,670	2.25%	\$1,388,148	2.75%	\$226,522	16.3%

N/M - Not meaningful

(1) Represents FHLB advances with an original maturity term of less than one year.

Average total short-term borrowings increased \$156.4 million, or 36.8%, as a result of loan growth out-pacing the increase in deposits. Interest expense on average short-term borrowings increased by \$1.7 million, mainly driven by the 32 basis points increase in the rate, contributing \$1.3 million to interest expense.

The increase of \$35.8 million, or 6.0%, in average long-term FHLB advances provided additional funding to support loan growth. Average long-term debt increased \$70.2 million, or 7.3%, primarily as a result of the \$125 million of senior notes issued in March 2017, partially offset by the repayment of \$100.0 million of 10-year subordinated notes, which matured on May 1, 2017. The 65 basis point, or 16.8%, decrease in the average rate on long-term debt was primarily a result of \$200 million of FHLB advances that were refinanced in December of 2016, which reduced the weighted average rate on these advances from 4.03% to 2.40%.

Provision for Credit Losses

The provision for credit losses was \$16.6 million for the first nine months of 2017, an increase of \$8.4 million from the same period of 2016, driven mainly by loan growth and the impact of normal changes in the risk characteristics of the loan portfolio.

The provision for credit losses is recognized as an expense in the consolidated statements of income and is the amount necessary to adjust the allowance for credit losses to its appropriate balance, as determined through the Corporation's allowance methodology. The Corporation determines the appropriate level of the allowance for credit losses based on many quantitative and qualitative factors, including, but not limited to: the size and composition of the loan portfolio, changes in risk ratings, changes in collateral values, delinquency levels, historical losses and economic conditions. See the "Financial Condition" section of Management's Discussion under the heading "Provision and Allowance for Credit Losses" for details related to the Corporation's allowance and provision for credit losses.

Non-Interest Income

The following table presents the components of non-interest income:

	Nine months ended		Increase	
	September 30	September 30	(Decrease)	
	2017	2016	\$	%
	(dollars in thousands)			
Service charges on deposit accounts:				
Overdraft fees	\$16,961	\$16,426	\$535	3.3 %
Cash management fees	10,775	10,651	124	1.2
Other	10,600	11,455	(855)	(7.5)
Total service charges on deposit accounts	38,336	38,532	(196)	(0.5)
Other service charges and fees:				
Merchant fees	12,536	12,155	381	3.1 %
Commercial loan interest rate swap fees	8,780	8,552	228	2.7
Debit card income	8,379	7,948	431	5.4
Letter of credit fees	3,366	3,385	(19)	(0.6)
Other	5,969	6,100	(131)	(2.1)
Total other service charges and fees	39,030	38,140	890	2.3
Investment management and trust services	36,097	33,660	2,437	7.2
Mortgage banking income:				
Gains on sales of mortgage loans	10,122	11,967	(1,845)	(15.4)
Mortgage servicing income	5,420	489	4,931	N/M
Total mortgage banking income	15,542	12,456	3,086	24.8
Credit card income	8,143	7,688	455	5.9
Other income	6,731	5,922	809	13.7
Total, excluding investment securities gains, net	143,879	136,398	7,481	5.5
Investment securities gains, net	7,139	1,025	6,114	N/M
Total	\$151,018	\$137,423	\$13,595	9.9 %

N/M - Not meaningful

Excluding investment securities gains, non-interest income increased \$7.5 million, or 5.5%, for the first nine months of 2017, as compared to the same period in 2016. Other service charges and fees increased \$890,000, or 2.3%, mainly due to increases in merchant fees, debit card income and commercial loan interest rate swap fees.

The \$534,000, or 3.3%, increase in overdraft fee income during the nine months ended September 30, 2017, in comparison to the same period during 2016, consisted of a \$358,000 increase in fees assessed on personal accounts and a \$176,000 increase in fees assessed on commercial accounts, due to higher transaction volumes. Other service charges on deposit accounts decreased \$854,000, or 7.5%, resulting from changes in customer behavior and the loss of a significant processing customer.

Investment management and trust services income increased \$2.4 million, or 7.2%, with growth in both trust and brokerage income, due to overall market performance and an increase in assets under management.

Gains on sales of mortgage loans decreased \$1.8 million, or 15.4%, compared to the same period in 2016, as both volumes and pricing spreads decreased. Mortgage servicing income increased \$4.9 million compared to the same period in 2016 due to a \$1.3 million reduction to the MSR's valuation allowance in 2017, which was originally established in 2016 through impairment charges of \$3.0 million. Excluding the impact of the MSR valuation allowance adjustments, mortgage servicing income increased \$639,000, or 18.3%. For more information, see Note 6,

"Mortgage Servicing Rights," in the Notes to Consolidated Financial Statements for additional details.

Gains on sales of investment securities increased \$6.1 million compared to the first nine months of 2016. The increase resulted from sales of financial institution common stocks. See Note 4, "Investment Securities," in the Notes to Consolidated Financial Statements for additional details.

Non-Interest Expense

The following table presents the components of non-interest expense:

	Nine months ended		Increase		
	September 30		(Decrease)		
	2017	2016	\$	%	
	(dollars in thousands)				
Salaries and employee benefits	\$216,626	\$210,097	\$6,529	3.1	%
Net occupancy expense	37,159	35,813	1,346	3.8	
Data processing and software	28,334	27,477	857	3.1	
Other outside services	19,836	17,347	2,489	14.3	
Equipment expense	9,691	9,380	311	3.3	
Professional fees	9,056	8,221	835	10.2	
Amortization of tax credit investments	7,652	—	7,652	100.0	
FDIC insurance expense	7,431	7,700	(269)	(3.5))
Marketing	6,309	5,314	995	18.7	
Other	45,033	40,549	4,484	11.1	
Total	\$387,127	\$361,898	\$25,229	7.0	%

The \$6.5 million, or 3.1%, increase in salaries and employee benefits during the nine months ended September 30, 2017, in comparison to the same period during 2016, primarily resulted from a \$7.7 million, or 4.4%, increase in salaries, resulting from annual merit increases and an increase in staffing levels. Average full-time equivalent employees increased 1.9%, to 3,559, in 2017, as compared to 3,492 in 2016.

Other outside services increased \$2.5 million, or 14.3%, largely due to consulting services related to pre-bank consolidation efforts and technology initiatives.

As previously mentioned, in 2017 amortization of certain new tax credit investments was classified in non-interest expense, rather than income taxes.

Marketing expense increased \$995,000, or 18.7%, compared to the first nine months of 2016, due to an increase in the number of marketing promotions. In 2017, many of these promotions were focused on deposit generation.

Other expenses increased \$4.5 million, or 11.1%, due to higher state taxes resulting from legislated increases in the Pennsylvania bank shares tax rate, certain sales tax liabilities, and higher operating risk loss expense.

Income Taxes

Income tax expense for the first nine months of 2017 was \$35.5 million, an \$888,000, or 2.4%, decrease from \$36.4 million in 2016. The Corporation's effective tax rate was 20.5% in the first nine months of 2017, as compared to 23.4% in the same period of 2016. The effective tax rate is generally lower than the federal statutory rate of 35% due to tax-exempt interest income earned on loans, investments in tax-free municipal securities, credits earned from investments in partnerships that generate tax credits under various federal programs and excess tax benefits realized on stock-based compensation. In 2017, amortization of certain new tax credit investments was recorded in non-interest expense, rather than as a component of income tax expense. If the amortization had been included as a component of income tax expense, the effective tax rate for the first nine months of 2017 would have been 23.9%.

FINANCIAL CONDITION

The table below presents condensed consolidated ending balance sheets.

	September 30, 2017	December 31, 2016	Increase (Decrease)	
			\$	%
(dollars in thousands)				
Assets				
Cash and due from banks	\$99,803	\$118,763	\$(18,960)	(16.0)%
Other interest-earning assets	645,796	291,252	354,544	121.7
Loans held for sale	23,049	28,697	(5,648)	(19.7)
Investment securities	2,561,516	2,559,227	2,289	0.1
Loans, net of allowance	15,314,654	14,530,593	784,061	5.4
Premises and equipment	221,551	217,806	3,745	1.7
Goodwill and intangible assets	531,556	531,556	—	—
Other assets	664,935	666,353	(1,418)	(0.2)
Total Assets	\$20,062,860	\$18,944,247	\$1,118,613	5.9%
Liabilities and Shareholders' Equity				
Deposits	\$16,141,780	\$15,012,864	\$1,128,916	7.5%
Short-term borrowings	298,751	541,317	(242,566)	(44.8)
Long-term debt	1,038,159	929,403	108,756	11.7
Other liabilities	358,384	339,548	18,836	5.5
Total Liabilities	17,837,074	16,823,132	1,013,942	6.0
Total Shareholders' Equity	2,225,786	2,121,115	104,671	4.9
Total Liabilities and Shareholders' Equity	\$20,062,860	\$18,944,247	\$1,118,613	5.9%

Other Interest-earning Assets

Other interest-earning assets increased \$354.5 million, or 121.7%, during the first nine months of 2017 as a result of higher balances on deposit with the Federal Reserve Bank, due to deposit growth in excess of loan growth during the period driven mainly by an increase in municipal deposits.

Investment Securities

The following table presents the carrying amount of investment securities:

	September 30, 2017	December 31, 2016	Increase (Decrease)	
			\$	%
(dollars in thousands)				
U.S. Government sponsored agency securities	\$6,015	\$134	\$5,881	N/M
State and municipal securities	413,913	391,641	22,272	5.7
Corporate debt securities	92,977	109,409	(16,432)	(15.0)
Collateralized mortgage obligations	593,678	593,860	(182)	—
Residential mortgage-backed securities	1,182,086	1,317,838	(135,752)	(10.3)
Commercial mortgage-backed securities	161,632	24,563	137,069	N/M
Auction rate securities	98,156	97,256	900	0.9
Total debt securities	2,548,457	2,534,701	13,756	0.5
Equity securities	13,059	24,526	(11,467)	(46.8)

Total	\$2,561,516	\$2,559,227	\$2,289	0.1	%
N/M - Not meaningful					

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Commercial mortgage-backed securities increased \$137.1 million, while residential mortgage-backed securities decreased \$135.8 million, or 10.3%, as residential mortgage backed securities cash flows were reinvested in commercial mortgage-backed securities to diversify the portfolio into securities with a shorter average life.

Loans, net of Unearned Income

The following table presents ending balances of loans outstanding, net of unearned income:

	September 30, 2017	December 31, 2016	Increase (Decrease)	
			\$	%
	(dollars in thousands)			
Real estate – commercial mortgage	\$6,275,140	\$ 6,018,582	\$256,558	4.3 %
Commercial – industrial, financial and agricultural	4,223,075	4,087,486	135,589	3.3
Real estate – residential mortgage	1,887,907	1,601,994	285,913	17.8
Real estate – home equity	1,567,473	1,625,115	(57,642)	(3.5)
Real estate – construction	973,108	843,649	129,459	15.3
Consumer	302,448	291,470	10,978	3.8
Leasing, other and overdrafts	257,748	230,976	26,772	11.6
Loans, net of unearned income	\$15,486,899	\$14,699,272	\$787,627	5.4 %

Loans, net of unearned income, increased \$787.6 million, or 5.4%, in comparison to December 31, 2016. In general, this growth resulted from improved business activity and customer sentiment during the first half of 2017, which was tempered somewhat in the third quarter of 2017. Increases were realized mainly in Pennsylvania, Maryland and Virginia.

Residential mortgage loans increased \$285.9 million, or 17.8%, compared to December 31, 2016, with the growth occurring primarily in Maryland (\$110.1 million, or 37.2%), Virginia (\$97.0 million, or 31.4%) and Pennsylvania (\$52.4 million, or 7.7%).

Commercial mortgage loans increased \$256.6 million, or 4.3%, in comparison to December 31, 2016, with the growth occurring largely in Pennsylvania (\$122.2 million, or 3.9%), Maryland (\$65.8 million, or 10.6%) and Virginia (\$30.0 million, or 6.0%).

Commercial loans increased \$135.6 million, or 3.3%, in comparison to December 31, 2016, with the growth occurring primarily in Pennsylvania (\$140.7 million, or 4.7%) and New Jersey (\$15.6 million, or 3.0%). Construction loans increased \$129.5 million, or 15.3%, in comparison to December 31, 2016, with the growth occurring primarily in Maryland (\$48.4 million, or 52.0%), New Jersey (\$24.9 million, or 16.7%), Pennsylvania (\$23.6 million, or 4.8%), and Delaware (\$22.6 million, or 42.6%). Leasing, other and overdrafts increased compared to December 31, 2016 as a result of a \$28.3 million increase in the leasing portfolio.

Construction loans include loans to commercial borrowers secured by commercial real estate, loans to commercial borrowers secured by residential real estate, and other construction loans, which represent loans to individuals secured by residential real estate. The following table presents outstanding construction loans and their delinquency rates by these class segments:

September 30, 2017			December 31, 2016		
Balance	Delinquency Rate (1)	% of Total	Balance	Delinquency Rate (1)	% of Total
(dollars in thousands)					

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Commercial	\$751,398	0.1	%	77.3	%	\$644,490	0.2	%	76.4	%
Commercial - residential	156,127	8.1		16.0		142,189	6.0		16.9	
Other	65,583	2.2		6.7		56,970	1.9		6.7	
Total Real estate - construction	\$973,108	1.5	%	100.0	%	\$843,649	1.3	%	100.0	%

(1) Represents all accruing loans 30 days or more past due and non-accrual loans as a percentage of total loans in each class segment.

The Corporation does not have a significant concentration of credit risk with any single borrower, industry or geographical location. Approximately \$7.2 billion, or 46.8%, of the loan portfolio was in commercial mortgage and construction loans as of September 30, 2017. The Corporation's maximum total lending commitment to an individual borrowing relationship was \$50.0 million as of September 30, 2017. In addition to its policy of limiting the maximum total lending commitment to any individual borrowing

relationship to \$50.0 million, the Corporation has established lower total lending limits for certain types of lending commitments, and lower total lending limits based on the Corporation's internal risk rating of an individual borrowing relationship at the time the lending commitment is approved. As of September 30, 2017, the Corporation had 143 individual borrowing relationships with total borrowing commitments between \$20.0 million and \$50.0 million.

The following table summarizes the industry concentrations within the commercial loan portfolio:

	September 30,		December 31,	
	2017		2016	
Services	22.1	%	21.8	%
Retail	15.6		15.1	
Manufacturing	9.9		9.2	
Health care	9.7		10.5	
Construction ⁽¹⁾	8.6		9.0	
Wholesale	6.8		7.0	
Real estate ⁽²⁾	6.4		6.7	
Agriculture	4.9		5.0	
Arts and entertainment	2.5		2.6	
Transportation	2.3		2.3	
Financial services	2.1		2.1	
Other	9.1		8.7	
Total	100.0	%	100.0	%

(1) Includes commercial loans to borrowers engaged in the construction industry.

(2) Includes commercial loans to borrowers engaged in the business of: renting, leasing or managing real estate for others; selling and/or buying real estate for others; and appraising real estate.

Commercial loans and commercial mortgage loans also include shared national credits, which are participations in loans or loan commitments of at least \$20.0 million that are shared by three or more banks. Below is a summary of the Corporation's outstanding purchased shared national credits:

	September 30,		December 31,	
	2017		2016	
	(in thousands)			
Commercial - industrial, financial and agricultural	\$ 161,619		\$ 155,353	
Real estate - commercial mortgage	102,160		81,573	
Total	\$ 263,779		\$ 236,926	

Total shared national credits increased \$26.9 million, or 11.3%, in comparison to December 31, 2016 as a result of both new relationships and growth in existing relationships. The Corporation's shared national credits are to borrowers located in its geographical markets, and are granted subject to the Corporation's standard underwriting policies. None of the shared national credits were past due as of September 30, 2017 or December 31, 2016.

Provision and Allowance for Credit Losses

The Corporation has historically maintained an unallocated allowance for loan losses for factors and conditions that exist at the balance sheet date, but are not specifically identifiable, and to recognize the inherent imprecision in estimating and measuring loss exposure. In 2017, enhancements were made to allow for the impact of these factors and conditions to be quantified in the allowance allocation process. Accordingly, an unallocated allowance for loan losses is no longer necessary.

The following table presents the activity in the allowance for credit losses:

	Three months ended September 30		Nine months ended September 30		
	2017	2016	2017	2016	
Average balance of loans, net of unearned income	\$ 15,392,067	\$ 14,212,250	\$ 15,127,569	\$ 14,011,301	
Balance of allowance for credit losses at beginning of period	\$ 174,998	\$ 165,108	\$ 171,325	\$ 171,412	
Loans charged off:					
Real estate – commercial mortgage	483	1,350	1,949	3,406	
Commercial – industrial, financial and agricultural	2,714	3,144	13,594	13,957	
Real estate – residential mortgage	195	802	535	2,210	
Real estate – home equity	547	709	1,837	3,295	
Real estate – construction	2,744	150	3,765	1,218	
Consumer	373	685	1,659	2,261	
Leasing, other and overdrafts	739	832	2,578	3,226	
Total loans charged off	7,795	7,672	25,917	29,573	
Recoveries of loans previously charged off:					
Real estate – commercial mortgage	106	296	1,490	2,488	
Commercial – industrial, financial and agricultural	665	1,539	6,830	6,789	
Real estate – residential mortgage	219	228	600	784	
Real estate – home equity	252	241	604	929	
Real estate – construction	629	898	1,550	2,844	
Consumer	193	222	899	957	
Leasing, other and overdrafts	407	168	793	357	
Total recoveries	2,471	3,592	12,766	15,148	
Net loans charged off	5,324	4,080	13,151	14,425	
Provision for credit losses	5,075	4,141	16,575	8,182	
Balance of allowance for credit losses at end of period	\$ 174,749	\$ 165,169	\$ 174,749	\$ 165,169	
Net charge-offs to average loans (annualized)	0.14	% 0.11	% 0.12	% 0.14	%

The following table presents the components of the allowance for credit losses:

	September 30, 2017	December 31, 2016
	(dollars in thousands)	
Allowance for loan losses	\$ 172,245	\$ 168,679
Reserve for unfunded lending commitments	2,504	2,646
Allowance for credit losses	\$ 174,749	\$ 171,325

Allowance for credit losses to loans outstanding 1.13 % 1.17 %

The provision for credit losses for the three months ended September 30, 2017 was \$5.1 million, an increase of \$934,000 in comparison to the same period in 2016. For the nine months ended September 30, 2017, the provision for credit losses was \$16.6 million, an increase of \$8.4 million in comparison to the first nine months of 2016. The increases in the provision for credit losses largely reflected growth in the loan portfolio.

Net charge-offs increased \$1.2 million, to \$5.3 million for the third quarter of 2017, compared to \$4.1 million for the third quarter of 2016. This increase resulted from a decrease in recoveries of loans previously charged off. Of the \$5.3 million of net charge-offs recorded in the third quarter of 2017, the majority were for loans originated in Pennsylvania (\$4.4 million), New Jersey (\$638,000) and Maryland (\$406,000), partially offset by net recoveries in Virginia and

Delaware.

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For the first nine months of 2017, net charge-offs decreased \$1.3 million, to \$13.2 million compared to \$14.4 million for the same period of 2016. A \$3.7 million decrease in gross charge-offs was partially offset by a \$2.4 million decrease in recoveries. Of the \$13.2 million of net charge-offs recorded in the first nine months of 2017, the majority were for loans originated in Pennsylvania (\$11.9 million), New Jersey (\$1.2 million) and Maryland (\$349,000), partially offset by net recoveries in Virginia and Delaware.

The following table summarizes non-performing assets as of the indicated dates:

	September 30, 2017	September 30, 2016	December 31, 2016	
	(dollars in thousands)			
Non-accrual loans	\$123,345	\$124,017	\$120,133	
Loans 90 days or more past due and still accruing	13,124	14,095	11,505	
Total non-performing loans	136,469	138,112	131,638	
Other real estate owned (OREO)	10,542	11,981	12,815	
Total non-performing assets	\$147,011	\$150,093	\$144,453	
Non-accrual loans to total loans	0.80	% 0.86	% 0.82	%
Non-performing assets to total assets	0.73	% 0.80	% 0.76	%
Allowance for credit losses to non-performing loans	128.05	% 119.59	% 130.15	%

The following table presents loans whose terms have been modified under troubled debt restructurings ("TDRs"), by type, as of the indicated dates:

	September 30, 2017	September 30, 2016	December 31, 2016
	(in thousands)		
Real-estate - residential mortgage	\$26,193	\$26,854	\$27,617
Real-estate - commercial mortgage	14,439	16,085	15,957
Real estate - home equity	14,789	7,668	8,594
Commercial	7,512	7,488	6,627
Construction	169	843	726
Consumer	33	39	39
Total accruing TDRs	63,135	58,977	59,560
Non-accrual TDRs ⁽¹⁾	28,742	27,904	27,850
Total TDRs	\$91,877	\$86,881	\$87,410

(1) Included with non-accrual loans in the preceding table.

TDRs modified during the first nine months of 2017 and still outstanding as of September 30, 2017 totaled \$16.6 million. During the first nine months of 2017, \$5.4 million of TDRs that were modified in the previous 12 months had a payment default, which the Corporation defines as a single missed scheduled payment, subsequent to modification.

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The following table presents the changes in non-accrual loans for the three and nine months ended September 30, 2017:

	Commercial - Industrial, - Financial and Agricultural (in thousands)	Real Estate Commercial Mortgage	Real Estate Construction	Real Estate - Residential Mortgage	Real Estate - Home Equity	Consumer	Leasing	Total
Three months ended September 30, 2017								
Balance of non-accrual loans at June 30, 2017	\$48,087	\$32,267	\$15,586	\$16,940	\$9,720	\$—	\$—	\$122,600
Additions	16,107	6,281	1,512	1,399	995	373	325	26,992
Payments	(8,774)	(5,974)	(999)	(891)	(483)	—	—	(17,121)
Charge-offs	(2,714)	(483)	(2,744)	(195)	(547)	(373)	(325)	(7,381)
Transfers to OREO	—	(325)	—	(868)	(552)	—	—	(1,745)
Balance of non-accrual loans at September 30, 2017	\$52,706	\$31,766	\$13,355	\$16,385	\$9,133	\$—	\$—	\$123,345
Nine months ended September 30, 2017								
Balance of non-accrual loans at December 31, 2016	\$42,349	\$38,936	\$9,806	\$18,431	\$10,611	\$—	\$—	\$120,133
Additions	40,508	14,055	10,259	2,545	3,694	1,659	1,443	74,163
Payments	(16,554)	(16,955)	(2,796)	(2,141)	(1,141)	—	—	(39,587)
Charge-offs	(13,594)	(1,949)	(3,765)	(535)	(1,837)	(1,659)	(1,443)	(24,782)
Transfers to accrual status	—	(913)	—	(54)	(678)	—	—	(1,645)
Transfers to OREO	(3)	(1,408)	(149)	(1,861)	(1,516)	—	—	(4,937)
Balance of non-accrual loans at September 30, 2017	\$52,706	\$31,766	\$13,355	\$16,385	\$9,133	\$—	\$—	\$123,345

Non-accrual loans increased \$672,000, or 0.5%, and \$3.2 million, or 2.7%, in comparison to September 30, 2016 and December 31, 2016, respectively.

The following table summarizes non-performing loans, by type, as of the indicated dates:

	September 30, 2017	September 30, 2016	December 31, 2016
(in thousands)			
Commercial – industrial, financial and agricultural	\$54,209	\$47,330	\$43,460
Real estate – commercial mortgage	34,650	39,631	39,319
Real estate – residential mortgage	21,643	23,451	23,655
Real estate – construction	13,415	11,223	9,842
Real estate – home equity	12,229	14,260	13,154
Consumer	243	2,166	1,891
Leasing	80	51	317
Total non-performing loans	\$136,469	\$138,112	\$131,638

Non-performing loans decreased \$1.6 million, or 1.2%, and increased \$4.8 million, or 3.7%, in comparison to September 30, 2016 and December 31, 2016, respectively. Non-performing loans to total loans was 0.88% at September 30, 2017 in comparison to 0.96% at September 30, 2016 and 0.90% at December 31, 2016.

The following table summarizes the Corporation's OREO, by property type, as of the indicated dates:

	September 30, 2017	September 30, 2016	December 31, 2016
	(in thousands)		
Residential properties	\$4,223	\$ 6,279	\$ 7,655
Commercial properties	3,709	3,050	2,651
Undeveloped land	2,610	2,652	2,509
Total OREO	\$10,542	\$ 11,981	\$ 12,815

The ability to identify potential problem loans in a timely manner is important to maintaining an adequate allowance for credit losses. For commercial loans, commercial mortgages and construction loans to commercial borrowers, an internal risk rating process is used to monitor credit quality. The evaluation of credit risk for residential mortgages, home equity loans, construction loans to individuals, consumer loans and lease receivables is based on payment history, through the monitoring of delinquency levels and trends. For a description of the Corporation's risk ratings, see Note 5, "Loans and Allowance for Credit Losses," in the Notes to Consolidated Financial Statements.

Total internally risk-rated loans were \$11.4 billion and \$10.9 billion as of September 30, 2017 and December 31, 2016, respectively. The following table presents internal risk ratings for commercial loans, commercial mortgages and construction loans to commercial borrowers with internal risk ratings of Special Mention (considered criticized loans) or Substandard or lower (considered classified loans), by class segment. The shift from special mention to substandard or lower from December 31, 2016 to September 30, 2017 was primarily the result of downgrades of three large relationships to substandard during the first nine months of 2017.

	Special Mention		Increase (Decrease)		Substandard or lower		Increase (Decrease)		Total Criticized and Classified Loans	
	September 30, 2017	December 31, 2016	\$	%	September 30, 2017	December 31, 2016	\$	%	September 30, 2017	December 31, 2016
	(dollars in thousands)									
Real estate - commercial mortgage	\$118,947	\$132,484	\$(13,537)	(10.2)%	\$127,670	\$122,976	\$4,694	3.8	\$246,617	\$255,460
Commercial - secured	98,639	128,873	(30,234)	(23.5)	183,181	118,527	64,654	54.5	281,820	247,400
Commercial - unsecured	3,474	4,481	(1,007)	(22.5)	3,082	3,531	(449)	(12.7)	6,556	8,012
Total Commercial - industrial, financial and agricultural	102,113	133,354	(31,241)	(23.4)	186,263	122,058	64,205	52.6	288,376	255,412
Construction - commercial residential	6,746	15,447	(8,701)	(56.3)	14,595	13,172	1,423	10.8	21,341	28,619
Construction - commercial	4,418	3,412	1,006	29.5	3,869	5,115	(1,246)	(24.4)	8,287	8,527
Total real estate - construction	11,164	18,859	(7,695)	(40.8)	18,464	18,287	177	1.0	29,628	37,146

(excluding
construction
- other)

Total	\$232,224	\$284,697	\$(52,473)	(18.4)%	\$332,397	\$263,321	\$69,076	26.2	%	\$564,621	\$548,01
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% of total
risk-rated
loans

2.0	%	2.6	%	2.9	%	2.4	%	5.0	%	5.0
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The following table summarizes loan delinquency rates, by type, as of the dates indicated:

	September 30, 2017			September 30, 2016			December 31, 2016			
	30-89 Days	≥ 90 Days (1)	Total	30-89 Days	≥ 90 Days (1)	Total	30-89 Days	≥ 90 Days (1)	Total	
Real estate – commercial mortgage	0.20	% 0.55	% 0.75	% 0.18	% 0.69	% 0.87	% 0.13	% 0.65	% 0.78	%
Commercial – industrial, financial and agricultural	0.26	% 1.28	% 1.54	% 0.31	% 1.17	% 1.48	% 0.25	% 1.06	% 1.31	%
Real estate – construction	0.12	% 1.38	% 1.50	% 0.31	% 1.30	% 1.61	% 0.12	% 1.17	% 1.29	%
Real estate – residential mortgage	1.10	% 1.15	% 2.25	% 1.15	% 1.52	% 2.67	% 1.27	% 1.48	% 2.75	%
Real estate – home equity	0.83	% 0.78	% 1.61	% 0.64	% 0.87	% 1.51	% 0.57	% 0.81	% 1.38	%
Consumer, leasing and other	0.69	% 0.06	% 0.75	% 1.18	% 0.44	% 1.62	% 1.23	% 0.42	% 1.65	%
Total	0.40	% 0.88	% 1.28	% 0.42	% 0.96	% 1.38	% 0.38	% 0.89	% 1.27	%
Total dollars (in thousands)	\$62,247	\$136,469	\$198,716	\$59,822	\$138,112	\$197,934	\$55,149	\$131,638	\$186,787	

(1) Includes non-accrual loans.

Management believes that the allowance for credit losses of \$174.7 million as of September 30, 2017 is sufficient to cover incurred losses in the loan and lease portfolio and unfunded lending commitments as of that date and is appropriate based on U.S. GAAP.

Deposits and Borrowings

The following table presents ending deposits, by type, as of the dates indicated:

	September 30, 2017		December 31, 2016		Increase (Decrease)	
	\$	%	\$	%	\$	%
Noninterest-bearing demand	\$4,363,915		\$4,376,137		\$(12,222)	(0.3)%
Interest-bearing demand	4,119,419		3,703,712		415,707	11.2
Savings and money market accounts	4,790,985		4,179,773		611,212	14.6
Total demand and savings	13,274,319		12,259,622		1,014,697	8.3
Brokered deposits	109,936		—		109,936	N/M
Time deposits	2,757,525		2,753,242		4,283	0.2
Total deposits	\$16,141,780		\$15,012,864		\$1,128,916	7.5%

N/M - Not meaningful

Interest-bearing demand accounts increased \$415.7 million, or 11.2%, due to a \$401.4 million, or 30.8%, seasonal increase in municipal account balances and a \$25.3 million, or 7.8%, increase in business accounts, which was partially offset by a \$10.1 million, or 0.5%, decrease in personal account balances.

The \$611.2 million, or 14.6%, increase in savings and money market account balances was primarily due to a \$449.1 million, or 16.0%, increase in personal account balances and an \$83.3 million, or 10.5%, increase in business account balances as a result of certain promotions that occurred during the year. In addition, municipal account balances experienced seasonal increases of \$78.8 million, or 13.7%.

Brokered deposits totaled \$109.9 million as of September 30, 2017. As previously noted, during the third quarter of 2017, the Corporation began accepting deposits pursuant to an agreement with a non-bank third party, which are considered to be brokered deposits.

The following table presents ending short-term borrowings and long-term debt by type, as of the dates indicated:

			Increase (Decrease)	
	September 30, 2017	December 31, 2016	\$	%
(dollars in thousands)				
Short-term borrowings:				
Customer repurchase agreements	\$ 185,945	\$ 195,734	\$(9,789)	(5.0)%
Customer short-term promissory notes	106,994	67,013	39,981	59.7
Total short-term customer funding	292,939	262,747	30,192	11.5
Federal funds purchased	5,812	278,570	(272,758)	(97.9)
Total short-term borrowings	298,751	541,317	(242,566)	(44.8)
Long-term debt:				
FHLB advances	652,145	567,240	84,905	15.0
Other long-term debt	386,014	362,163	23,851	6.6
Total long-term debt	1,038,159	929,403	108,756	11.7
Total borrowings	\$ 1,336,910	\$ 1,470,720	\$(133,810)	(9.1)%

Total borrowings decreased \$133.8 million, or 9.1%, due to a \$242.6 million, or 44.8%, decrease in short-term borrowings, partially offset by an \$108.8 million, or 11.7%, increase in long-term debt. The decrease in short-term borrowings was mainly in federal funds purchased as borrowings were reduced with funding provided by deposit growth. The increase of \$84.9 million, or 15.0%, in long-term FHLB advances provided additional funding to support loan growth. The increase in other long-term debt was primarily the result of the issuance of \$125.0 million of senior notes in March 2017, offset by the repayment of the \$100.0 million of 10-year subordinated notes, which matured on May 1, 2017.

Shareholders' Equity

Total shareholders' equity increased \$104.7 million, or 4.9%, during the first nine months of 2017. The increase was due primarily to \$137.8 million of net income, \$7.0 million of stock issued and a \$14.2 million increase in other comprehensive income, partially offset by \$57.7 million of common stock dividends.

In November 2016, the Corporation's board of directors approved an extension, through December 31, 2017, to a share repurchase program pursuant to which the Corporation is authorized to repurchase up to \$50.0 million of its outstanding shares of common stock, or approximately 2.3% of its outstanding shares. Repurchased shares may be added to treasury stock, at cost. As permitted by securities laws and other legal requirements and subject to market conditions and other factors, purchases may be made from time to time in open market or privately negotiated transactions, including without limitation, through accelerated share repurchase transactions. The share repurchase program may be discontinued at any time. As of September 30, 2017, 1.5 million shares had been repurchased under this program for a total cost of \$18.5 million, or \$12.48 per share. Up to an additional \$31.5 million of the Corporation's common stock may be repurchased under this program through December 31, 2017.

Regulatory Capital

The Corporation and its subsidiary banks are subject to regulatory capital requirements administered by various banking regulators. Failure to meet minimum capital requirements could result in certain actions by regulators that could have a material effect on the Corporation's financial statements. In July 2013, the Federal Reserve Board

approved final rules (the "U.S. Basel III Capital Rules") establishing a new comprehensive capital framework for U.S. banking organizations and implementing the Basel Committee on Banking Supervision's December 2010 framework for strengthening international capital standards. The U.S. Basel III Capital Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions.

The minimum regulatory capital requirements established by the U.S. Basel III Capital Rules became effective for the Corporation on January 1, 2015, and will be fully phased in on January 1, 2019.

The U.S. Basel III Capital Rules require the Corporation and its bank subsidiaries to:

• Meet a minimum Common Equity Tier 1 capital ratio of 4.50% of risk-weighted assets and a Tier 1 capital ratio of 6.00% of risk-weighted assets;

• Continue to require a minimum Total capital ratio of 8.00% of risk-weighted assets and a minimum Tier 1 leverage capital ratio of 4.00% of average assets; and

• Comply with a revised definition of capital to improve the ability of regulatory capital instruments to absorb losses.

• Certain non-qualifying capital instruments, including cumulative preferred stock and trust preferred securities ("TruPS"), have been phased out as a component of Tier 1 capital for institutions of the Corporation's size.

When fully phased in on January 1, 2019, the Corporation and its bank subsidiaries will also be required to maintain a "capital conservation buffer" of 2.50% above the minimum risk-based capital requirements, which must be maintained to avoid restrictions on capital distributions and certain discretionary bonus payments.

The U.S. Basel III Capital Rules use a standardized approach for risk weightings that expands the risk-weightings for assets and off-balance sheet exposures from the previous 0%, 20%, 50% and 100% categories to a much larger and more risk-sensitive number of categories, depending on the nature of the assets and off-balance sheet exposures and resulting in higher risk weights for a variety of asset categories.

As of September 30, 2017, the Corporation and each of its bank subsidiaries met the minimum requirements of the U.S. Basel III Capital Rules, and each of the Corporation's bank subsidiaries' capital ratios exceeded the amounts required to be considered "well capitalized" as defined in the regulations. As of September 30, 2017, the Corporation's capital levels also met the fully-phased in minimum capital requirements, including the capital conservation buffers, as prescribed in the U.S. Basel III Capital Rules.

The following table summarizes the Corporation's capital ratios in comparison to regulatory requirements:

	September 30, 2017		December 31, 2016		Regulatory Minimum for Capital Adequacy		Fully Phased-in, with Capital Conservation Buffers	
Total Capital (to Risk-Weighted Assets)	13.1	%	13.2	%	8.0	%	10.5	%
Tier I Capital (to Risk-Weighted Assets)	10.4	%	10.4	%	6.0	%	8.5	%
Common Equity Tier I (to Risk-Weighted Assets)	10.4	%	10.4	%	4.5	%	7.0	%
Tier I Capital (to Average Assets)	9.0	%	9.0	%	4.0	%	4.0	%

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market risk is the exposure to economic loss that arises from changes in the values of certain financial instruments. The types of market risk exposures generally faced by financial institutions include interest rate risk, equity market price risk, debt security market price risk, foreign currency price risk and commodity price risk. Due to the nature of its operations, foreign currency price risk and commodity price risk are not significant to the Corporation.

Interest Rate Risk, Asset/Liability Management and Liquidity

Interest rate risk creates exposure in two primary areas. First, changes in rates have an impact on the Corporation's liquidity position and could affect its ability to meet obligations and continue to grow. Second, movements in interest rates can create fluctuations in the Corporation's net interest income and changes in the economic value of its equity.

The Corporation employs various management techniques to minimize its exposure to interest rate risk. An Asset/Liability Management Committee ("ALCO") is responsible for reviewing the interest rate sensitivity and liquidity positions of the Corporation, approving asset and liability management policies, and overseeing the formulation and implementation of strategies regarding balance sheet positions.

The Corporation uses two complementary methods to measure and manage interest rate risk. They are simulation of net interest income and estimates of economic value of equity. Using these measurements in tandem provides a reasonably comprehensive summary of the magnitude of the Corporation's interest rate risk, level of risk as time evolves, and exposure to changes in interest rates.

Simulation of net interest income is performed for the next 12-month period. A variety of interest rate scenarios are used to measure the effects of sudden and gradual movements upward and downward in the yield curve. These results are compared to the results obtained in a flat or unchanged interest rate scenario. Simulation of net interest income is used primarily to measure the Corporation's short-term earnings exposure to rate movements. The Corporation's policy limits the potential exposure of net interest income, in a non-parallel instantaneous shock, to 10% of the base case net interest income for a 100 basis point shock in interest rates, 15% for a 200 basis point shock and 20% for a 300 basis point shock. A "shock" is an immediate upward or downward movement of interest rates. The shocks do not take into account changes in customer behavior that could result in changes to mix and/or volumes in the balance sheet, nor do they take into account the potential effects of competition on the pricing of deposits and loans over the forward 12-month period.

Contractual maturities and repricing opportunities of loans are incorporated in the simulation model as are prepayment assumptions, maturity data and call options in the investment portfolio. Assumptions based on past experience are incorporated into the model for non-maturity deposit accounts. The assumptions used are inherently uncertain and, as a result, the model cannot precisely measure future net interest income or precisely predict the impact of fluctuations in market interest rates on net interest income. Actual results will differ from the model's simulated results due to timing, amount and frequency of interest rate changes as well as changes in market conditions and the application and timing of various management strategies.

The following table summarizes the expected impact of abrupt interest rate changes on net interest income as of September 30, 2017 (due to the current level of interest rates, the 200 and 300 basis point downward shock scenarios are not shown):

Rate Shock (1)	Annual change in net interest income	% Change in net interest income
+300 bp	+ \$93.9 million	15.5%
+200 bp	+ \$64.5 million	10.6%

+100 bp	+ \$32.9 million	5.4%
-100 bp	- \$49.0 million	- 8.1%

(1) These results include the effect of implicit and explicit interest rate floors that limit further reduction in interest rates.

Economic value of equity estimates the discounted present value of asset and liability cash flows. Discount rates are based upon market prices for like assets and liabilities. Abrupt changes or "shocks" in interest rates, both upward and downward, are used to determine the comparative effect of such interest rate movements relative to the unchanged environment. This measurement tool is used primarily to evaluate the longer-term repricing risks and options in the Corporation's balance sheet. The Corporation's policy limits the economic value of equity that may be at risk, in a non-parallel instantaneous shock, to 10% of the base case economic value of equity for a 100 basis point shock in interest rates, 20% for a 200 basis point shock and 30% for a 300 basis

point shock. As of September 30, 2017, the Corporation was within economic value of equity policy limits for every 100 basis point shock.

Interest Rate Swaps

The Corporation enters into interest rate swaps with certain qualifying commercial loan customers to meet their interest rate risk management needs. The Corporation simultaneously enters into interest rate swaps with dealer counterparties, with identical notional amounts and terms. The net result of these interest rate swaps is that the customer pays a fixed rate of interest and the Corporation receives a floating rate. These interest rate swaps are derivative financial instruments that are recorded at their fair value in other assets and liabilities on the consolidated balance sheets. Changes in fair value during the period are recorded in other non-interest expense on the consolidated statements of income.

Liquidity

The Corporation must maintain a sufficient level of liquid assets to meet the cash needs of its customers, who, as depositors, may want to withdraw funds or who, as borrowers, need credit availability. Liquidity is provided on a continuous basis through scheduled and unscheduled principal and interest payments on investments and outstanding loans and through the availability of deposits and borrowings. The Corporation also maintains secondary sources that provide liquidity on a secured and unsecured basis to meet short-term and long-term needs.

The Corporation maintains liquidity sources in the form of demand and savings deposits, brokered deposits, time deposits, repurchase agreements and short-term promissory notes. The Corporation can access additional liquidity from these sources, if necessary, by increasing the rates of interest paid on those accounts and borrowings. The positive impact to liquidity resulting from paying higher interest rates could have a detrimental impact on the net interest margin and net income if rates on interest-earning assets do not experience a proportionate increase. Borrowing availability with the FHLB and the Federal Reserve Bank, along with federal funds lines at various correspondent banks, provides the Corporation with additional liquidity.

Each of the Corporation's subsidiary banks is a member of the FHLB and has access to FHLB overnight and term credit facilities. As of September 30, 2017, the Corporation had \$652.1 million of advances outstanding from the FHLB with an additional borrowing capacity of approximately \$3.2 billion under these facilities. Advances from the FHLB are secured by qualifying commercial real estate and residential mortgage loans, investments and other assets.

As of September 30, 2017, the Corporation had aggregate availability under federal funds lines of \$1.1 billion with \$5.8 million borrowed against that amount. A combination of commercial real estate loans, commercial loans and securities are pledged to the Federal Reserve Bank of Philadelphia to provide access to Federal Reserve Bank Discount Window borrowings. As of September 30, 2017, the Corporation had \$908.5 million of collateralized borrowing availability at the Discount Window, and no outstanding borrowings.

Liquidity must also be managed at the Fulton Financial Corporation parent company level. For safety and soundness reasons, banking regulations limit the amount of cash that can be transferred from subsidiary banks to the parent company in the form of loans and dividends. Generally, these limitations are based on the subsidiary banks' regulatory capital levels and their net income. Management continues to monitor the liquidity and capital needs of the parent company and will implement appropriate strategies, as necessary, to remain adequately capitalized and to meet its cash needs.

The Corporation's sources and uses of funds were discussed in general terms in the "Net Interest Income" section of Management's Discussion and Analysis. The consolidated statements of cash flows provide additional information.

The Corporation's operating activities during the first nine months of 2017 generated \$194.4 million of cash, mainly due to net income. Cash used in investing activities was \$1.2 billion, mainly due to net increases in loans and short-term investments. Net cash provided by financing activities was \$945.7 million due mainly to increases in deposits, long-term debt and short-term borrowings.

Equity Market Price Risk

Equity market price risk is the risk that changes in the values of equity investments could have a material impact on the financial position or results of operations of the Corporation. As of September 30, 2017, equity investments consisted of \$12.1 million of common stocks of publicly traded financial institutions and \$1.0 million of other equity investments.

The equity investments most susceptible to equity market price risk are the financial institutions stocks, which had a cost basis of approximately \$5.8 million and an estimated fair value of \$12.1 million at September 30, 2017, including an investment in a single financial institution with a cost basis of \$4.2 million and an estimated fair value of \$8.8 million. The fair value of this investment

accounted for 73.4% of the fair value of the common stocks of publicly traded financial institutions. No other investment in a single financial institution in the financial institutions stock portfolio exceeded 10% of the portfolio's fair value. In total, net unrealized gains in this portfolio were approximately \$6.3 million as of September 30, 2017.

Management continuously monitors the fair value of its equity investments and evaluates current market conditions and operating results of the issuers. Periodic sale and purchase decisions are made based on this monitoring process. None of the Corporation's equity securities are classified as trading.

In addition to its equity portfolio, investment management and trust services income may be impacted by fluctuations in the equity markets. A portion of this revenue is based on the value of the underlying investment portfolios, many of which include equity investments. If the values of those investment portfolios decrease, whether due to factors influencing U.S. or international securities markets in general or otherwise, the Corporation's revenue would be negatively impacted. In addition, the Corporation's ability to sell its brokerage services in the future will be dependent, in part, upon consumers' level of confidence in financial markets.

Debt Security Market Price Risk

Debt security market price risk is the risk that changes in the values of debt securities, unrelated to interest rate changes, could have a material impact on the financial position or results of operations of the Corporation. The Corporation's debt security investments consist primarily of U.S. government sponsored agency issued mortgage-backed securities and collateralized mortgage obligations, state and municipal securities, U.S. government debt securities, auction rate securities and corporate debt securities. All of the Corporation's investments in commercial and residential mortgage-backed securities and collateralized mortgage obligations have principal payments that are guaranteed by U.S. government sponsored agencies.

State and Municipal Securities

As of September 30, 2017, the Corporation owned \$413.9 million of municipal securities issued by various states or municipalities. Downward pressure on local tax revenues of issuers could have an adverse impact on the underlying credit quality of issuers. The Corporation evaluates existing and potential holdings primarily based on the creditworthiness of the issuing state or municipality and then, to a lesser extent, on any underlying credit enhancement. State or municipal securities can be supported by the general obligation of the issuing state or municipality, allowing the securities to be repaid by any means available to the issuing municipality. As of September 30, 2017, approximately 98% of state or municipal securities were supported by the general obligation of corresponding states or municipalities. Approximately 60% of these securities were school district issuances, which are also supported by the states of the issuing municipalities.

Auction Rate Securities

As of September 30, 2017, the Corporation's investments in auction rate certificates ("ARCs"), a type of auction rate security, had a cost basis of \$107.4 million and a fair value of \$98.2 million.

As of September 30, 2017, the fair values of the ARCs currently in the portfolio were derived using significant unobservable inputs based on an expected cash flows model which produced fair values that were materially different from those that would be expected from settlement of these investments in the current market. The expected cash flows model produced fair values which assumed a return to market liquidity sometime in the next five years. The Corporation believes that the trusts underlying the ARCs will self-liquidate as student loans are repaid.

The credit quality of the underlying debt associated with the ARCs is also a factor in the determination of their estimated fair value. As of September 30, 2017, all of the ARCs were rated above investment grade. All of the loans underlying the ARCs have principal payments that are guaranteed by the federal government. At September 30, 2017, all ARCs were current and making scheduled interest payments.

Corporate Debt Securities

The Corporation holds corporate debt securities in the form of pooled trust preferred securities, single-issuer trust preferred securities, subordinated debt and senior debt issued by financial institutions. As of September 30, 2017, these securities had an amortized cost of \$92.4 million and an estimated fair value of \$93.0 million.

See "Note 4 - Investment Securities," in the Notes to Consolidated Financial Statements for further discussion related to the Corporation's other-than-temporary impairment evaluations for debt securities, and see "Note 11 - Fair Value Measurements," in the Notes to Consolidated Financial Statements for further discussion related to the fair values of debt securities.

Item 4. Controls and Procedures

The Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Corporation's disclosure controls and procedures pursuant to Rule 13a-15, promulgated under the Securities Exchange Act of 1934 (the "Exchange Act"). Based upon that evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this quarterly report, the Corporation's disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in Corporation reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

There have been no changes in the Corporation's internal control over financial reporting during the fiscal quarter covered by this quarterly report that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

The information presented in the "Legal Proceedings" section of Note 10 "Commitment and Contingencies" of the Notes to Consolidated Financial Statements is incorporated herein by reference.

Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in Part I, Item 1A of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2016.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) None.

(b) None.

(c) There were no purchases of equity securities by the issuer or any affiliated purchasers during the three months ended September 30, 2017.

Item 6. Exhibits

3.1 Articles of Incorporation, as amended and restated, of Fulton Financial Corporation– Incorporated by reference to Exhibit 3.1 of the Fulton Financial Corporation Current Report on Form 8-K dated June 24, 2011. (File No. 0-10587)

3.2 Bylaws of Fulton Financial Corporation as amended – Incorporated by reference to Exhibit 3.1 of the Fulton Financial Corporation Current Report on an Amended Form 8-K dated September 23, 2014.

31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101 Financial statements from the Quarterly Report on Form 10-Q of Fulton Financial Corporation for the period ended September 30, 2017, filed on November 3, 2017, formatted in XBRL: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Shareholders' Equity, (v) the Consolidated Statements of Cash Flows and (vi) the Notes to Consolidated Financial Statements - filed herewith.

FULTON FINANCIAL CORPORATION AND SUBSIDIARIES
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.

FULTON FINANCIAL
CORPORATION

Date: November 3, 2017 /s/ E. Philip Wenger
E. Philip Wenger
Chairman, Chief Executive Officer and President

Date: November 3, 2017 /s/ Philmer H. Rohrbaugh
Philmer H. Rohrbaugh
Senior Executive Vice President, Chief Operating Officer
and Chief Financial Officer