AVALONBAY COMMUNITIES INC
Form 10-Q
August 05, 2016
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2016

Commission file number 1-12672

AVALONBAY COMMUNITIES, INC.
(Exact name of registrant as specified in its charter)

Maryland	77-0404318
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

Ballston Tower
671 N. Glebe Rd, Suite 800
Arlington, Virginia 22203
(Address of principal executive offices, including zip code)

(703) 329-6300
(Registrant's telephone number, including area code)

(Former name, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 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 ý No o

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date:

137,313,555 shares of common stock, par value $0.01 per share, were outstanding as of July 29, 2016.

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AVALONBAY COMMUNITIES, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except per share data)

	6/30/2016 (unaudited)	12/31/2015
ASSETS		
Real estate:		
Land and improvements	$3,793,026	$3,636,761
Buildings and improvements	13,636,933	13,056,292
Furniture, fixtures and equipment	492,284	458,224
	17,922,243	17,151,277
Less accumulated depreciation	(3,540,481)	(3,303,751)
Net operating real estate	14,381,762	13,847,526
Construction in progress, including land	1,538,641	1,592,917
Land held for development	511,797	484,377
Real estate assets held for sale, net	65,894	17,489
Total real estate, net	16,498,094	15,942,309
Cash and cash equivalents	182,306	400,507
Cash in escrow	105,385	104,821
Resident security deposits	33,624	30,077
Investments in unconsolidated real estate entities	325,614	216,919
Deferred development costs	40,627	37,577
Prepaid expenses and other assets	209,417	199,095
Total assets	$17,395,067	$16,931,305
LIABILITIES AND EQUITY		
Unsecured notes, net	$4,319,165	$3,845,674
Variable rate unsecured credit facility	—	—
Mortgage notes payable	2,514,826	2,611,274
Dividends payable	185,369	171,257
Payables for construction	100,876	98,802
Accrued expenses and other liabilities	306,306	260,005
Accrued interest payable	42,395	40,085
Resident security deposits	58,093	53,132
Liabilities related to real estate assets held for sale	1,549	553
Total liabilities	7,528,579	7,080,782
Commitments and contingencies		
Redeemable noncontrolling interests	9,969	9,997
Equity:		
Preferred stock, $0.01 par value; $25 liquidation preference; 50,000,000 shares authorized at June 30, 2016 and December 31, 2015; zero shares issued and outstanding at June 30, 2016 and December 31, 2015	—	—
	1,373	1,370

Common stock, $0.01 par value; 280,000,000 shares authorized at June 30, 2016 and December 31, 2015; 137,312,534 and 137,002,031 shares issued and outstanding at June 30, 2016 and December 31, 2015, respectively		
Additional paid-in capital	10,092,951	10,068,532
Accumulated earnings less dividends	(134,808)	(197,989)
Accumulated other comprehensive loss	(102,997)	(31,387)
Total equity	9,856,519	9,840,526
Total liabilities and equity	$17,395,067	$16,931,305

See accompanying notes to Condensed Consolidated Financial Statements.

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AVALONBAY COMMUNITIES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(unaudited)
(Dollars in thousands, except per share data)

	For the three months ended		For the six months ended	
	6/30/2016	6/30/2015	6/30/2016	6/30/2015
Revenue:				
Rental and other income	$500,840	$454,517	$1,007,814	$894,273
Management, development and other fees	1,467	2,942	2,990	5,553
Total revenue	502,307	457,459	1,010,804	899,826
Expenses:				
Operating expenses, excluding property taxes	118,903	112,069	235,530	224,845
Property taxes	51,107	45,913	101,174	93,089
Interest expense, net	46,581	44,590	89,991	90,164
Loss (gain) on extinguishment of debt, net	2,461	(7,749)	2,461	(7,749)
Depreciation expense	132,469	118,627	259,685	235,480
General and administrative expense	12,011	10,335	23,414	20,803
Expensed acquisition, development and other pursuit costs, net of recoveries	1,436	673	4,897	1,860
Casualty and impairment (gain) loss, net	(1,732)	(17,114)	(3,935)	(11,326)
Total expenses	363,236	307,344	713,217	647,166
Equity in income of unconsolidated real estate entities	27,151	13,806	55,120	48,371
Gain on sale of communities	30,990	—	82,420	70,936
Gain on sale of other real estate	143	9,625	143	9,647
Income before taxes	197,355	173,546	435,270	381,614
Income tax expense	36	1,293	73	1,308
Net income	197,319	172,253	435,197	380,306
Net loss attributable to noncontrolling interests	125	71	180	163
Net income attributable to common stockholders	$197,444	$172,324	$435,377	$380,469
Other comprehensive income (loss):				
Loss on cash flow hedges	(26,788)	(6)	(74,545)	(36)
Cash flow hedge losses reclassified to earnings	1,561	1,433	2,935	3,028
Comprehensive income	$172,217	$173,751	$363,767	$383,461
Earnings per common share - basic:				
Net income attributable to common stockholders	$1.44	$1.30	$3.17	$2.88
Earnings per common share - diluted:				
Net income attributable to common stockholders	$1.44	$1.29	$3.17	$2.86
Dividends per common share	$1.35	$1.25	$2.70	$2.50

See accompanying notes to Condensed Consolidated Financial Statements.

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AVALONBAY COMMUNITIES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)
(Dollars in thousands)

	For the six months ended	
	6/30/2016	6/30/2015
Cash flows from operating activities:		
Net income	$435,197	$380,306
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation expense	259,685	235,480
Amortization of deferred financing costs	3,827	3,379
Amortization of debt premium	(9,436)	(14,815)
Loss (gain) on extinguishment of debt, net	2,461	(7,749)
Amortization of stock-based compensation	8,482	8,255
Equity in loss of, and return on, unconsolidated entities and noncontrolling interests, net of eliminations	7,255	8,432
Casualty and impairment (gain) loss, net	(3,935)	(17,303)
Cash flow hedge losses reclassified to earnings	2,935	2,992
Gain on sale of real estate assets	(135,735)	(91,456)
Increase in cash in operating escrows	(2,221)	(9,357)
Increase in resident security deposits, prepaid expenses and other assets	(9,936)	(3,439)
Decrease in accrued expenses, other liabilities and accrued interest payable	(13,060)	(2,823)
Net cash provided by operating activities	545,519	491,902
Cash flows from investing activities:		
Development/redevelopment of real estate assets including land acquisitions and deferred development costs	(587,287)	(865,497)
Acquisition of real estate assets, including partnership interest	(170,022)	—
Capital expenditures - existing real estate assets	(24,696)	(50,584)
Capital expenditures - non-real estate assets	(3,919)	(1,432)
Proceeds from sale of real estate, net of selling costs	116,941	135,841
Insurance proceeds for property damage claims	17,196	44,142
Increase in payables for construction	2,074	7,126
Distributions from unconsolidated real estate entities	58,870	36,858
Investments in unconsolidated real estate entities	(121,648)	(803)
Net cash used in investing activities	(712,491)	(694,349)
Cash flows from financing activities:		
Issuance of common stock, net	12,804	97,326
Dividends paid	(356,235)	(318,240)
Repayments of mortgage notes payable, including prepayment penalties	(157,552)	(588,226)
Issuance of unsecured notes	474,838	574,066
Payment of deferred financing costs	(10,014)	(4,277)
Payment for termination of forward interest rate swaps	(14,847)	—
Distributions to DownREIT partnership unitholders	(20)	(19)
Distributions to joint venture and profit-sharing partners	(203)	(187)
Redemption of preferred interest obligation	—	(2,330)
Net cash used in financing activities	(51,229)	(241,887)

Net decrease in cash and cash equivalents	(218,201)	(444,334)
Cash and cash equivalents, beginning of period	400,507	509,460
Cash and cash equivalents, end of period	$182,306	$65,126
Cash paid during the period for interest, net of amount capitalized	$90,355	$91,572

See accompanying notes to Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)

Supplemental disclosures of non-cash investing and financing activities:

During the six months ended June 30, 2016:

- As described in Note 4, “Equity,” 196,059 shares of common stock were issued as part of the Company's stock based compensation plans, of which 115,618 shares related to the conversion of performance awards to restricted shares, and the remaining 80,441 shares valued at $13,049,000 were issued in connection with new stock grants; 44,327 shares valued at $3,894,000 were issued in conjunction with the conversion of deferred stock awards; 1,041 shares valued at $186,000 were issued through the Company’s dividend reinvestment plan; 53,011 shares valued at $8,280,000 were withheld to satisfy employees’ tax withholding and other liabilities; and 2,243 restricted shares as well as performance awards with an aggregate value of $360,000 previously issued in connection with employee compensation were canceled upon forfeiture.

- Common stock dividends declared but not paid totaled $185,369,000.

- The Company recorded an increase of $375,000 in redeemable noncontrolling interest with a corresponding decrease to accumulated earnings less dividends to adjust the redemption value associated with the put options held by joint venture partners and DownREIT partnership units. For further discussion of the nature and valuation of these items, see Note 10, “Fair Value.”

- The Company recorded a decrease in prepaid expenses and other assets of $2,689,000 and an increase in accrued expenses and other liabilities of $54,311,000, and a corresponding loss to other comprehensive income of $57,000,000, and reclassified $2,935,000 of cash flow hedge losses from other comprehensive income to interest expense, net, to record the impact of the Company’s derivative and hedge accounting activity.

- The Company assumed fixed rate indebtedness with a principal amount of $67,904,000 in conjunction with the acquisition of Avalon Hoboken.

During the six months ended June 30, 2015:

- The Company issued 157,779 shares of common stock as part of the Company's stock based compensation plans, of which 95,826 shares related to the conversion of performance awards to restricted shares, and the remaining 61,953 shares valued at $10,721,000 were issued in connection with new stock grants; 46,589 shares valued at $3,552,000 were issued in conjunction with the conversion of deferred stock awards; 1,028 shares valued at $177,000 were issued through the Company’s dividend reinvestment plan; 36,104 shares valued at $5,793,000 were withheld to satisfy employees’ tax withholding and other liabilities; and 2,011 restricted stock units with a value of $226,000 previously issued in connection with employee compensation were canceled upon forfeiture.

- Common stock dividends declared but not paid totaled $166,113,000.

- The Company recorded a decrease of $1,807,000 in redeemable noncontrolling interest with a corresponding increase to accumulated earnings less dividends to adjust the redemption value associated with the put options held by joint venture partners and DownREIT partnership units.

- The Company recorded a decrease in prepaid expenses and other assets and a corresponding loss to other comprehensive income of $36,000, and reclassified $3,028,000 of cash flow hedge losses from other comprehensive income to interest expense, net, to record the impact of the Company’s derivative and hedge accounting activity.

- The Company recognized a charge of $26,039,000 to write off the net book value of the fixed assets destroyed by the fire that occurred in 2015 at Avalon at Edgewater ("Edgewater") and winter storm damage.

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AVALONBAY COMMUNITIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)
1. Organization, Basis of Presentation and Significant Accounting Policies

Organization and Basis of Presentation

AvalonBay Communities, Inc. (the “Company,” which term, unless the context otherwise requires, refers to AvalonBay Communities, Inc. together with its subsidiaries), is a Maryland corporation that has elected to be treated as a real estate investment trust (“REIT”) for federal income tax purposes under the Internal Revenue Code of 1986 (the “Code”). The Company focuses on the development, redevelopment, acquisition, ownership and operation of multifamily communities primarily in New England, the New York/New Jersey metro area, the Mid-Atlantic, the Pacific Northwest, and Northern and Southern California.

At June 30, 2016, the Company owned or held a direct or indirect ownership interest in 260 operating apartment communities containing 75,504 apartment homes in 10 states and the District of Columbia, of which seven communities containing 2,917 apartment homes were under reconstruction. In addition, the Company owned or held a direct or indirect interest in 23 communities under construction that are expected to contain an aggregate of 7,480 apartment homes when completed. The Company also owned or held a direct or indirect ownership interest in land or rights to land on which the Company expects to develop an additional 30 communities that, if developed as expected, will contain an estimated 10,452 apartment homes.

The interim unaudited financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information and in conjunction with the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements required by GAAP have been condensed or omitted pursuant to such rules and regulations. These unaudited financial statements should be read in conjunction with the financial statements and notes included in the Company’s 2015 Annual Report on Form 10-K. The results of operations for the three and six months ended June 30, 2016 are not necessarily indicative of the operating results for the full year. Management believes the disclosures are adequate to ensure the information presented is not misleading. In the opinion of management, all adjustments and eliminations, consisting only of normal, recurring adjustments necessary for a fair presentation of the financial statements for the interim periods, have been included.

Capitalized terms used without definition have meanings provided elsewhere in this Form 10-Q.

Earnings per Common Share

Basic earnings per share is computed by dividing net income attributable to common stockholders by the weighted average number of shares outstanding during the period. All outstanding unvested restricted share awards contain rights to non-forfeitable dividends and participate in undistributed earnings with common shareholders and, accordingly, are considered participating securities that are included in the two-class method of computing basic earnings per share (“EPS”). Both the unvested restricted shares and other potentially dilutive common shares, and the related impact to earnings, are considered when calculating earnings per share on a diluted basis. The Company’s earnings per common share are determined as follows (dollars in thousands, except per share data):

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	For the three months ended		For the six months ended	
	6/30/2016	6/30/2015	6/30/2016	6/30/2015
Basic and diluted shares outstanding				
Weighted average common shares - basic	136,918,770	131,977,578	136,852,323	131,930,916
Weighted average DownREIT units outstanding	7,500	7,500	7,500	7,500
Effect of dilutive securities	511,463	1,101,361	550,564	1,192,947
Weighted average common shares - diluted	137,437,733	133,086,439	137,410,387	133,131,363
Calculation of Earnings per Share - basic				
Net income attributable to common stockholders	$ 197,444	$ 172,324	$ 435,377	$ 380,469
Net income allocated to unvested restricted shares	(516)	(445)	(1,147)	(975)
Net income attributable to common stockholders, adjusted	$ 196,928	$ 171,879	$ 434,230	$ 379,494
Weighted average common shares - basic	136,918,770	131,977,578	136,852,323	131,930,916
Earnings per common share - basic	$ 1.44	$ 1.30	$ 3.17	$ 2.88
Calculation of Earnings per Share - diluted				
Net income attributable to common stockholders	$ 197,444	$ 172,324	$ 435,377	$ 380,469
Add: noncontrolling interests of DownREIT unitholders in consolidated partnerships, including discontinued operations	10	9	20	19
Adjusted net income available to common stockholders	$ 197,454	$ 172,333	$ 435,397	$ 380,488
Weighted average common shares - diluted	137,437,733	133,086,439	137,410,387	133,131,363
Earnings per common share - diluted	$ 1.44	$ 1.29	$ 3.17	$ 2.86

All options to purchase shares of common stock outstanding as of June 30, 2016 and 2015 are included in the computation of diluted earnings per share.

The Company is required to estimate the forfeiture of stock options and recognize compensation cost net of the estimated forfeitures. The estimated forfeitures included in compensation cost are adjusted to reflect actual forfeitures at the end of the vesting period. The forfeiture rate at June 30, 2016 was 0.8% and is based on the average forfeiture activity over a period equal to the estimated life of the stock options. The application of estimated forfeitures did not materially impact compensation expense for the three and six months ended June 30, 2016 or 2015.

Derivative Instruments and Hedging Activities

The Company enters into interest rate swap and interest rate cap agreements (collectively, “Hedging Derivatives”) for interest rate risk management purposes and in conjunction with certain variable rate secured debt to satisfy lender requirements. The Company does not enter into Hedging Derivative transactions for trading or other speculative purposes. The Company assesses the effectiveness of qualifying cash flow and fair value hedges, both at inception and on an on-going basis. Hedge ineffectiveness is reported as a component of general and administrative expenses. The fair values of Hedging Derivatives that are in an asset position are recorded in prepaid expenses and other assets. The fair value of Hedging Derivatives that are in a liability position are included in accrued expenses and other liabilities. Fair value changes for derivatives that are not in qualifying hedge relationships are reported as a component of interest expense, net. For the Hedging Derivative positions that the Company has determined qualify as effective cash flow hedges, the Company has recorded the effective portion of cumulative changes in the fair value of Hedging Derivatives in other comprehensive income (loss). Amounts recorded in other comprehensive income (loss) will be reclassified into earnings in the periods in which earnings are affected by the hedged cash flow. The effective portion of the change in fair value of the Hedging Derivatives that the Company has determined qualified as effective fair value hedges is reported as an adjustment to the carrying amount of the corresponding debt being hedged. See Note 10, "Fair Value," for further discussion of derivative financial instruments.

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Legal and Other Contingencies

In January 2015, a fire occurred at the Company's Avalon at Edgewater apartment community located in Edgewater, New Jersey. Edgewater consisted of two residential buildings. One building, containing 240 apartment homes, was destroyed. The second building, containing 168 apartment homes, suffered minimal damage and has been repaired.

The Company is aware that third parties incurred significant property damage and are claiming other losses, such as relocation costs, as a result of the fire. The Company has established protocols for processing claims and has encouraged any party who sustained a loss to contact the Company's insurance carrier to file a claim.

Three class action lawsuits have been filed against the Company on behalf of occupants of the destroyed building and consolidated in the United States District Court for the District of New Jersey. The Company has agreed with class counsel to the terms of a proposed settlement which would provide a claims process (with agreed upon protocols for instructing the adjuster as to how to evaluate claims) and, if needed, an arbitration process to determine damage amounts to be paid to individual claimants covered by the class settlement. On July 8, 2016, class counsel filed with the court a motion for preliminary approval of this class settlement, and the Company did not oppose such motion. However, the Company cannot predict when or if the court will approve the settlement. A fourth class action, being heard in the same federal court, was filed against the Company on behalf of residents of the second Edgewater building that suffered minimal damage. In addition to the class action lawsuits described above, 20 lawsuits representing approximately 141 individual plaintiffs have been filed in the Superior Court of New Jersey Bergen County - Law Division and 19 of these lawsuits are currently pending. Most of these state court cases have been consolidated by the court and the Company expects all of them to be consolidated shortly. The Company believes that it has meritorious defenses to the extent of damages claimed in all of the suits.

Having incurred applicable deductibles, the Company currently believes that all of its remaining liability to third parties (including any liability to third parties determined in accordance with the class settlement described above, if approved) will be substantially covered by its insurance policies. However, the Company can give no assurances in this regard and continues to evaluate this matter. See Note 5, "Investments in Real Estate Entities," and Part II, Item 1, "Legal Proceedings," for further discussion of the casualty gains and losses and lawsuits associated with the Edgewater casualty loss.

The Company is involved in various other claims and/or administrative proceedings unrelated to the Edgewater casualty loss that arise in the ordinary course of its business. While no assurances can be given, the Company does not currently believe that any of these other outstanding litigation matters, individually or in the aggregate, will have a material adverse effect on its financial condition or results of operations.

Acquisitions of Investments in Real Estate

The Company accounts for acquisitions of investments in real estate in accordance with the authoritative guidance for the initial measurement, which requires the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree to be recognized at fair value. Typical assets and liabilities acquired include land, building, furniture, fixtures, and equipment, and identified intangible assets and liabilities, consisting of the value of above or below market leases and in-place leases. In making estimates of fair values for purposes of allocating purchase price, the Company utilizes various sources, including its own analysis of recently acquired and existing comparable properties in its portfolio and other market data.

Use of Estimates

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

Reclassifications

Certain reclassifications have been made to amounts in prior years' notes to financial statements to conform to current year presentations as a result of changes in held for sale classification and disposition activity.

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Recently Issued Accounting Standards

In March 2016, the FASB issued ASU 2016-09, Compensation-Stock Compensation: Improvements to Employee Share-Based Payment Accounting, which simplifies several aspects of share-based payment transactions, including income tax consequences, classification of awards as equity or liability, statement of cash flows classification and policy election options for forfeitures. The new standard requires either a prospective, retrospective or modified retrospective approach depending on the amendment type. The guidance will be effective in the first quarter of 2017 and allows for early adoption. The Company is assessing whether the new standard will have a material effect on its financial position or results of operations.

2. Interest Capitalized

The Company capitalizes interest during the development and redevelopment of real estate assets. Capitalized interest associated with the Company's development or redevelopment activities totaled $20,024,000 and $19,800,000 for the three months ended June 30, 2016 and 2015, respectively, and $40,633,000 and $38,830,000 for the six months ended June 30, 2016 and 2015, respectively.

3. Mortgage Notes Payable, Unsecured Notes and Credit Facility

The Company's mortgage notes payable, unsecured notes, variable rate unsecured term loan (the "Term Loan") and Credit Facility, as defined below, as of June 30, 2016 and December 31, 2015 are summarized below (dollars in thousands). The following amounts and discussion do not include the mortgage notes related to the communities classified as held for sale, if any, as of June 30, 2016 and December 31, 2015, as shown in the accompanying Condensed Consolidated Balance Sheets (dollars in thousands) (see Note 6, "Real Estate Disposition Activities").

6/30/2016	12/31/2015