

AVALONBAY COMMUNITIES INC

Form 10-Q

November 04, 2010

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 September 30, 2010

Commission file number 1-12672

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

Maryland
(State or other jurisdiction of
incorporation or organization)

77-0404318
(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 No

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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 No

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes No

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:

85,284,504 shares of common stock, par value \$0.01 per share, were outstanding as of October 31, 2010

AVALONBAY COMMUNITIES, INC.
FORM 10-Q
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AVALONBAY COMMUNITIES, INC.
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (Dollars in thousands, except per share data)

| | 9-30-10 | 12-31-09 |
|---|-------------|-------------|
| | (unaudited) | |
| ASSETS | | |
| Real estate: | | |
| Land | \$1,330,289 | \$1,249,236 |
| Buildings and improvements | 6,409,618 | 5,980,423 |
| Furniture, fixtures and equipment | 197,586 | 185,395 |
| | 7,937,493 | 7,415,054 |
| Less accumulated depreciation | (1,650,905) | (1,474,147) |
| Net operating real estate | 6,286,588 | 5,940,907 |
| Construction in progress, including land | 402,721 | 531,299 |
| Land held for development | 228,496 | 237,095 |
| Operating real estate assets held for sale, net | 6,265 | 124,186 |
| Total real estate, net | 6,924,070 | 6,833,487 |
| Cash and cash equivalents | 229,111 | 105,691 |
| Cash in escrow | 178,030 | 210,676 |
| Resident security deposits | 22,605 | 23,646 |
| Investments in unconsolidated real estate entities | 93,770 | 74,570 |
| Deferred financing costs, net | 32,006 | 34,531 |
| Deferred development costs | 81,124 | 87,763 |
| Prepaid expenses and other assets | 113,686 | 87,241 |
| Total assets | \$7,674,402 | \$7,457,605 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Unsecured notes, net | \$1,660,480 | \$1,658,029 |
| Mortgage notes payable | 2,287,410 | 2,316,843 |
| Dividends payable | 76,127 | 72,773 |
| Payables for construction | 37,706 | 49,623 |
| Accrued expenses and other liabilities | 241,875 | 232,964 |
| Accrued interest payable | 22,377 | 35,069 |
| Resident security deposits | 33,966 | 33,646 |
| Liabilities related to real estate assets held for sale | -- | 2,734 |
| Total liabilities | 4,359,941 | 4,401,681 |
| Redeemable noncontrolling interests | 10,630 | 5,797 |
| Stockholders' equity: | | |
| Common stock, \$0.01 par value; 140,000,000 shares authorized at both September 30, 2010 and December 31, 2009; 85,284,865 and 81,528,957 shares issued and outstanding at September 30, 2010 and December 31, 2009, respectively | 853 | 815 |
| Noncontrolling interest | 4,812 | -- |
| Additional paid-in capital | 3,532,451 | 3,200,367 |
| Accumulated earnings less dividends | (232,770) | (149,988) |
| Accumulated other comprehensive loss | (1,515) | (1,067) |

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| | | |
|--|-------------|-------------|
| Total stockholders' equity | 3,303,831 | 3,050,127 |
| Total liabilities and stockholders' equity | \$7,674,402 | \$7,457,605 |

See accompanying notes to Condensed Consolidated Financial Statements.

AVALONBAY COMMUNITIES, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
 AND OTHER COMPREHENSIVE INCOME

(unaudited)

(Dollars in thousands, except per share data)

| | For the three months ended | | For the nine months ended | |
|---|----------------------------|-----------|---------------------------|-----------|
| | 9-30-10 | 9-30-09 | 9-30-10 | 9-30-09 |
| Revenue: | | | | |
| Rental and other income | \$225,783 | \$213,165 | \$658,040 | \$631,392 |
| Management, development and other fees | 1,800 | 1,878 | 5,334 | 5,423 |
| Total revenue | 227,583 | 215,043 | 663,374 | 636,815 |
| Expenses: | | | | |
| Operating expenses, excluding property taxes | 69,848 | 66,693 | 200,575 | 195,226 |
| Property taxes | 23,402 | 21,093 | 69,695 | 61,871 |
| Interest expense, net | 44,262 | 41,205 | 128,260 | 108,215 |
| Gain on extinguishment of debt, net | -- | -- | -- | (1,062) |
| Depreciation expense | 58,628 | 52,987 | 171,956 | 153,992 |
| General and administrative expense | 7,039 | 5,750 | 19,975 | 18,388 |
| Impairment loss - land holdings | -- | -- | -- | 20,302 |
| Total expenses | 203,179 | 187,728 | 590,461 | 556,932 |
| Equity in income (loss) of unconsolidated entities | (325) | 190 | 364 | 4,139 |
| Gain on sale of land | -- | 241 | -- | 241 |
| Income from continuing operations | 24,079 | 27,746 | 73,277 | 84,263 |
| Discontinued operations: | | | | |
| Income (loss) from discontinued operations | (99) | 3,685 | 1,917 | 10,991 |
| Gain on sale of communities | -- | 26,670 | 72,220 | 26,670 |
| Total discontinued operations | (99) | 30,355 | 74,137 | 37,661 |
| Net income | 23,980 | 58,101 | 147,414 | 121,924 |
| Net (income) loss attributable to noncontrolling interests | 674 | 53 | 890 | 1,329 |
| Net income attributable to common stockholders | \$24,654 | \$58,154 | \$148,304 | \$123,253 |
| Other comprehensive income: | | | | |
| Unrealized (loss) gain on cash flow hedges | (314) | 521 | (448) | 1,318 |
| Comprehensive income | \$24,340 | \$58,675 | \$147,856 | \$124,571 |
| Earnings per common share - basic: | | | | |
| Income from continuing operations attributable to common stockholders | \$0.29 | \$0.34 | \$0.88 | \$1.08 |
| Discontinued operations attributable to common stockholders | -- | 0.38 | 0.89 | 0.47 |

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| | | | | |
|---|----------|----------|----------|----------|
| Net income attributable to common stockholders | \$0.29 | \$0.72 | \$1.77 | \$1.55 |
| Earnings per common share - diluted: | | | | |
| Income from continuing operations attributable to common stockholders | \$0.29 | \$0.34 | \$0.88 | \$1.07 |
| Discontinued operations attributable to common stockholders | -- | 0.38 | 0.88 | 0.47 |
| Net income attributable to common stockholders | \$0.29 | \$0.72 | \$1.76 | \$1.54 |
| Dividends per common share: | \$0.8925 | \$0.8925 | \$2.6775 | \$2.6775 |

See accompanying notes to Condensed Consolidated Financial Statements.

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

| | For the nine months ended | |
|--|---------------------------|------------|
| | 9-30-10 | 9-30-09 |
| Cash flows from operating activities: | | |
| Net income | \$ 147,414 | \$ 121,924 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Depreciation expense | 171,956 | 153,992 |
| Depreciation expense from discontinued operations | 371 | 7,701 |
| Amortization of deferred financing costs and debt premium/discount | 5,944 | 5,422 |
| Amortization of stock-based compensation | 4,536 | 4,887 |
| Equity in income of unconsolidated entities and noncontrolling interests, net of eliminations | 852 | (3,992) |
| Impairment loss - land holdings | -- | 20,302 |
| Gain on sale of real estate assets | (72,220) | (26,911) |
| Gain on extinguishment of debt, net | -- | (1,062) |
| Increase in cash in operating escrows | (294) | (2,699) |
| Increase in resident security deposits, prepaid expenses and other assets | (25,221) | (17,711) |
| Increase in accrued expenses, other liabilities and accrued interest payable | 1,041 | 11,125 |
| Net cash provided by operating activities | 234,379 | 272,978 |
| Cash flows from investing activities: | | |
| Development/redevelopment of real estate assets including land acquisitions and deferred development costs | (330,251) | (444,892) |
| Capital expenditures - existing real estate assets | (9,683) | (4,112) |
| Capital expenditures - non-real estate assets | (517) | (699) |
| Proceeds from sale of real estate, net of selling costs | 186,058 | 67,893 |
| Decrease in payables for construction | (11,917) | (14,742) |
| Decrease in cash in construction escrows | 32,940 | 66,492 |
| Acquisition of mortgage note | (24,000) | -- |
| Decrease (increase) in investments in unconsolidated real estate entities | (20,977) | 382 |
| Net cash used in investing activities | (178,347) | (329,678) |
| Cash flows from financing activities: | | |
| Issuance of common stock | 322,257 | 102,442 |
| Dividends paid | (222,081) | (211,269) |
| Payments under unsecured credit facility | -- | (124,000) |
| Issuance of mortgage notes payable and draws on construction loans | -- | 741,140 |
| Repayments of mortgage notes payable | (29,433) | (29,516) |
| Issuance of unsecured notes | -- | 499,372 |
| Repayment of unsecured notes | -- | (420,936) |
| Payment of deferred financing costs | (3,149) | (11,635) |

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| | | |
|---|------------|------------|
| Redemption of units for cash by minority partners | -- | (202) |
| Distributions to DownREIT partnership unitholders | (42) | (39) |
| Distributions to joint venture and profit-sharing partners | (164) | -- |
| Net cash provided by financing activities | 67,388 | 545,357 |
| Net increase in cash and cash equivalents | 123,420 | 488,657 |
| Cash and cash equivalents, beginning of period | 105,691 | 65,678 |
| Cash and cash equivalents, end of period | \$ 229,111 | \$ 554,335 |
| Cash paid during the period for interest, net of amount capitalized | \$ 125,190 | \$ 101,059 |

See accompanying notes to Condensed Consolidated Financial Statements.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)

Supplemental disclosures of non-cash investing and financing activities (dollars in thousands):

During the nine months ended September 30, 2010:

As described in Note 4, "Stockholders' Equity," 102,984 shares of common stock valued at \$7,777 were issued in connection with stock grants; 4,716 shares valued at \$419 were issued through the Company's dividend reinvestment plan; 46,852 shares valued at \$3,990 were withheld to satisfy employees' tax withholding and other liabilities; 1,300 shares valued at \$39 were forfeited and 61,055 shares valued at \$3,322 were issued to members of the board of directors in fulfillment of deferred stock awards for a net value of \$7,489. In addition, the Company granted 126,484 options for common stock at a value of \$2,460.

25 units of limited partnership, valued at \$3, were presented for redemption to the DownREIT partnerships that issued such units and were acquired by the Company in exchange for an equal number of shares of the Company's common stock.

The Company recorded an increase to other liabilities and a corresponding decrease to other comprehensive income of \$448 and recorded an increase to prepaid expenses and other assets of \$2,181, with a corresponding offset to the basis of unsecured notes, net to record the impact of the Company's hedge accounting activity (as described in Note 5, "Derivative Instruments and Hedging Activities").

Common dividends declared but not paid totaled \$76,127.

The Company recorded an increase of \$5,305 in redeemable noncontrolling interests 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 11, "Fair Value".

The Company recognized \$4,812 in noncontrolling interest in conjunction with the consolidation of a Fund I subsidiary. See Note 6, "Investments in Real Estate Entities" for further discussion.

During the nine months ended September 30, 2009:

2,624,641 shares of common stock valued at \$139,058 were issued as part of the special dividend declared in the fourth quarter of 2008; 169,851 shares of common stock valued at \$8,360 were issued in connection with stock grants; 9,201 shares valued at \$505 were issued through the Company's dividend reinvestment plan; 33,006 shares valued at \$1,502 were withheld to satisfy employees' tax withholding and other liabilities and 1,031 shares valued at \$147 were forfeited, for a net value of \$146,274. In addition, the Company granted 344,801 options for common stock at a value of \$2,252.

The Company recorded a decrease to other liabilities and a corresponding increase to other comprehensive income of \$1,318 to record the impact of the Company's hedge accounting activity.

Common dividends declared but not paid totaled \$72,595.

The Company recorded a decrease of \$4,745 in redeemable noncontrolling interests 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.

In May 2009, the Company obtained \$93,440 in variable rate tax-exempt bond financing related to a Development Right (as defined elsewhere in this Form 10-Q), the proceeds of which will be held in escrow until requisitioned for construction funding. This loan provides an option for the Company to request an additional construction loan of up to \$83,560 subject to the lender's discretion.

AVALONBAY COMMUNITIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)
(Dollars in thousands, except per share data)

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 consolidated subsidiaries), is a Maryland corporation that elected to be taxed as a real estate investment trust (“REIT”) under the Internal Revenue Code of 1986 (“the Code”). The Company focuses on the development, acquisition, ownership and operation of apartment communities in high barrier to entry markets of the United States. These markets are located in the New England, Metro New York/New Jersey, Mid-Atlantic, Midwest, Pacific Northwest, and Northern and Southern California regions of the country.

At September 30, 2010, the Company owned or held a direct or indirect ownership interest in 167 operating apartment communities containing 49,061 apartment homes in ten states and the District of Columbia, of which seven communities containing 2,361 apartment homes were under reconstruction. In addition, the Company owned or held a direct or indirect ownership interest in 12 communities under construction that are expected to contain an aggregate of 3,429 apartment homes when completed. The Company also owned or held a direct or indirect ownership interest in land or rights to land in which the Company expects to develop an additional 24 communities that, if developed as expected, will contain an estimated 6,984 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 2009 Annual Report on Form 10-K. The results of operations for the three and nine months ended September 30, 2010 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.

All capitalized terms have the meaning as 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:

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| | For the three months ended | | For the nine months ended | |
|---|----------------------------|------------|---------------------------|------------|
| | 9-30-10 | 9-30-09 | 9-30-10 | 9-30-09 |
| Basic and diluted shares outstanding | | | | |
| Weighted average common shares - basic | 84,968,804 | 80,132,409 | 83,385,833 | 79,521,277 |
| Weighted average DownREIT units outstanding | 15,346 | 15,351 | 15,349 | 16,874 |
| Effect of dilutive securities | 784,546 | 461,517 | 728,712 | 631,942 |
| Weighted average common shares - diluted | 85,768,696 | 80,609,277 | 84,129,894 | 80,170,093 |
| Calculation of Earnings per Share - basic | | | | |
| Net income attributable to common stockholders | \$ 24,654 | \$ 58,154 | \$ 148,304 | \$ 123,253 |
| Net income allocated to unvested restricted shares | (68) | (182) | (429) | (389) |
| Net income attributable to common stockholders, adjusted | \$ 24,586 | \$ 57,972 | \$ 147,875 | \$ 122,864 |
| Weighted average common shares - basic | 84,968,804 | 80,132,409 | 83,385,833 | 79,521,277 |
| Earnings per common share - basic | \$ 0.29 | \$ 0.72 | \$ 1.77 | \$ 1.55 |
| Calculation of Earnings per Share - diluted | | | | |
| Net income attributable to common stockholders | \$ 24,654 | \$ 58,154 | \$ 148,304 | \$ 123,253 |
| Add: noncontrolling interests of DownREIT unitholders in consolidated partnerships, including discontinued operations | 14 | 14 | 41 | 52 |
| Adjusted net income attributable to common stockholders | \$ 24,668 | \$ 58,168 | \$ 148,345 | \$ 123,305 |
| Weighted average common shares - diluted | 85,768,696 | 80,609,277 | 84,129,894 | 80,170,093 |
| Earnings per common share - diluted | \$ 0.29 | \$ 0.72 | \$ 1.76 | \$ 1.54 |

Certain options to purchase shares of common stock in the amounts of 1,039,724 and 2,023,878 were outstanding at September 30, 2010 and 2009, respectively, but were not included in the computation of diluted earnings per share because such options were anti-dilutive.

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 September 30, 2010 is based on the average forfeiture activity over a period equal to the estimated life of the stock options, and was 1.4%. The application of estimated forfeitures did not materially impact compensation expense for the three and nine months ended September 30, 2010 or 2009.

Abandoned Pursuit Costs and Impairment of Long-Lived Assets

The Company capitalizes pre-development costs incurred in pursuit of new development opportunities for which the Company currently believes future development is probable (“Development Rights”). Future development of these Development Rights is dependent upon various factors, including zoning and regulatory approval, rental market conditions, construction costs and the availability of capital. Initial pre-development costs incurred for pursuits for which future development is not yet considered probable are expensed as incurred. In addition, if the status of a Development Right changes, making future development by the Company no longer probable, any capitalized pre-development costs are written off with a charge to expense. The Company expensed costs related to abandoned pursuits, which includes the abandonment of Development Rights as well as costs incurred in pursuing the disposition of assets for which the disposition did not occur, in the amounts of \$737 and \$1,721 for the three months ended September 30, 2010 and 2009, respectively and \$1,685 and \$5,096 for the nine months ended September 30, 2010 and 2009, respectively. These costs are included in operating expenses, excluding property taxes on the accompanying Condensed Consolidated Statements of Operations and Other Comprehensive Income. Abandoned pursuit costs can vary greatly, and the costs incurred in any given period may be significantly different in future periods.

The Company evaluates its real estate and other long-lived assets for impairment when potential indicators of impairment exist. Such assets are stated at cost, less accumulated depreciation and amortization, unless the carrying amount of the asset is not recoverable. If events or circumstances indicate that the carrying amount of a long-lived asset may not be recoverable, the Company assesses its recoverability by comparing the carrying amount of the long-lived asset to its estimated undiscounted future cash flows. If the carrying amount exceeds the aggregate undiscounted future cash flows, the Company recognizes an impairment loss to the extent the carrying amount exceeds the estimated fair value of the long-lived asset. Based on periodic tests of recoverability of long-lived assets, the Company did not record any impairment losses for the three and nine months ended September 30, 2010. In the second quarter of 2009, the Company concluded that the economic downturn and the related decline in employment levels did not support the development and construction of certain new apartment communities previously in planning. As a result the Company recognized a charge of \$20,302 related to the impairment of two land parcels for which the Company decided not to pursue development. The Company looked to third-party pricing estimates to determine the fair values of the land parcels considered to be impaired. Given the heterogeneous nature of multifamily real estate, the third-party values incorporated significant unobservable inputs, including the use of estimated rates of return, investment time horizons and sales prices for land parcels considered to be market comparables, adjusted for known differences in critical areas including the existing entitlements (such as zoning and state of infrastructure readiness). Accordingly, the third-party values are classified as Level 3 prices in the fair value hierarchy. In 2009, the Company also recognized a charge for severance related costs associated with this reduction in planned development activity of approximately \$2,000, reported as a component of general and administrative expense. However, as a result of improved economic conditions, the Company has increased its investment activity, allowing the Company to retain staff previously expected to depart. Therefore, certain planned terminations are no longer expected to take place, resulting in a decline of \$1,550 in accrued severance recorded as a reduction in general and administrative expenses in the nine months ended September 30, 2010.

Legal and Other Contingencies

As previously reported, on August 13, 2008 the U.S. Attorney's Office for the Southern District of New York filed a civil lawsuit against the Company and the joint venture in which it has an interest that owns Avalon Chrystie Place. The lawsuit alleged that Avalon Chrystie Place was not designed and constructed in accordance with the accessibility requirements of the Fair Housing Act ("FHA"). Without admitting or denying liability, the Company settled the outstanding claims under this matter in October 2010. The Company does not expect that the settlement and its fulfillment of settlement terms will have a material impact to its financial position or results of operations. Refer to Note 12, Subsequent Events.

The Company accounts for recoveries from legal matters as a reduction in the legal and related costs incurred associated with the matter, with recoveries in excess of these costs reported as a gain or, where appropriate, a reduction in the basis of a community to which the suit related. During the nine months ended September 30, 2010, the Company recognized receipt of settlement proceeds of \$3,300 related to environmental contamination matters pursued by the Company. The Company reported \$1,200 of these recoveries as a reduction in the legal and professional fees related to costs incurred in pursuit of the matters during 2010 and years prior as a component of general and administrative expense, with the remainder of the recovery reported as a reduction in the associated capitalized basis of the related communities.

The Company is involved in various claims and/or administrative proceedings that arise in the ordinary course of the Company's business. While no assurances can be given, the Company does not believe that any of these outstanding litigation matters, individually or in the aggregate, will have a material adverse effect on the Company's operations.

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 period financial statements to conform to current period presentations.

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 \$7,774 and \$11,878 for the three months ended September 30, 2010 and 2009, respectively and \$27,265 and \$37,923 for the nine months ended September 30, 2010 and 2009, respectively.

3. Notes Payable, Unsecured Notes and Credit Facility

The Company's mortgage notes payable, unsecured notes and Credit Facility, as defined below, as of September 30, 2010 and December 31, 2009, are summarized below. The following amounts and discussion do not include the mortgage notes related to the communities classified as held for sale, if any, as of September 30, 2010 and December 31, 2009, as shown in the Condensed Consolidated Balance Sheets (see Note 7, "Real Estate Disposition Activities").

| | 9-30-10 | 12-31-09 |
|--|--------------------|--------------------|
| Fixed rate unsecured notes(1) | \$1,360,477 | \$1,360,477 |
| Variable rate unsecured notes(1) | 300,000 | 300,000 |
| Fixed rate mortgage notes payable - conventional and tax-exempt | 1,661,705 | 1,632,605 |
| Variable rate mortgage notes payable - conventional and tax-exempt | 625,705 | 684,238 |
| Total notes payable and unsecured notes | 3,947,887 | 3,977,320 |
| Credit Facility | -- | -- |
| Total mortgage notes payable, unsecured notes and Credit Facility | \$3,947,887 | \$3,977,320 |

(1) Balances at September 30, 2010 and December 31, 2009 exclude \$1,950 and \$2,220 respectively of debt discount, and \$1,953 and (\$228) respectively for basis adjustments, as reflected in unsecured notes on the Company's Condensed Consolidated Balance sheets.

The following debt activity occurred during the nine months ended September 30, 2010:

In February 2010, the Company repaid a 6.47% fixed rate secured mortgage note in the amount of \$13,961 in advance of its March 2012 scheduled maturity date.

In March 2010, the Company repaid a 6.95% fixed rate secured mortgage note in the amount of \$11,226 in advance of its February 2025 scheduled maturity date.

In the aggregate, secured notes payable mature at various dates from October 2010 through July 2066, and are secured by certain apartment communities and improved land parcels (with a net carrying value of \$1,827,153 as of September 30, 2010). As of September 30, 2010, the Company has guaranteed approximately \$278,728 of mortgage notes payable held by wholly owned subsidiaries; all such mortgage notes payable are consolidated for financial reporting purposes. The weighted average interest rate of the Company's fixed rate mortgage notes payable (conventional and tax-exempt) was 5.7% at September 30, 2010 and 5.9% at December 31, 2009. The weighted average interest rate of the Company's variable rate mortgage notes payable and its Credit Facility, including the effect of certain financing related fees, was 2.2% at September 30, 2010 and 1.9% at December 31, 2009.

Scheduled payments and maturities of mortgage notes payable and unsecured notes outstanding at September 30, 2010 are as follows:

| Year | Secured notes payments (1) | Secured notes maturities | Unsecured notes maturities | Stated interest rate of unsecured notes |
|------------|----------------------------|--------------------------|----------------------------|---|
| 2010 | \$ 1,325 | \$ 28,989 | \$ 14,576 | 7.500 % |
| | | | 75,000 | 7.072 % (2) |
| 2011 | 10,776 | 36,425 | 39,900 | 6.625 % |
| | | | 150,000 | 5.701 % (2) |
| 2012 | 14,034 | 108,101 | 201,601 | 6.125 % |
| | | | 104,400 | 5.500 % |
| | | | 75,000 | 4.600 % (2) |
| 2013 | 14,876 | 264,697 | 100,000 | 4.950 % |
| 2014 | 15,769 | 33,100 | 150,000 | 5.375 % |
| 2015 | 14,725 | 365,130 | -- | -- |
| 2016 | 15,600 | -- | 250,000 | 5.750 % |
| 2017 | 16,533 | 18,300 | 250,000 | 5.700 % |
| 2018 | 17,522 | -- | -- | -- |
| 2019 | 2,588 | 699,529 | -- | -- |
| Thereafter | 110,707 | 498,684 | 250,000 | 6.100 % |
| | \$ 234,455 | \$ 2,052,955 | \$ 1,660,477 | |

(1) Secured note payments are comprised of the principal pay downs for amortizing mortgage notes.

(2) The weighted average interest rate for the swapped unsecured notes as of September 30, 2010.

The Company has a variable rate unsecured credit facility (the "Credit Facility") in the amount of \$1,000,000 with a syndicate of commercial banks, to whom the Company pays an annual facility fee of approximately \$1,250. The Company did not have any amounts outstanding under the Credit Facility and had \$50,933 outstanding in letters of credit as of September 30, 2010. At December 31, 2009, there were no amounts outstanding under the Credit Facility and \$44,105 outstanding in letters of credit. The Credit Facility bears interest at varying levels based on the London Interbank Offered Rate ("LIBOR"), rating levels achieved on the Company's unsecured notes and on a maturity schedule selected by the Company. The current stated pricing is LIBOR plus 0.40% per annum (0.66% at September 30,

2010). During the three months ended September 30, 2010, the Company executed its option to extend the maturity of the Credit Facility for one year to November 2011, at a cost of approximately \$1,000.

The Company was in compliance at September 30, 2010 with certain customary financial and other covenants under the Credit Facility and the Company's unsecured notes.

4. Stockholders' Equity

The following summarizes the changes in stockholders' equity for the nine months ended September 30, 2010:

| | Common stock | Additional paid-in capital | Accumulated earnings less dividends | Accumulated other comprehensive loss | Total AvalonBay stockholders' equity | Noncontrolling interests | Total equity |
|--|-----------------|----------------------------------|--|---|---|-----------------------------|-----------------|
| Balance at December 31, 2009 | \$ 815 | \$ 3,200,367 | \$ (149,988) | \$ (1,067) | \$ 3,050,127 | \$ -- | \$ 3,050,127 |
| Net income attributable to common stockholders | -- | -- | 148,304 | -- | 148,304 | -- | 148,304 |
| Unrealized loss on cash flow hedges | -- | -- | -- | (448) | (448) | -- | (448) |
| Change in redemption value of redeemable noncontrolling interest | -- | -- | (5,305) | -- | (5,305) | -- | (5,305) |
| Noncontrolling interests (a) | -- | -- | -- | -- | - | 4,812 | 4,812 |
| Dividends declared to common stockholders | -- | -- | (225,854) | -- | (225,854) | -- | (225,854) |
| Issuance of common stock, net of withholdings | 38 | 321,857 | 73 | -- | 321,968 | -- | 321,968 |
| Amortization of deferred compensation | -- | 10,227 | -- | -- | 10,227 | -- | 10,227 |
| Balance at September 30, 2010 | \$ 853 | \$ 3,532,451 | \$ (232,770) | \$ (1,515) | \$ 3,299,019 | \$ 4,812 | \$ 3,303,831 |

(a) Represents the impact of consolidating a Fund I subsidiary. See Note 6, "Investments in Real Estate Entities".

During the nine months ended September 30, 2010, the Company:

- (i) issued 3,080,204 shares of common stock through public offerings;
- (ii) issued 555,076 shares of common stock in connection with stock options exercised;
- (iii) issued 4,716 common shares through the Company's dividend reinvestment plan;
- (iv) issued 102,984 common shares in connection with stock grants;
- (v) issued 61,055 common shares to two members of the Board of Directors in fulfillment of deferred stock awards;

- (vi) issued 25 common shares for DownREIT OP units conversion;
- (vii) withheld 46,852 common shares to satisfy employees' tax withholding and other liabilities; and
- (viii) redeemed 1,300 shares of restricted common stock upon forfeiture.

In addition, the Company granted 126,484 options for common stock to employees. Any deferred compensation related to the Company's stock option and restricted stock grants during the nine months ended September 30, 2010 is not reflected on the Company's Condensed Consolidated Balance Sheet as of September 30, 2010, and will not be reflected until earned as compensation cost.

In August 2009, the Company commenced a continuous equity program (the "CEP"), under which the Company was authorized to sell up to \$400,000 of its common stock until August 2012. During the three and nine months ended September 30, 2010, the Company completed the sale of common stock authorized under the CEP, selling 76,700 and 3,080,204 shares under this program at an average sales price of \$100.41 and \$95.88 per share, for net proceeds of \$7,586 and \$290,884, respectively. From program inception in August 2009 through completion of the currently registered offering, the Company sold 4,585,105 shares at an average price of \$87.24 for net proceeds of \$393,993.

During the three months ended September 30, 2010, the Company recognized noncontrolling interest of \$4,812 in conjunction with the consolidation of an AvalonBay Value Added Fund, LP ("Fund I") subsidiary. See Note 6, "Investments in Real Estate Entities" for further discussion.

5. Derivative Instruments and Hedging Activities

The Company enters into interest rate swap and interest rate cap agreements (collectively, the "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 derivative transactions for trading or other speculative purposes. The following table summarizes the consolidated Hedging Derivatives at September 30, 2010, excluding derivatives executed to hedge debt on communities classified as held for sale (dollars in thousands):

| | Non-designated Hedges Interest Rate Caps | Cash Flow Hedges Interest Rate Caps | Fair Value Hedges Interest Rate Swaps |
|---|---|--|---|
| Notional balance | \$ 109,847 | \$ 196,678 | \$ 300,000 |
| Weighted average interest rate (1) | 1.5 % | 2.5 % | 5.8 % |
| Weighted average capped interest rate | 6.9 % | 5.3 % | N/A |
| Earliest maturity date | Apr-11 | Jun-12 | Dec-10 |
| Latest maturity date | Mar-14 | Jun-15 | Jan-12 |
| Estimated fair value, asset/(liability) | \$ 22 | \$ 370 | \$ 1,953 |

(1) For interest rate caps, this represents the weighted average interest rate on the debt.

Excluding derivatives executed to hedge debt on communities classified as held for sale, the Company had five derivatives designated as cash flow hedges, five derivatives designated as fair value hedges and five derivatives not designated as hedges at September 30, 2010. Fair value changes for derivatives that are not in qualifying hedge relationships are reported as a component of general and administrative expenses on the accompanying Condensed Consolidated Statements of Operations and Other Comprehensive Income. Fair value changes for derivatives not in qualifying hedge relationships for the nine months ended September 30, 2010, were not material. For the 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 the Hedging Derivatives in other comprehensive income. Amounts recorded in other comprehensive income will be reclassified into earnings in the periods in which earnings are affected by the hedged cash flow. To adjust the Hedging Derivatives in qualifying cash flow hedges to their fair value and recognize the impact of hedge accounting, the Company recorded a decrease in other comprehensive income of \$448 and an increase of \$1,318 during the nine months ended September 30, 2010 and 2009, respectively. The amount reclassified into earnings for the nine months ended September 30, 2010, as well as the estimated amount included in accumulated other comprehensive income as of September 30, 2010, expected to be reclassified into earnings within the next twelve months to offset the variability of cash flows of the hedged items during this period are not material. For the derivative positions that the Company has determined qualify as effective fair value hedges during the nine months ended September 30, 2010, the Company has recorded an increase in the fair value of \$2,181 with the derivatives fair value reported as a component of prepaid expenses and other assets, with the associated gain as an adjustment to the carrying amount of the corresponding debt being hedged on the accompanying Condensed Consolidated Balance Sheets as of September 30, 2010.

The Company assesses, both at inception and on an on-going basis, the effectiveness of qualifying cash flow and fair value hedges. Hedge ineffectiveness, reported as a component of general and administrative expenses, did not have a

material impact on earnings of the Company for any prior period, and the Company does not anticipate that it will have a material effect in the future. The fair values of the Hedging Derivatives and non-designated derivatives that are in an asset position are recorded in prepaid expenses and other assets. The fair value of derivatives that are in a liability position are included in accrued expenses and other liabilities on the accompanying Condensed Consolidated Balance Sheets.

Derivative financial instruments expose the Company to credit risk in the event of nonperformance by the counterparties under the terms of the Hedging Derivatives. The Company minimizes its credit risk on these transactions by dealing with major, creditworthy financial institutions which have an A+ or better credit rating by the Standard & Poor's Ratings Group. As part of its on-going control procedures, the Company monitors the credit ratings of counterparties and the exposure of the Company to any single entity, thus minimizing credit risk concentration. The Company believes the likelihood of realizing losses from counterparty non-performance is remote. The Company incorporates credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counterparty's nonperformance risk in the fair value measurements of its derivative financial instruments. Refer to Note 11, "Fair Value," for further discussion.

6. Investments in Real Estate Entities

As of September 30, 2010, the Company had investments in six unconsolidated real estate entities with ownership interest percentages ranging from 15.2% to 50%. In the third quarter of 2010, a lender ran a competitive bid process to sell a \$26,000 non-recourse mortgage note secured by a Fund I operating community with an estimated fair value of approximately \$30,000. The Company participated in the bidding and purchased the note on an arms length basis for \$24,000. The note pays interest-only through the maturity date of October 2014 at a stated interest rate of 6.06%. Subsequent to acquisition, the Company modified certain terms of the mortgage note, including (i) conforming the original principal balance to the Company's purchase price, (ii) modifying the interest payment terms to require remittance of interest based on available cash flow with any deficiency in the monthly payment amount accruing to the principal due on the note, and (iii) modifying certain terms to help eliminate any potential conflicts between the Company and Fund I, such as removing any prepayment penalty.

Upon the acquisition of the note, the Company determined that it had control of the Fund I subsidiary, as a result of its collective equity and debt investments, the relationship between the Company and Fund I, and the nature of the Company's operations being more similar to those of the Fund I subsidiary than those of Fund I. Therefore, the Company consolidated the results of operations and net assets of the Fund I subsidiary. The Fund I subsidiary was consolidated at fair value, determined using a discounted cash flow analysis on the expected cash flows of the underlying community. This analysis reflects the use of estimated rates of return, capitalization rates, estimated holding periods and estimated sales proceeds, all of which are considered significant other unobservable inputs and are therefore classified as Level 3 prices in the fair value hierarchy.

During the three months ended September 30, 2010, AvalonBay Value Added Fund II, LP ("Fund II") acquired the following three apartment communities:

Creekside Meadows, a garden-style community consisting of 628 apartment homes located in Tustin (Orange County), CA, was acquired for a purchase price of \$98,500;

Grove Park Apartments, a garden-style community consisting of 684 apartment homes located in Gaithersburg, MD was acquired for a purchase price of \$101,000; and

The Apartments at Briarwood, a garden-style community consisting of 348 apartment homes located in Owings Mills, MD, was acquired for a purchase price of \$44,750.

There were no other changes in the Company's ownership interest in, or presentation of, its investments in unconsolidated real estate entities during the nine months ended September 30, 2010.

Detail of the real estate and associated funding underlying the Company's unconsolidated investments is presented in the following table (unaudited).

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| Unconsolidated Real Estate Investments | Company Ownership Percentage | # of Apartment Homes | Total Capitalized Cost (1) | Amount (2) | Debt Type | Interest Rate (3) | Maturity Date |
|--|---|----------------------|----------------------------|------------|-----------|-------------------|---------------|
| Fund I | | | | | | | |
| 1. | Avalon at Redondo Beach - Los Angeles, CA | 105 | \$ 24,622 | \$ 21,033 | Fixed | 4.87 % | Oct 2011 |
| 2. | Avalon Lakeside - Chicago, IL | 204 | 18,362 | 12,056 | Fixed | 5.74 % | Mar 2012 |
| 3. | Avalon Columbia - Baltimore, MD | 170 | 29,406 | 22,275 | Fixed | 5.48 % | Apr 2012 |
| 4. | Avalon Sunset - Los Angeles, CA | 82 | 20,903 | 12,750 | Fixed | 5.41 % | Mar 2014 |
| 5. | Avalon at Poplar Creek - Chicago, IL | 196 | 28,093 | 16,500 | Fixed | 4.83 % | Oct 2012 |
| 6. | Avalon at Civic Center - Norwalk, CA | 192 | 42,756 | 27,001 | Fixed | 5.38 % | Aug 2013 |
| 7. | Avalon Paseo Place - Fremont, CA | 134 | 24,840 | 11,800 | Fixed | 5.74 % | Nov 2013 |
| 8. | Avalon at Yerba Buena - San Francisco, CA | 160 | 66,805 | 41,500 | Fixed | 5.88 % | Mar 2014 |
| 9. | Avalon at Aberdeen Station - Aberdeen, NJ | 290 | 58,385 | 39,842 | Fixed | 5.64 % | Sep 2013 |
| 10. | The Springs - Corona, CA (4) | 320 | 30,832 | 24,000 | Fixed | 6.06 % | Oct 2014 |
| 11. | Avalon Lombard - Lombard, IL | 256 | 35,319 | 17,243 | Fixed | 5.43 % | Jan 2014 |
| 12. | Avalon Cedar Place - Columbia, MD | 156 | 24,466 | 12,000 | Fixed | 5.68 % | Feb 2014 |
| 13. | Avalon Centerpoint - Baltimore, MD | 392 | 80,059 | 45,000 | Fixed | 5.74 % | Dec 2013 |
| 14. | Middlesex Crossing - Billerica, MA | 252 | 38,089 | 24,100 | Fixed | 5.49 % | Dec 2013 |

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| | | | | | | | |
|-----|--|--------|--------|------------|------------|--------|-------------|
| 15. | Avalon Crystal Hill - Ponoma, NY | 168 | 38,610 | 24,500 | Fixed | 5.43 % | Dec 2013 |
| 16. | Avalon Skyway - San Jose, CA | 348 | 78,198 | 37,500 | Fixed | 6.11 % | Mar 2014 |
| 17. | Avalon Rutherford Station - East Rutherford, NJ | 108 | 36,795 | 19,865 | Fixed | 6.13 % | Sep 2016 |
| 18. | South Hills Apartments - West Covina, CA | 85 | 24,756 | 11,761 | Fixed | 5.92 % | Oct 2013 |
| 19. | Weymouth Place - Weymouth, MA | 211 | 25,299 | 13,455 | Fixed | 5.12 % | Mar 2015 |
| | Total Fund I | 15.2 % | 3,829 | \$ 726,595 | \$ 434,181 | 5.6 % | |

Fund II

| | | | | | | | |
|----|---|--------|-----------|------------|------------|--------|-------------|
| 1. | Avalon Bellevue Park - Bellevue, WA | 220 | \$ 33,969 | \$ 21,515 | Fixed | 5.52 % | Jun 2019 |
| 2. | The Hermitage - Fairfax, VA | 491 | 72,029 | 42,600 | Fixed | 5.26 % | May 2017 |
| 3. | Avalon Rothbury - Gaithersburg, MD | 203 | 31,364 | 18,750 | Variable | 2.85 % | Jun 2017 |
| 4. | The Apartments at Briarwood - Owings Mills, MD | 348 | 44,750 | - | N/A | N/A | N/A |
| 5. | Grove Park Apartments - Gaithersburg, MD | 684 | 101,000 | 63,200 | Fixed | 5.42 % | Jan 2017 |
| 6. | Creekside Meadows - Tustin, CA | 628 | 98,500 | 59,100 | Fixed | 3.81 % | Sep 2017 |
| | Fund II corporate debt | N/A | N/A | 46,000 | Variable | 2.76 % | 2010 (5) |
| | Total Fund II | 31.3 % | 2,574 | \$ 381,612 | \$ 251,165 | 4.3 % | |

Other Operating Joint Ventures

| | | | | | | | | |
|----|--|--------|-----|------------|------------|----------|--------|-------------|
| 1. | Avalon Chrystie Place I - New York, NY (6) | 20.0 % | 361 | \$ 135,393 | \$ 117,000 | Variable | 0.97 % | Nov 2036 |
| 2. | Avalon at Mission Bay North II - San Francisco, CA (7) | 25.0 % | 313 | 124,014 | 105,000 | Fixed | 6.02 % | Dec 2015 |
| 3. | | 30.0 % | 309 | 70,037 | 45,292 | Variable | 3.60 % | |

Avalon Del Rey - Los Angeles, CA

Apr 2016

Other Development Joint Ventures

| | | | | | | | | | Jun 2010 |
|----|--|--------|-------|--------------|------------|----------|--------|-----|----------|
| 1. | Aria at Hathorne - Danvers, MA (7) (8) | 50.0 % | 64 | N/A | 1,860 | Variable | 4.19 % | (9) | |
| | Total Other Joint Ventures | | 1,047 | \$ 329,444 | \$ 269,152 | | 3.4 % | | |
| | Total Unconsolidated Investments | | 7,450 | \$ 1,437,651 | \$ 954,498 | | 4.7 % | | |

(1) Represents total capitalized cost as of September 30, 2010.

(2)The Company has not guaranteed the debt of its unconsolidated investees and bears no responsibility for the repayment, other than the construction and completion and related financing guarantee for Avalon Chrystie Place I associated with the construction completion and occupancy certificate.

(3) Represents weighted average rate on outstanding debt.

(4)As discussed elsewhere in this Form 10-Q, beginning in the three months ended September 30, 2010, the Company consolidated the net assets and results of operations of The Springs.

(5)As of September 30, 2010, these borrowings are drawn under an unsecured credit facility maturing in December 2011, assuming exercise of a one-year extension option.

(6)After the venture makes certain threshold distributions to the third-party partner, the Company generally receives 50% of all further distributions.

(7) The Company has contributed land at a stepped up basis as its only capital contribution to this development.

(8)After the venture makes certain threshold distributions to the Company, the Company receives 50% of all further distributions.

(9)The loan for this venture matured in June 2010. As of September 30, 2010, the amounts under this borrowing have not been repaid. The venture is negotiating an extension or refinancing of the amounts outstanding. The lender has not to date declared an event of default with respect to the note or required the venture to pay a default rate of interest. Although the Company bears no responsibility to repay the amounts outstanding, the Company has the right to cure any event of default by the venture.

The following is a combined summary of the financial position of the entities accounted for using the equity method, as of the dates presented:

| | 9-30-10 (unaudited) | 12-31-09 (unaudited) |
|--|------------------------|-------------------------|
| Assets: | | |
| Real estate, net | \$ 1,291,271 | \$ 1,065,328 |
| Other assets | 68,711 | 39,502 |
| Total assets | \$ 1,359,982 | \$ 1,104,830 |
| Liabilities and partners' capital: | | |
| Mortgage notes payable and credit facility | \$ 930,498 | \$ 758,487 |
| Other liabilities | 25,278 | 19,669 |
| Partners' capital | 404,206 | 326,674 |
| Total liabilities and partners' capital | \$ 1,359,982 | \$ 1,104,830 |

The following is a combined summary of the operating results of the entities accounted for using the equity method, for the periods presented:

| | For the three months ended (unaudited) | | For the nine months ended (unaudited) | |
|------------------------------|--|--------------------|---|---------------------|
| | 9-30-10 | 9-30-09 | 9-30-10 | 9-30-09 |
| Rental and other income | \$ 28,236 | \$ 25,230 | \$ 81,066 | \$ 75,871 |
| Operating and other expenses | (15,488) | (12,282) | (40,290) | (36,636) |
| Interest expense, net | (9,957) | (9,277) | (28,548) | (27,458) |
| Depreciation expense | (9,242) | (8,392) | (26,494) | (24,420) |
| Net loss | \$ (6,451) | \$ (4,721) | \$ (14,266) | \$ (12,643) |

In conjunction with the formation of Fund I and Fund II, as well as the acquisition and development of certain other investments in unconsolidated entities, the Company incurred costs in excess of its equity in the underlying net assets of the respective investments. These costs represent \$10,745 at September 30, 2010 and \$11,047 at December 31, 2009 of the respective investment balances.

As part of the formation of Fund I and Fund II, the Company provided separate and distinct guarantees to one of the limited partners in each of the ventures. These guarantees are specific to the respective fund and any impacts or obligation of the Company to perform under one of the guarantees has no impact on the Company's obligations with respect to the other guarantee. The guarantees provide that, if, upon final liquidation of Fund I or Fund II, the total amount of all distributions to the guaranteed partner during the life of the respective fund (whether from operating cash flow or property sales) does not equal the total capital contributions made by that partner, then the Company will pay the guaranteed partner an amount equal to the shortfall, but in no event more than 10% of the total capital contributions made by the guaranteed partner (maximum of approximately \$7,500 for Fund I and approximately \$3,495 for Fund II as of September 30, 2010). As of September 30, 2010, the expected realizable values of the real estate assets owned by Fund I and Fund II are considered adequate to cover such potential payments under a liquidation scenario. The estimated fair value of, and the Company's obligation under these guarantees, both at inception and as of September 30, 2010, was not significant and therefore the Company has not recorded any obligation for either of these guarantees as of September 30, 2010.

7. Real Estate Disposition Activities

The Company did not sell any communities during the three months ended September 30, 2010. As of September 30, 2010, the Company had one commercial real estate asset (the Company's former headquarters) that qualified as held for sale.

The operations for any real estate assets sold from January 1, 2009 through September 30, 2010 have been presented as income from discontinued operations in the accompanying Condensed Consolidated Statements of Operations and Other Comprehensive Income. Accordingly, certain reclassifications have been made to prior years to reflect discontinued operations consistent with current year presentation.

The following is a summary of income from discontinued operations for the periods presented:

| | For the three months ended | | For the nine months ended | |
|-------------------------------------|----------------------------|----------|---------------------------|-----------|
| | 9-30-10 | 9-30-09 | 9-30-10 | 9-30-09 |
| Rental income | \$ 127 | \$ 9,149 | \$ 4,142 | \$ 29,200 |
| Operating and other expenses | (101) | (3,134) | (1,854) | (9,825) |
| Interest expense, net | -- | -- | -- | (682) |
| Depreciation expense | (125) | (2,330) | (371) | (7,702) |
| Income from discontinued operations | \$ (99) | \$ 3,685 | \$ 1,917 | \$ 10,991 |

8. Segment Reporting

The Company's reportable operating segments include Established Communities, Other Stabilized Communities, and Development/Redevelopment Communities. Annually as of January 1st, the Company determines which of its communities fall into each of these categories and maintains that classification, unless disposition plans regarding a community change, throughout the year for the purpose of reporting segment operations.

In addition, the Company owns land for future development and has other corporate assets that are not allocated to an operating segment.

The Company's segment disclosures present the measure(s) used by the chief operating decision maker for purposes of assessing each segments' performance. The Company's chief operating decision maker is comprised of several members of its executive management team who use net operating income ("NOI") as the primary financial measure for Established Communities and Other Stabilized Communities. NOI is defined by the Company as total revenue less direct property operating expenses. Although the Company considers NOI a useful measure of a community's or communities' operating performance, NOI should not be considered an alternative to net income or net cash flow from operating activities, as determined in accordance with GAAP. NOI excludes a number of income and expense categories as detailed in the reconciliation of NOI to net income.

A reconciliation of NOI to net income for the three and nine months ended September 30, 2010 and 2009 is as follows:

| | For the three months ended | | For the nine months ended | |
|--|----------------------------|-----------|---------------------------|------------|
| | 9-30-10 | 9-30-09 | 9-30-10 | 9-30-09 |
| Net income | \$ 23,980 | \$ 58,101 | \$ 147,414 | \$ 121,924 |
| Indirect operating expenses, net of corporate income | 7,189 | 6,987 | 22,269 | 22,922 |

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| | | | | |
|--|------------|------------|------------|------------|
| Investments and investment management expense | 1,026 | 976 | 3,111 | 2,799 |
| Expensed development and other pursuit costs | 737 | 1,721 | 1,685 | 5,096 |
| Interest expense, net | 44,262 | 41,205 | 128,260 | 108,215 |
| Gain on extinguishment of debt, net | -- | -- | -- | (1,062) |
| General and administrative expense | 7,039 | 5,750 | 19,975 | 18,388 |
| Equity in (income) loss of unconsolidated entities | 325 | (190) | (364) | (4,139) |
| Depreciation expense | 58,628 | 52,987 | 171,956 | 153,992 |
| Impairment loss - land holdings | -- | -- | -- | 20,302 |
| Gain on sale of real estate assets | -- | (26,911) | (72,220) | (26,911) |
| (Income) loss from discontinued operations | 99 | (3,685) | (1,917) | (10,991) |
| Net operating income | \$ 143,285 | \$ 136,941 | \$ 420,169 | \$ 410,535 |

The primary performance measure for communities under development or redevelopment depends on the stage of completion. While under development, management monitors actual construction costs against budgeted costs as well as lease-up pace and rent levels compared to budget.

The following table provides details of the Company's segment information as of the dates specified. The segments are classified based on the individual community's status as of the beginning of the given calendar year. Therefore, each year the composition of communities within each business segment is adjusted. Accordingly, the amounts between years are not directly comparable. Segment information for the three and nine months ended September 30, 2010 and 2009 have been adjusted for the communities that were sold from January 1, 2009 through September 30, 2010, or otherwise qualify as discontinued operations as of September 30, 2010, as described in Note 7, "Real Estate Disposition Activities".

| | For the three months ended | | | For the nine months ended | | | Gross real estate (1) |
|---|----------------------------|------------|--|---------------------------|------------|--|-----------------------------|
| | Total revenue | NOI | % NOI change from prior year | Total revenue | NOI | % NOI change from prior year | |
| For the period ended September 30, 2010 | | | | | | | |
| Established | | | | | | | |
| New England | \$ 36,291 | \$ 22,562 | (0.1 %) | \$ 107,138 | \$ 66,505 | (2.3 %) | \$ 1,099,428 |
| Metro NY/NJ | 45,945 | 29,944 | (2.2 %) | 135,622 | 90,041 | (3.4 %) | 1,391,159 |
| Mid-Atlantic/Midwest | 30,382 | 18,290 | 1.9 % | 89,704 | 54,501 | (1.0 %) | 751,739 |
| Pacific Northwest | 6,593 | 4,035 | (14.7 %) | 19,824 | 12,710 | (14.6 %) | 239,936 |
| Northern California | 29,754 | 20,248 | (1.4 %) | 88,707 | 60,651 | (8.0 %) | 1,113,445 |
| Southern California | 14,683 | 9,328 | (2.8 %) | 44,142 | 28,466 | (6.9 %) | 468,666 |
| Total Established | 163,648 | 104,407 | (1.5 %) | 485,137 | 312,874 | (4.6 %) | 5,064,373 |
| Other Stabilized | 31,783 | 19,411 | N/A | 90,442 | 54,403 | N/A | 1,597,052 |
| Development / Redevelopment | 30,352 | 19,467 | N/A | 82,461 | 52,892 | N/A | 1,604,250 |
| Land Held for Future Development | N/A | N/A | N/A | N/A | N/A | N/A | 228,496 |
| Non-allocated (2) | 1,800 | N/A | N/A | 5,334 | N/A | N/A | 74,539 |
| Total | \$ 227,583 | \$ 143,285 | 4.6 % | \$ 663,374 | \$ 420,169 | 2.3 % | \$ 8,568,710 |
| For the period ended September 30, 2009 | | | | | | | |
| Established | | | | | | | |
| New England | \$ 30,313 | \$ 18,964 | (7.2 %) | \$ 91,665 | \$ 57,750 | (6.1 %) | \$ 857,868 |
| Metro NY/NJ | 38,620 | 25,541 | (9.5 %) | 117,568 | 79,283 | (5.5 %) | 1,047,469 |

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| | | | | | | | |
|----------------------------------|------------|------------|----------|------------|------------|---------|--------------|
| Mid-Atlantic/Midwest | 30,662 | 18,458 | (0.7 %) | 91,711 | 56,704 | (1.8 %) | 774,762 |
| Pacific Northwest | 6,983 | 4,720 | (9.9 %) | 21,537 | 14,870 | (5.6 %) | 238,801 |
| Northern California | 24,203 | 16,681 | (13.2 %) | 75,034 | 54,019 | (6.1 %) | 855,803 |
| Southern California | 15,551 | 10,066 | (14.2 %) | 47,442 | 32,159 | (9.9 %) | 426,957 |
| Total Established | 146,332 | 94,430 | (8.7 %) | 444,957 | 294,785 | (5.5 %) | 4,201,660 |
| Other Stabilized | 32,154 | 21,321 | N/A | 94,691 | 61,582 | N/A | 1,410,927 |
| Development / Redevelopment | 34,679 | 21,190 | N/A | 91,744 | 54,168 | N/A | 2,148,151 |
| Land Held for Future Development | N/A | N/A | N/A | N/A | N/A | N/A | 243,656 |
| Non-allocated (2) | 1,878 | N/A | N/A | 5,423 | N/A | N/A | 71,765 |
| Total | \$ 215,043 | \$ 136,941 | (0.0 %) | \$ 636,815 | \$ 410,535 | 2.1 % | \$ 8,076,159 |

Does not include gross real estate assets held for sale of \$10,210 and \$274,573 as of September 30, 2010 and (1) 2009, respectively.

Revenue represents third-party management, asset management and developer fees and miscellaneous income (2) which are not allocated to a reportable segment.

9. Stock-Based Compensation Plans

Information with respect to stock options granted under the Company's 1994 Stock Option and Incentive Plan (the "1994 Plan") and under the AvalonBay Communities, Inc. 2009 Stock Option and Incentive Plan (the "2009 Plan") are as follows:

| | 2009 Plan shares | Weighted average exercise price per share | 1994 Plan shares | Weighted average exercise price per share |
|---|---------------------|---|---------------------|---|
| Options Outstanding, December 31, 2009 | -- | \$ -- | 2,836,254 | \$ 80.76 |
| Exercised | -- | -- | (555,076) | 57.09 |
| Granted | 126,484 | 74.20 | -- | -- |
| Forfeited | -- | -- | (34,656) | 100.02 |
| Options Outstanding, September 30, 2010 | 126,484 | \$ 74.20 | 2,246,522 | \$ 86.32 |
| Options Exercisable September 30, 2010 | -- | N/A | 1,896,182 | \$ 90.69 |

The weighted average fair value of the options granted under the 2009 Plan during the nine months ended September 30, 2010 is estimated at \$19.45 per share on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of 5.5% over the expected life of the option, volatility of 43.00%, risk-free interest rate of 3.15% and an expected life of approximately seven years.

At September 30, 2010, the Company had 234,194 outstanding unvested shares granted under restricted stock awards. The Company issued 102,984 shares of restricted stock valued at \$7,777 as part of its stock-based compensation plan during the nine months ended September 30, 2010. Restricted stock vesting during the nine months ended September 30, 2010 totaled 113,398 shares and had fair values at the grant date ranging from \$48.60 to \$147.75 per share. The total grant date fair value of shares vested was \$9,467 and \$10,687 for the nine months ended September 30, 2010 and 2009, respectively.

Total employee stock-based compensation cost recognized in income was \$7,709 and \$10,056 for the nine months ended September 30, 2010 and 2009, respectively, and total capitalized stock-based compensation cost was \$3,857 and \$5,193 for the nine months ended September 30, 2010 and 2009, respectively. At September 30, 2010, there was a total of \$1,929 and \$6,589 in unrecognized compensation cost for unvested stock options and unvested restricted stock, respectively, which does not include estimated forfeitures. The unrecognized compensation cost for unvested stock options and restricted stock is expected to be recognized over a weighted average period of 1.77 years and 2.36 years, respectively.

Deferred Stock Performance Plan

The total cost recognized in earnings in connection with the multi-year performance plan implemented by the Company in 2008 was \$1,280 and \$1,313 for the nine months ended September 30, 2010 and 2009, respectively, and total capitalized stock-based compensation cost was \$699 and \$661 for the nine months ended September 30, 2010 and 2009, respectively.

10. Related Party Arrangements

Unconsolidated Entities

The Company manages unconsolidated real estate entities for which it receives asset management, property management, development and redevelopment fee revenue. From these entities, the Company received fees of \$1,800 and \$1,878 in the three months ended September 30, 2010 and 2009, respectively and \$5,334 and \$5,423 for the nine months ended September 30, 2010 and 2009, respectively. These fees are included in management, development and other fees on the accompanying Condensed Consolidated Statements of Operations and Other Comprehensive Income. In addition, the Company has outstanding receivables associated with its management role of \$4,634 and \$2,706 as of September 30, 2010 and 2009, respectively.

In addition, the Company acquired a mortgage note secured by a Fund I community. See Note 6, "Investments in Real Estate Entities" for further discussion.

Director Compensation

The Company recorded non-employee director compensation expense relating to the restricted stock grants and deferred stock awards in the amount of \$182 and \$614 for the three and nine months ended September 30, 2010 as a component of general and administrative expense. Deferred compensation relating to these restricted stock grants and deferred stock awards was \$500 and \$365 on September 30, 2010 and December 31, 2009, respectively.

11. Fair Value

Financial Instruments Carried at Fair Value

Derivative Financial Instruments

Currently, the Company uses interest rate swap and interest rate cap agreements to manage its interest rate risk. These instruments are carried at fair value in the Company's financial statements. See Note 5, "Derivative Instruments and Hedging Activities," for derivative values at September 30, 2010 and a description of where these amounts are recorded in the financial statements. In adjusting the fair value of its derivative contracts for the effect of counterparty nonperformance risk, the Company has considered the impact of its net position with a given counterparty, as well as any applicable credit enhancements, such as collateral postings, thresholds, mutual puts, and guarantees. Although the Company has determined that the majority of the inputs used to value its derivatives fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with its derivatives use Level 3 inputs, such as estimates of current credit spreads, to evaluate the likelihood of default by itself and its counterparties. As of September 30, 2010, the Company assessed the significance of the impact of the credit valuation adjustments on the overall valuation of its derivative positions and has determined it is not significant. As a result, the Company has determined that its derivative valuations are classified in Level 2 of the fair value hierarchy.

Redeemable Noncontrolling Interests

Puts – The Company provided redemption options (the "Puts") that allow two of the Company's joint venture partners to require the Company to purchase their interests in the investments at the future fair market value. One Put is payable in cash or, at the Company's option, common stock of the Company, and the second is payable in cash. The Company determines the fair value of the Puts based on unobservable inputs considering the assumptions that market participants would make in pricing the obligations. The Company applies discount factors to the estimated future cash flows of the asset underlying the associated joint venture, which in the case of the Puts is the NOI from an apartment community, as well as potential disposition proceeds utilizing market capitalization rates, to derive the fair value of the position. Given the significance of the unobservable inputs, the valuations are classified in Level 3 of the fair value hierarchy. At December 31, 2009, the Puts' aggregate fair value was \$4,101. At September 30, 2010, the aggregate fair value of the Puts was \$8,600.

DownREIT units – The Company issued units of limited partnership interest in DownREITs which provide the DownREIT limited partners the ability to present all or some of their units for redemption for a cash amount as determined by the applicable partnership agreement. Under the DownREIT agreements, for each limited partnership unit, the limited partner is entitled to receive cash in the amount equal to the fair value of the Company's common stock on or about the date of redemption. In lieu of cash redemption, the Company may elect to exchange such units for an equal number of shares in the Company's common stock. The limited partnership units in DownREITs are valued using the market price of the Company's common stock, a Level 1 price under the fair value hierarchy. At December 31, 2009, the fair value of the DownREIT units was \$1,260. At September 30, 2010, the fair value of the DownREIT units was \$1,594.

Financial Instruments Not Carried at Fair Value

Cash and Cash Equivalents

Cash and cash equivalent balances are held with various financial institutions within principal protected accounts. The Company monitors credit ratings of these financial institutions and the concentration of cash and cash equivalent balances with any one financial institution and believes the likelihood of realizing material losses related to

cash and cash equivalent balances is remote. Cash and cash equivalents are carried at their face amounts, which reasonably approximate their fair values.

Other Financial Instruments

Rents receivable, accounts and construction payable and accrued expenses and other liabilities are carried at their face amounts, which reasonably approximate their fair values.

The Company values its bond indebtedness, notes payable and outstanding amounts under the Credit Facility using a discounted cash flow analysis on the expected cash flows of each instrument. This analysis reflects the contractual terms of the instrument, including the period to maturity, and uses observable market-based inputs, including interest rate curves. The process also considers credit valuation adjustments to appropriately reflect the Company's nonperformance risk. The Company has concluded that the value of its bond indebtedness and notes payable are Level 2 prices as the majority of the inputs used to value its positions fall within Level 2 of the fair value hierarchy. Bond indebtedness, notes payable and outstanding amounts under the Credit Facility (as applicable) with an aggregate outstanding par amount of approximately \$3,947,887 and \$3,977,320 had an estimated aggregate fair value of \$4,159,873 and \$4,052,817 at September 30, 2010 and December 31, 2009, respectively.

12. Subsequent Events

The Company has evaluated subsequent events through the date on which this Form 10-Q was filed, the date on which these financial statements were issued, and identified the following for disclosure.

In October 2010, the Company repaid a variable rate secured mortgage note in the amount of \$28,989 in accordance with its scheduled maturity date.

In October 2010, the Company repaid a 5.17% fixed rate secured mortgage note in the amount of \$9,780 in advance of its July 2024 scheduled maturity date.

Also in October 2010, without admitting or denying liability, the Company settled the outstanding litigation with the U.S. Attorney's Office for the Southern District of New York regarding the Avalon Chrystie Place joint venture, in which the Company has an interest. The settlement requirements include that the Company make various agreed upon modifications to the apartment homes and common areas at Avalon Chrystie Place and inspect and, to the extent necessary, negotiate and make modifications at six other New York City communities. The Company expects that all retrofits will be capitalized as real estate improvements, and that the settlement and the Company's fulfillment of its terms will not have a material impact on the Company's financial condition or results of operations.

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 ("MD&A") is intended to help provide an understanding of our business and results of operations. This MD&A should be read in conjunction with our Condensed Consolidated Financial Statements and the accompanying Notes to Condensed Consolidated Financial Statements included elsewhere in this report. This report, including the following MD&A, contains forward-looking statements regarding future events or trends as described more fully under "Forward-Looking Statements" included in this report. Actual results or developments could differ materially from those projected in such statements as a result of the factors described under "Forward-Looking Statements" below and the risk factors described in Item 1a, "Risk Factors," of our Form 10-K for the year ended December 31, 2009 (our "Form 10-K").

All capitalized terms have the meaning as provided elsewhere in this Form 10-Q.

Executive Overview

Business Description

We are primarily engaged in developing, acquiring, owning and operating apartment communities in high barrier to entry markets of the United States. We believe that apartment communities are an attractive long-term investment opportunity compared to other real estate investments because a broad potential resident base should help reduce demand volatility over a real estate cycle. We seek to create long-term shareholder value by accessing capital at cost effective terms; deploying that capital to develop, redevelop and acquire apartment communities in high barrier to entry markets; operating apartment communities; and selling communities when they no longer meet our long-term investment strategy or when pricing is attractive. Barriers to entry in our markets generally include a difficult and lengthy entitlement process with local jurisdictions and dense urban or suburban areas where zoned and entitled land is in limited supply.

We regularly evaluate the allocation of our investments by the amount of invested capital and by product type within our individual markets, which are located in New England, the New York/New Jersey metro area, the Mid-Atlantic, the Midwest, the Pacific Northwest, and the Northern and Southern California regions of the United States. Our strategy is to be leaders in market research and capital allocation, delivering a range of multifamily offerings tailored to serve the needs of the most attractive customer segments in the best-performing submarkets of the United States. Our communities are predominately upscale, which generally command among the highest rents in their markets. However, we also pursue the ownership and operation of apartment communities that target a variety of customer segments and price points, consistent with our goal of offering a broad range of products and services.

Third Quarter 2010 Highlights

Net income attributable to common stockholders for the quarter ended September 30, 2010 was \$24,654,000, a decrease of \$33,500,000 or 57.6% from the prior year period. The decrease is attributable primarily to gains from dispositions in the third quarter of 2009, with no comparable activity in the third quarter of 2010.

For the quarter ended September 30, 2010, Established Communities NOI decreased by 1.5% or \$1,614,000 from the prior year period, a continued improvement over the NOI declines of 7.6% and 4.4% for the quarters ended March 31, 2010 and June 30, 2010, respectively. This year-over-year decline for the three months ended September 30, 2010 was driven primarily by an increase in operating expenses of 3.3%. The increase in expenses is offset somewhat by an increase in rental revenue of 0.2%, the first quarter of year-over-year growth in rental revenue for our Established Communities since 2008.

Financial Outlook

Our portfolio results for the quarter ended September 30, 2010 reflect both year-over-year revenue growth, as well as continued sequential rental revenue growth. The increase in revenues is driven by both our portfolio growth through new development as well as an increase in rental rates, partially offset by a decrease in occupancy. We expect year-over-year revenue growth to continue for the balance of 2010. The improvement in fundamentals in the multifamily sector continues to be supported by a combination of a decline in the homeownership rate, modest employment growth and limited supply of new multifamily rental product. We expect further improvement in revenue growth and operating fundamentals will be driven by home ownership trends, demographic trends, as well as the timing and magnitude of employment growth. We believe that the recent improvement in apartment fundamentals, as well as favorable capital markets activity, supports our expanded investment activity as further discussed below.

During the quarter ended September 30, 2010, we started construction of five communities containing 920 apartment homes at an aggregate total capitalized cost of \$232,500,000. Four of our five development starts are second phases of current operating communities. At September 30, 2010, twelve communities were under construction with a total projected capitalized cost of approximately \$1,072,500,000. As of September 30, 2010, approximately \$779,889,000 of the capital for this development was invested, with \$292,611,000 remaining to invest. We have obtained \$28,100,000 of this required funding through financing from secured tax-exempt and taxable debt. At September 30, 2010 our combined development under way and in planning currently is \$3,192,500,000, providing us the ability to deliver assets into expected favorable market conditions in late 2011 and 2012.

During the three months ended September 30, 2010, we started the redevelopment of Avalon at Discoverly. The redevelopment will focus on the first phase of the community, which comprises 368 of the 564 apartment homes. We expect to complete the redevelopment of Avalon at Discoverly for \$7,800,000, excluding costs incurred prior to redevelopment. At September 30, 2010, there were seven communities under redevelopment, with an expected investment of approximately \$73,400,000, excluding costs incurred prior to the start of redevelopment, with \$33,046,000 remaining to be invested. During the three months ended September 30, 2010, we completed the redevelopment of Avalon Burbank, a 400 apartment home community in Burbank, CA for \$23,400,000, excluding costs incurred prior to redevelopment. We expect to increase our current level of redevelopment activity through the end of 2010 and into 2011, taking the opportunity to reinvest and reposition our assets to meet the needs of our residents and ensure that our assets are positioned to outperform as the economy fully recovers.

At present, cash on hand and available capital from our Credit Facility are sufficient to provide the capital necessary to fund our development and redevelopment activities for the balance of 2010. We believe that the strength of our balance sheet, as measured by our current level of indebtedness, our current ability to service interest and other fixed charges and our current limited use of financial encumbrances (such as secured financing), provides us with adequate access to liquidity from the capital markets through the issuance of corporate securities (which could include unsecured debt and/or common and preferred equity) and secured debt, as well as other sources of liquidity such as from joint ventures or from our retained cash, to meet any reasonably foreseeable liquidity needs as they arise. See the discussion under Liquidity and Capital Resources.

While we continue to grow principally through our demonstrated core competency of developing wholly owned assets, we also acquire interests in additional assets, primarily through our investment in two private discretionary investment funds.

We established Fund I and Fund II (collectively "the Funds") to engage in acquisition programs through discretionary investment funds. We believe this investment format provides the following attributes: (i) third-party joint venture equity as an additional source of financing to expand and diversify our portfolio; (ii) additional sources of income in

the form of property management and asset management fees and, potentially, incentive distributions if the performance of the Funds exceeds certain thresholds; and (iii) visibility into the transactions occurring in multi-family assets that helps us with other investment decisions related to our wholly owned portfolio.

One of our wholly owned subsidiaries is the general partner of Fund I and we have made an equity investment of approximately \$44,000,000 in Fund I (net of distributions and excluding the purchase of a mortgage note secured by a Fund I community), representing a 15.2% combined general partner and limited partner equity interest. Fund I was our principal vehicle for acquiring apartment communities through the close of its investment period in March 2008. Subsidiaries of Fund I have 21 loans, including one held by us, as discussed below, secured by individual assets with amounts outstanding in the aggregate of \$434,181,000 with varying maturity dates (or dates after which the loans can be prepaid without penalty), ranging from October 2011 to September 2016. These mortgage loans are secured by the underlying real estate.

In the third quarter of 2010, a lender ran a competitive bid process to sell a \$26,000,000 non-recourse mortgage note secured by a Fund I asset. We participated in the bidding and purchased the note on an arms length basis for \$24,000,000. The note pays interest-only through the maturity date of October 2014 at a stated interest rate of 6.06%. Subsequent to acquisition, we modified certain terms of the mortgage note, including (i) conforming the original principal balance to our purchase price, (ii) modifying the interest payment terms to require remittance of interest based on available cash flow with any deficiency in the monthly payment amount accruing to the principal due on the note, and (iii) modifying certain terms to help eliminate any potential conflicts between us and Fund I, such as removing any prepayment penalty. At the date of acquisition and at September 30, 2010, the fair value of the underlying collateral exceeded the note's carrying balance.

Fund II has six institutional investors, including us. One of our wholly owned subsidiaries is the general partner of Fund II and we have total equity commitments of \$125,000,000, representing a 31.3% combined general partner and limited partner equity interest. Fund II had invested \$381,612,000 as of September 30, 2010. Fund II has a term that expires in August 2018, plus two one-year extension options. Fund II now serves as the exclusive vehicle through which we will acquire investment interests in apartment communities until August 2011 or, if earlier, until 90% of the committed capital of Fund II is invested, subject to limited exceptions. Fund II will not include or involve our development activities. We will receive, in addition to any returns on our invested equity, asset management fees, property management fees and redevelopment fees. We will also receive a promoted interest if certain return thresholds are met. During the three months ended September 30, 2010 subsidiaries of Fund II acquired the following three operating communities:

Creekside Meadows, a garden-style community consisting of 628 apartment homes located in Tustin (Orange County), CA, was acquired for a purchase price of \$98,500,000;

Grove Park Apartments, a garden-style community consisting of 684 apartment homes located in Gaithersburg, MD was acquired for a purchase price of \$101,000,000; and

The Apartments at Briarwood, a garden-style community consisting of 348 apartment homes located in Owings Mills, MD, was acquired for a purchase price of \$44,750,000.

Subsidiaries of Fund II have five loans secured by individual assets with amounts outstanding in the aggregate of \$205,165,000 with varying maturity dates (or dates after which the loans can be prepaid without penalty), ranging from May 2017 to June 2019. These mortgage loans are secured by the underlying real estate.

Communities Overview

Our real estate investments consist primarily of current operating apartment communities, communities in various stages of development ("Development Communities") and Development Rights as defined below. Our current operating communities are further distinguished as Established Communities, Other Stabilized Communities, Lease-Up Communities and Redevelopment Communities. The following is a description of each category:

Current Communities are categorized as Established, Other Stabilized, Lease-Up, or Redevelopment according to the following attributes:

Established Communities (also known as Same Store Communities) are consolidated communities where a comparison of operating results from the prior year to the current year is meaningful, as these communities were owned and had stabilized occupancy and operating expenses as of the beginning of the prior year. For the period ended September 30, 2010, the Established Communities are communities that are consolidated for financial reporting purposes, had stabilized occupancy and operating expenses as of January 1, 2009, are not conducting or planning to conduct substantial redevelopment activities and are not held for sale or planned for disposition within

the current year. A community is considered to have stabilized occupancy at the earlier of (i) attainment of 95% physical occupancy or (ii) the one-year anniversary of completion of development or redevelopment.

Other Stabilized Communities are all other completed communities that we own or have a direct or indirect ownership interest in, and that have stabilized occupancy, as defined above. Other Stabilized Communities do not include communities that are conducting or planning to conduct substantial redevelopment activities within the current year.

Lease-Up Communities are communities where construction has been complete for less than one year and where physical occupancy has not reached 95%.

Redevelopment Communities are communities where substantial redevelopment is in progress or is planned to begin during the current year. Redevelopment is considered substantial when capital invested during the reconstruction effort is expected to exceed either \$5,000,000 or 10% of the community's pre-redevelopment basis and is expected to have a material impact on the operations of the community, including occupancy levels and future rental rates.

Development Communities are communities that are under construction and for which a certificate of occupancy has not been received. These communities may be partially or fully complete and operating.

Development Rights are development opportunities in the early phase of the development process for which we either have an option to acquire land or enter into a leasehold interest, for which we are the buyer under a long-term conditional contract to purchase land or where we control the land through a ground lease or own land to develop a new community. We capitalize related pre-development costs incurred in pursuit of new developments for which we currently believe future development is probable.

We currently lease our corporate headquarters located in Arlington, Virginia under an operating lease. The lease term ends in 2020, subject to two five year renewal options. In addition, we currently own approximately 60,000 square feet of office space in Alexandria, Virginia, which formerly served as our corporate office. We have entered into an agreement to sell the office space in Alexandria, Virginia, and expect to finalize the sale in the fourth quarter of 2010. All other regional and administrative offices are leased under operating leases.

As of September 30, 2010, communities that we owned or held a direct or indirect interest in were classified as follows:

| | Number of communities | Number of apartment homes |
|--------------------------------------|--------------------------|---------------------------------|
| Current Communities | | |
| Established Communities: | | |
| New England | 25 | 6,442 |
| Metro NY/NJ | 21 | 6,908 |
| Mid-Atlantic/Midwest | 15 | 5,944 |
| Pacific Northwest | 8 | 1,943 |
| Northern California | 20 | 5,975 |
| Southern California | 12 | 3,460 |
| Total Established | 101 | 30,672 |
| Other Stabilized Communities: | | |
| New England | 9 | 2,169 |
| Metro NY/NJ | 9 | 2,423 |
| Mid-Atlantic/Midwest | 13 | 3,836 |
| Pacific Northwest | 4 | 1,021 |
| Northern California | 8 | 2,145 |
| Southern California | 15 | 4,158 |
| Total Other Stabilized | 58 | 15,752 |
| Lease-Up Communities | 1 | 276 |
| Redevelopment Communities | 7 | 2,361 |
| Total Current Communities | 167 | 49,061 |
| Development Communities | 12 | 3,429 |
| Development Rights | 24 | 6,984 |

Results of Operations

Our year-over-year operating performance is primarily affected by both overall and individual geographic market conditions and apartment fundamentals and is reflected in changes in NOI of our Established Communities; NOI derived from acquisitions and development completions; the loss of NOI related to disposed communities; and capital market and financing activity. A comparison of our operating results for the three and nine months ended September 30, 2010 and 2009 follows (dollars in thousands):

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| | For the three months ended | | | | For the nine months ended | | | | |
|---|----------------------------|------------|-----------|----------|---------------------------|------------|-----------|----------|--|
| | 9-30-10 | 9-30-09 | \$ Change | % Change | 9-30-10 | 9-30-09 | \$ Change | % Change | |
| Revenue: | | | | | | | | | |
| Rental and other income | \$ 225,783 | \$ 213,165 | \$ 12,618 | 5.9 % | \$ 658,040 | \$ 631,392 | \$ 26,648 | 4.2 % | |
| Management, development and other fees | 1,800 | 1,878 | (78) | (4.2 %) | 5,334 | 5,423 | (89) | (1.6 %) | |
| Total revenue | 227,583 | 215,043 | 12,540 | 5.8 % | 663,374 | 636,815 | 26,559 | 4.2 % | |
| Expenses: | | | | | | | | | |
| Direct property operating expenses, excluding property taxes | 59,114 | 55,164 | 3,950 | 7.2 % | 168,492 | 158,821 | 9,671 | 6.1 % | |
| Property taxes | 23,402 | 21,093 | 2,309 | 10.9 % | 69,695 | 61,871 | 7,824 | 12.6 % | |
| Total community operating expenses | 82,516 | 76,257 | 6,259 | 8.2 % | 238,187 | 220,692 | 17,495 | 7.9 % | |
| Corporate-level property management and other indirect operating expenses | 8,971 | 8,832 | 139 | 1.6 % | 27,287 | 28,510 | (1,223) | (4.3 %) | |
| Investments and investment management expense | 1,026 | 976 | 50 | 5.1 % | 3,111 | 2,799 | 312 | 11.1 % | |
| Expensed development and other pursuit costs | 737 | 1,721 | (984) | (57.2 %) | 1,685 | 5,096 | (3,411) | (66.9 %) | |
| Interest expense, net | 44,262 | 41,205 | 3,057 | 7.4 % | 128,260 | 108,215 | 20,045 | 18.5 % | |
| Gain on extinguishment of debt, net | -- | -- | N/A | N/A | -- | (1,062) | 1,062 | (100.0%) | |
| Depreciation expense | 58,628 | 52,987 | 5,641 | 10.6 % | 171,956 | 153,992 | 17,964 | 11.7 % | |
| General and administrative expense | 7,039 | 5,750 | 1,289 | 22.4 % | 19,975 | 18,388 | 1,587 | 8.6 % | |
| Impairment loss | -- | -- | -- | N/A | -- | 20,302 | (20,302) | (100.0%) | |

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| | | | | | | | | |
|--|-----------|-----------|-------------|-----------|------------|------------|-----------|-----------|
| Gain on sale of land | -- | (241) | 241 | (100.0 %) | -- | (241) | 241 | (100.0 %) |
| Total other expenses | 120,663 | 111,230 | 9,433 | 8.5 % | 352,274 | 335,999 | 16,275 | 4.8 % |
| Equity in income (loss) of unconsolidated entities | (325) | 190 | (515) | (271.1 %) | 364 | 4,139 | (3,775) | (91.2 %) |
| Income from continuing operations | 24,079 | 27,746 | (3,667) | (13.2 %) | 73,277 | 84,263 | (10,986) | (13.0 %) |
| Discontinued operations: | | | | | | | | |
| Income (loss) from discontinued operations | (99) | 3,685 | (3,784) | (102.7 %) | 1,917 | 10,991 | (9,074) | (82.6 %) |
| Gain on sale of communities | - | 26,670 | (26,670) | (100.0 %) | 72,220 | 26,670 | 45,550 | 170.8 % |
| Total discontinued operations | (99) | 30,355 | (30,454) | (100.3 %) | 74,137 | 37,661 | 36,476 | 96.9 % |
| Net income | 23,980 | 58,101 | (34,121) | (58.7 %) | 147,414 | 121,924 | 25,490 | 20.9 % |
| Net (income) loss attributable to noncontrolling interests | 674 | 53 | 621 | 1,171.7 % | 890 | 1,329 | (439) | (33.0 %) |
| Net income attributable to common stockholders | \$ 24,654 | \$ 58,154 | \$ (33,500) | (57.6 %) | \$ 148,304 | \$ 123,253 | \$ 25,051 | 20.3 % |

Net income attributable to common stockholders decreased \$33,500,000 or 57.6%, to \$24,654,000 for the three months ended September 30, 2010 and increased \$25,051,000 or 20.3% to \$148,304,000 for the nine months ended September 30, 2010. The decrease for the three months ended September 30, 2010 from the prior year period is due primarily to gains on asset sales during the three months ended September 30, 2009 that were not present in the three months ended September 30, 2010. The increase for the nine months ended September 30, 2010 over the prior year period is due primarily to increased gains from the disposition of communities in 2010 as compared to the prior year period as well as the asset impairment reported in 2009 with no comparable charge in 2010. Both the three and nine months ended September 30, 2010 were also impacted by the growth in income from newly developed communities and increases in interest and depreciation expense in 2010 over the prior year period.

NOI is considered by management to be an important and appropriate supplemental performance measure to net income because it helps both investors and management to understand the core operations of a community or communities prior to the allocation of any corporate-level or financing-related costs. NOI reflects the operating performance of a community and allows for an easy comparison of the operating performance of individual assets or

groups of assets. In addition, because prospective buyers of real estate have different financing and overhead structures, with varying marginal impacts to overhead by acquiring real estate, NOI is considered by many in the real estate industry to be a useful measure for determining the value of a real estate asset or group of assets. We define NOI as total property revenue less direct property operating expenses, including property taxes, and excluding corporate-level income (including management, development and other fees), corporate-level property management and other indirect operating expenses, investments and investment management expenses, expensed development and other pursuit costs, net interest expense, gain (loss) on extinguishment of debt, general and administrative expense, joint venture income (loss), depreciation expense, impairment loss on land holdings, gain on sale of real estate assets and income from discontinued operations.

NOI does not represent cash generated from operating activities in accordance with GAAP. Therefore, NOI should not be considered an alternative to net income as an indication of our performance. NOI should also not be considered an alternative to net cash flow from operating activities, as determined by GAAP, as a measure of liquidity, nor is NOI indicative of cash available to fund cash needs. Reconciliations of NOI for the three and nine months ended September 30, 2010 and 2009 to net income for each period, are as follows (dollars in thousands):

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| | For the three months ended | | For the nine months ended | |
|--|----------------------------|------------|---------------------------|------------|
| | 9-30-10 | 9-30-09 | 9-30-10 | 9-30-09 |
| Net income | \$ 23,980 | \$ 58,101 | \$ 147,414 | \$ 121,924 |
| Indirect operating expenses, net of corporate income | 7,189 | 6,987 | 22,269 | 22,922 |
| Investments and investment management expense | 1,026 | 976 | 3,111 | 2,799 |
| Expensed development and other pursuit costs | 737 | 1,721 | 1,685 | 5,096 |
| Interest expense, net | 44,262 | 41,205 | 128,260 | 108,215 |
| Gain on extinguishment of debt, net | -- | -- | -- | (1,062) |
| General and administrative expense | 7,039 | 5,750 | 19,975 | 18,388 |
| Equity in (income) loss of unconsolidated entities | 325 | (190) | (364) | (4,139) |
| Depreciation expense | 58,628 | 52,987 | 171,956 | 153,992 |
| Impairment loss - land holdings | -- | -- | -- | 20,302 |
| Gain on sale of real estate assets | -- | (26,911) | (72,220) | (26,911) |
| (Income) loss from discontinued operations | 99 | (3,685) | (1,917) | (10,991) |
| Net operating income | \$ 143,285 | \$ 136,941 | \$ 420,169 | \$ 410,535 |

The NOI changes for the three and nine months ended September 30, 2010, as compared to the prior year period, consist of changes in the following categories (dollars in thousands):

| | For the three months ended | For the nine months ended |
|---|----------------------------|---------------------------|
| | 9-30-10 | 9-30-10 |
| Established Communities | \$ (1,614) | \$ (14,918) |
| Other Stabilized Communities | 4,086 | 20,819 |
| Development and Redevelopment Communities | 3,872 | 3,733 |
| Total | \$ 6,344 | \$ 9,634 |

The NOI decrease for our Established Communities for the quarter ended September 30, 2010 from the prior year period is due primarily to an increase in operating expenses related to repairs and maintenance activity. The decrease in our Established Communities' NOI for the nine months ended September 30, 2010 is due to a combination of the decline in rental revenues and an increase in operating expenses. In the third quarter of 2010, we experienced the first quarter of year-over-year growth in rental revenue for our Established Communities since 2008. For the balance of 2010, we expect to experience modest growth in rental revenue over the prior year period due to continued improvement in rental rates while maintaining occupancy near current occupancy levels at our Established Communities.

Rental and other income increased in the three and nine months ended September 30, 2010 as compared to the prior year period due to additional rental income generated from newly developed communities and increases in rental rates at our Established Communities, offset somewhat by decreased occupancy for our Established Communities.

Overall Portfolio – The weighted average number of occupied apartment homes decreased to 40,255 apartment homes for the nine months ended September 30, 2010 as compared to 42,323 homes for the prior year period. This decrease is primarily due to fewer homes available due to dispositions and homes taken out of service at our redevelopment communities during 2009 and 2010. The weighted average monthly revenue per occupied apartment home increased to \$1,811 for the nine months ended September 30, 2010 as compared to \$1,728 in the prior year period.

Established Communities – Rental revenue increased \$270,000, or 0.2%, for the three months ended September 30, 2010 from the prior year period. Rental revenue decreased \$10,120,000, or 2.0%, for the nine months ended September 30, 2010 over the prior year period. The increase for the three months ended September 30, 2010 is due to an increase in rental rates, partially offset by a decrease in the average economic occupancy. The decrease for the nine months ended September 30, 2010 was due primarily to a decrease in rental rates, partially offset by an increase in the average economic occupancy. Economic occupancy takes into account the fact that apartment homes of different sizes and locations within a community have different economic impacts on a community's gross revenue. Economic occupancy is defined as gross potential revenue less vacancy loss, as a percentage of gross potential revenue. Economic occupancy increased from 95.5% to 96.2% for the nine months ended September 30, 2010. Gross potential revenue is determined by valuing occupied homes at leased rates and vacant homes at market rents. For the nine months ended September 30, 2010, the weighted average monthly revenue per occupied apartment home decreased 2.7% to \$1,826 compared to \$1,877 in the prior year period.

