Douglas Emmett Inc
Form 10-Q
November 10, 2014

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, 2014

Commission file number 001-33106

Douglas Emmett, Inc.

(Exact name of registrant as specified in its charter)

MARYLAND	20-3073047
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
808 Wilshire Boulevard, Suite 200, Santa Monica, California	90401
(Address of principal executive offices)	(Zip Code)

(310) 255-7700
(Registrant’s telephone number, including area code)

None
(Former name, former address and former fiscal year, 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 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No ¨

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

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

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

Yes ¨ No x

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

Class	Outstanding at	October 31, 2014
Common Stock, $0.01 par value per share	144,826,542	shares

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements
Douglas Emmett, Inc.
Consolidated Balance Sheets
(in thousands, except share data)

	September 30, 2014 (unaudited)	December 31, 2013 (audited)
Assets		
Investment in real estate:		
Land	$867,355	$867,284
Buildings and improvements	5,402,864	5,386,446
Tenant improvements and lease intangibles	808,194	759,003
Investment in real estate, gross	7,078,413	7,012,733
Less: accumulated depreciation and amortization	(1,647,068)	(1,495,819)
Investment in real estate, net	5,431,345	5,516,914
Cash and cash equivalents	12,467	44,206
Tenant receivables, net	1,724	1,760
Deferred rent receivables, net	73,039	69,662
Acquired lease intangible assets, net	3,376	3,744
Investment in unconsolidated real estate funds	174,475	182,896
Other assets	64,225	28,607
Total assets	$5,760,651	$5,847,789
Liabilities		
Secured notes payable	$3,210,210	$3,241,140
Interest payable, accounts payable and deferred revenue	72,929	52,763
Security deposits	36,241	35,470
Acquired lease intangible liabilities, net	48,668	59,543
Interest rate contracts	42,628	63,144
Dividends payable	28,959	28,521
Total liabilities	3,439,635	3,480,581
Equity		
Douglas Emmett, Inc. stockholders' equity:		
Common Stock, $0.01 par value 750,000,000 authorized, 144,793,591 and 142,605,390 outstanding at September 30, 2014 and December 31, 2013, respectively	1,448	1,426
Additional paid-in capital	2,677,717	2,653,905
Accumulated other comprehensive income (loss)	(34,257)	(50,554)
Accumulated deficit	(687,170)	(634,380)
Total Douglas Emmett, Inc. stockholders' equity	1,957,738	1,970,397
Noncontrolling interests	363,278	396,811
Total equity	2,321,016	2,367,208
Total liabilities and equity	$5,760,651	$5,847,789

See notes to consolidated financial statements.

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Douglas Emmett, Inc.
Consolidated Statements of Operations
(unaudited and in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Revenues				
Office rental				
Rental revenues	$97,465	$99,795	$296,342	$296,275
Tenant recoveries	11,093	11,867	33,720	34,170
Parking and other income	19,404	18,677	58,547	55,979
Total office revenues	127,962	130,339	388,609	386,424
Multifamily rental				
Rental revenues	18,767	17,929	55,447	53,146
Parking and other income	1,417	1,418	4,392	4,290
Total multifamily revenues	20,184	19,347	59,839	57,436
Total revenues	148,146	149,686	448,448	443,860
Operating Expenses				
Office expense	47,636	46,494	135,657	130,525
Multifamily expense	5,261	5,157	15,490	15,108
General and administrative	6,658	6,546	20,181	20,724
Depreciation and amortization	50,111	47,402	151,249	141,528
Total operating expenses	109,666	105,599	322,577	307,885
Operating income	38,480	44,087	125,871	135,975
Other income	3,769	2,138	12,642	4,165
Other expenses	(1,983)	(1,402)	(5,114)	(2,777)
Income, including depreciation, from unconsolidated real estate funds	665	811	2,725	3,335
Interest expense	(32,098)	(32,601)	(95,888)	(97,832)
Acquisition-related expenses	(152)	(290)	(180)	(533)
Net income	8,681	12,743	40,056	42,333
Less: Net income attributable to noncontrolling interests	(1,292)	(1,992)	(6,328)	(5,865)
Net income attributable to common stockholders	$7,389	$10,751	$33,728	$36,468
Net income attributable to common stockholders per share – basic	$0.05	$0.08	$0.23	$0.26
Net income attributable to common stockholders per share – diluted	$0.05	$0.07	$0.23	$0.25
Dividends declared per common share	$0.20	$0.18	$0.60	$0.54

See notes to consolidated financial statements.

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Douglas Emmett, Inc.
Consolidated Statements of Comprehensive Income
(unaudited and in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	$8,681	$12,743	$40,056	$42,333
Other comprehensive income (loss): cash flow hedges	12,110	(1,060)	20,270	31,359
Comprehensive income	20,791	11,683	60,326	73,692
Less comprehensive income attributable to noncontrolling interests	(3,388)	(1,818)	(10,301)	(11,857)
Comprehensive income attributable to common stockholders	$17,403	$9,865	$50,025	$61,835

See notes to consolidated financial statements.

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Douglas Emmett, Inc.
Consolidated Statements of Cash Flows
(unaudited and in thousands)

	Nine Months Ended September 30,	
	2014	2013
Operating Activities		
Net income	$40,056	$42,333
Adjustments to reconcile net income to net cash provided by operating activities:		
Income, including depreciation, from unconsolidated real estate funds	(2,725)	(3,335)
Depreciation and amortization	151,249	141,528
Net accretion of acquired lease intangibles	(10,506)	(11,970)
Amortization of deferred loan costs	3,027	2,972
Non-cash market value adjustments on interest rate contracts	50	67
Non-cash amortization of equity compensation	4,049	4,560
Operating distributions from unconsolidated real estate funds	660	558
Change in working capital components:		
Tenant receivables	36	(263)
Deferred rent receivables	(3,377)	(4,717)
Interest payable, accounts payable and deferred revenue	21,230	20,288
Security deposits	771	1,126
Other assets	(9,811)	(2,423)
Net cash provided by operating activities	194,709	190,724
Investing Activities		
Capital expenditures for improvements to real estate	(63,278)	(49,697)
Capital expenditures for developments	(3,099)	(211)
Property acquisitions	—	(150,000)
Insurance recoveries for damage to real estate	4,236	—
Deposits for property acquisitions	(3,000)	—
Note receivable	(27,500)	
Loan to related party	—	(2,882)
Loan payments received from related party	882	
Contributions to unconsolidated real estate funds	—	(26,405)
Acquisitions of additional interests in unconsolidated real estate funds	—	(8,004)
Capital distributions received from unconsolidated real estate funds	8,664	4,755
Net cash used in investing activities	(83,095)	(232,444)
Financing Activities		
Deferred loan cost payments	(377)	(157)
Payment of refundable loan deposit	(1,550)	—
Repayment of borrowings	(30,930)	(90,000)
Contributions by noncontrolling interests	250	584
Distributions to noncontrolling interests	(17,315)	(15,993)
Repurchase of stock options	(4,524)	—
Repurchase of operating partnership units	(2,827)	(352)
Cash dividends to common stockholders	(86,080)	(76,754)
Net cash used in financing activities	(143,353)	(182,672)

Decrease in cash and cash equivalents	(31,739)	(224,392)
Cash and cash equivalents at beginning of period	44,206	373,203
Cash and cash equivalents at end of period	$12,467	$148,811

See notes to consolidated financial statements.

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Douglas Emmett, Inc.
Notes to Consolidated Financial Statements
(unaudited)

1. Overview

Organization and Description of Business

Douglas Emmett, Inc. is a fully integrated, self-administered and self-managed Real Estate Investment Trust (REIT). We are one of the largest owners and operators of high-quality office and multifamily properties in Los Angeles County, California and Honolulu, Hawaii. We focus on owning and acquiring a substantial share of top-tier office properties and premier multifamily communities in neighborhoods that possess significant supply constraints, high-end executive housing and key lifestyle amenities.

Through our interest in Douglas Emmett Properties, LP (our operating partnership) and its subsidiaries, as well as our investment in our institutional unconsolidated real estate funds (Funds), we own or partially own, manage, lease, acquire and develop real estate, consisting primarily of office and multifamily properties in Los Angeles County, California and Honolulu, Hawaii. As of September 30, 2014, we owned a consolidated portfolio of fifty-two office properties (including ancillary retail space) and nine multifamily properties, as well as the fee interests in two parcels of land subject to ground leases. Alongside our consolidated portfolio, we also manage and own equity interests in our Funds which, at September 30, 2014, owned eight additional office properties, for a combined sixty office properties in our total portfolio.

The terms "us," "we" and "our" as used in these financial statements refer to Douglas Emmett, Inc. and its subsidiaries.

Basis of Presentation

The accompanying consolidated financial statements as of September 30, 2014 and December 31, 2013, and for the three and nine months ended September 30, 2014 and 2013, are the consolidated financial statements of Douglas Emmett, Inc. and our subsidiaries, including our operating partnership. All significant intercompany balances and transactions have been eliminated in our consolidated financial statements, and certain prior period amounts have been reclassified to conform with the current period presentation.

The accompanying unaudited interim financial statements have been prepared pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in the financial statements prepared in accordance with accounting principles generally accepted in the United States (GAAP) may have been condensed or omitted pursuant to SEC rules and regulations, although we believe that the disclosures are adequate to make their presentation not misleading. The accompanying unaudited financial statements include, in our opinion, all adjustments, consisting of normal recurring adjustments, necessary to present fairly the financial information set forth therein. The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. The interim financial statements should be read in conjunction with the consolidated financial statements in our 2013 Annual Report on Form 10-K and the notes thereto. Any references to the number of properties, square footage and geography, are unaudited and outside the scope of our independent registered public accounting firm’s review of our financial statements, in accordance with the standards of the United States Public Company Accounting Oversight Board (PCAOB).

2. Summary of Significant Accounting Policies

During the period covered by this report, we have not made any material changes to our significant accounting policies included in our 2013 Annual Report on Form 10-K. During the first quarter of 2014, we added to our policies the accounting for insurance recoveries as follows:

The amount by which insurance recoveries related to property damage exceed any losses recognized from that damage are recorded as other income when payment is either received or receipt is determined to be probable.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make certain estimates and assumptions that affect the reported amounts in the consolidated financial statements and accompanying notes. Actual results could differ materially from those estimates.

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Douglas Emmett, Inc.
Notes to Consolidated Financial Statements (continued)
(unaudited)

Income Taxes

We have elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended. Provided that we qualify for taxation as a REIT, we are generally not subject to corporate-level income tax on the earnings distributed currently to our stockholders that we derive from our REIT qualifying activities. We are subject to corporate-level tax on the earnings that we derive through our taxable REIT subsidiaries (TRS).

Tenant improvements and lease intangibles

Tenant improvements and leasing intangibles are depreciated and amortized on a straight-line basis over the respective lease term. Unamortized lease intangible amounts related to leases terminated prior to their stated expirations are written off in the period of termination. As tenant improvements in our buildings generally remain in place after the expiration of the lease, we continue to carry these items, offset by the related accumulated depreciation, on our balance sheet even after the tenant has moved out. Accordingly, as of September 30, 2014, tenant improvements and leasing intangibles recognized from the purchase of buildings included $354.5 million of fully depreciated and amortized items, and $110.8 million of fully depreciated and amortized items recognized from our leasing activities, compared to $343.6 million and $84.1 million, respectively, at December 31, 2013. Because the inclusion of these items is entirely offset by the related accumulated depreciation and amortization, fully depreciated and amortized items have no impact on our net asset values.

Recently Issued Accounting Literature

Changes to GAAP are established by the Financial Accounting Standards Board (FASB) in the form of Accounting Standard Updates (ASUs). We consider the applicability and impact of all ASUs.

In February 2013, the FASB issued ASU No. 2013-04, Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation is Fixed at the Reporting Date (Topic 405), which provides guidance for the recognition, measurement and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of this ASU is fixed at the reporting date, except for obligations addressed within existing guidance in GAAP. The ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013, which for us was the first quarter of 2014. We adopted ASU No. 2013-04 during the first quarter of 2014, and it did not have a material impact on our financial position or results of operations, as we do not currently have any obligations within the scope of this ASU.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), which provides guidance for the accounting of revenue from contracts with customers. The guidance supersedes the revenue recognition requirements in Topic 605, Revenue Recognition, and most industry-specific guidance throughout the Industry Topics of the Codification. The ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016, which for us is the first quarter of 2017. Early adoption is not permitted. We do not expect this ASU to have a material impact on our financial position or results of operations, as lease contracts are not within the scope of this ASU.

In August 2014, the FASB issued ASU No. 2014-15, Presentation of Financial Statements - Going Concern (Subtopic 205-40), which provides guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures if necessary. The ASU is effective for the annual period ending after December 15, 2016, and for annual and interim periods thereafter, which for us is the fiscal year ended December 31, 2016. Early application is permitted. We do not expect this ASU to have a material impact on our disclosures.

The FASB has not issued any other ASUs during 2014 that we expect to be applicable and have a material impact on our future financial position or results of operations.

3. Acquired Lease Intangibles

The following summarizes our acquired lease intangibles related to above/below-market leases (in thousands) as of:

	September 30, 2014	December 31, 2013
Above-market tenant leases[1]	$34,997	$34,997
Accumulated amortization[1]	(34,210)	(33,899)
Below-market ground leases	3,198	3,198
Accumulated amortization	(609)	(552)
Acquired lease intangible assets, net	$3,376	$3,744
Below-market tenant leases[2]	$272,413	$272,413
Accumulated accretion[2]	(236,151)	(225,425)
Above-market ground leases	16,200	16,200
Accumulated accretion	(3,794)	(3,645)
Acquired lease intangible liabilities, net	$48,668	$59,543

(1) Includes fully amortized above-market tenant leases of $32.2 million at September 30, 2014 and $31.1 million at December 31, 2013.

(2) Includes fully accreted below-market tenant leases of $136.9 million at September 30, 2014 and $131.1 million at December 31, 2013.

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Douglas Emmett, Inc.
Notes to Consolidated Financial Statements (continued)
(unaudited)

4. Other Assets

Other assets consisted of the following (in thousands) as of:

	September 30, 2014	December 31, 2013
Deferred loan costs, net of accumulated amortization of $12,256 and $9,395 at September 30, 2014 and December 31, 2013, respectively [1]	$15,096	$17,745
Note receivable[2]	27,500	—
Restricted cash	194	194
Prepaid expenses	8,749	5,747
Other indefinite-lived intangible	1,988	1,988
Deposits in escrow	4,550	—
Insurance receivable[3]	2,270	—
Other	3,878	2,933
Total other assets	$64,225	$28,607

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(1) We recognized deferred loan cost amortization expense of $1.0 million and $0.9 million for the three months ended September 30, 2014 and 2013, respectively, and $3.0 million and $3.0 million for the nine months ended September 30, 2014 and 2013, respectively. Deferred loan cost amortization is included as a component of interest expense in our consolidated statements of operations.

(2) On February 28, 2014, we loaned $27.5 million to the owner of the land underlying one of our office properties. The loan carries interest of 4.9%, is currently due and payable in 2015, and is secured by that land.

(3) During the three and nine months ended September 30, 2014, we recognized approximately $1.3 million and $6.1 million, respectively, in other income for property repairs, as well as $214 thousand and $684 thousand, respectively, in multifamily rental revenues for lost rental income, and $202 thousand and $654 thousand, respectively, in other expenses for other recoverable expenses, all related to insurance recoveries with respect to a fire at one of our residential properties. At September 30, 2014, we had received cash of $5.2 million, and included in other assets an additional receivable of $2.3 million, the payment which has been confirmed by the insurance companies.

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Notes to Consolidated Financial Statements (continued)
(unaudited)

5. Secured Notes Payable

The table below summarizes our secured notes payable:

Description	Maturity Date	Outstanding Principal Balance as of September 30, 2014 (in thousands)	Outstanding Principal Balance as of December 31, 2013 (in thousands)	Variable Interest Rate	Effective Annual Fixed Interest Rate (2)	Swap Maturity Date
Term loan debt (1)						
Fannie Mae Loan (3)	2/1/2015	$111,920	$111,920	DMBS + 0.707%	N/A	--
Term Loan (4)	3/1/2016	16,140	16,140	LIBOR + 1.60%	N/A	--
Fannie Mae Loan	3/1/2016	82,000	82,000	LIBOR + 0.62%	N/A	--
Fannie Mae Loan	6/1/2017	18,000	18,000	LIBOR + 0.62%	N/A	--
Term Loan	10/2/2017	400,000	400,000	LIBOR + 2.00%	4.45%	7/1/2015
Term Loan	4/2/2018	510,000	510,000	LIBOR + 2.00%	4.12%	4/1/2016
Term Loan	8/1/2018	530,000	530,000	LIBOR + 1.70%	3.74%	8/1/2016
Term Loan (5)	8/5/2018	355,000	355,000	N/A	4.14%	--
Term Loan (6)	2/1/2019	155,000	155,000	N/A	4.00%	--
Term Loan (7)	6/5/2019	285,000	285,000	N/A	3.85%	--
Term Loan (8)	3/1/2020 (9)	349,070	350,000	N/A	4.46%	--
Fannie Mae Loans	11/2/2020	388,080	388,080	LIBOR + 1.65%	3.65%	11/1/2017
Aggregate term loan principal		$3,200,210	$3,201,140			
Revolving credit line (10)	12/11/2017	10,000	40,000	LIBOR + 1.40%	N/A	--
Total principal (11)		$3,210,210	$3,241,140			
Aggregate swapped to fixed rate loans		$1,828,080	$1,828,080		3.98%	
Aggregate fixed rate loans		1,144,070	1,145,000		4.15%	
Aggregate variable rate loans		238,060	268,060		N/A	
Total principal (11)		$3,210,210	$3,241,140			

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(1) As of September 30, 2014, (i) the weighted average remaining life of our outstanding term debt (excluding our revolving credit line) was 4.0 years and (ii) of the $2.97 billion of term debt on which the interest rate was fixed under the terms of the loan or a swap, (a) the weighted average remaining life was 4.3 years, the weighted average remaining period during which interest was fixed was 2.6 years, and the weighted average annual interest rate was 4.05% and (b) including the non-cash amortization of prepaid loan fees, the effective weighted average interest rate was 4.18%. Except as otherwise noted below, each loan is secured by a separate collateral pool consisting of one or more properties, requiring monthly payments of interest only, with the outstanding principal due upon maturity.

(2) Includes the effect of interest rate contracts as of September 30, 2014, and excludes amortization of prepaid loan fees, all shown on an actual/360-day basis. See Note 7 for the details of our interest rate contracts.

(3) The loan has a $75.0 million tranche bearing interest at DMBS + 0.76%, and a $36.9 million tranche bearing interest at DMBS + 0.60%. The loan was subsequently paid off on October 1, 2014, see Note 16.

(4) The borrower is a consolidated entity in which our operating partnership owns a two-thirds interest.

(5)

Interest-only until February 2016, with principal amortization thereafter based upon a thirty-year amortization schedule.

(6) Interest-only until February 2015, with principal amortization thereafter based upon a thirty-year amortization schedule.

(7) Interest only until February 2017, with principal amortization thereafter based upon a thirty-year amortization schedule.

(8) Interest is fixed until March 1, 2018, and is floating thereafter, with interest-only payments until May 1, 2016, and principal amortization thereafter based upon a thirty-year amortization schedule.

(9) We have two one-year extension options which could extend the maturity to March 1, 2020 from March 1, 2018, subject to meeting certain conditions.

(10) $300.0 million revolving credit facility secured by 3 separate collateral pools consisting of a total of 6 properties. Unused commitment fees range from 0.15% to 0.20%.

(11) See Note 10 for our fair value disclosures.

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The table below presents (in thousands) the minimum future principal payments due on our secured notes payable at September 30, 2014:

Twelve months ending September 30:	
2015	$113,728
2016	106,353
2017	35,963
2018	2,144,899
2019	421,187
Thereafter	388,080
Total future principal payments	$3,210,210

6. Interest Payable, Accounts Payable and Deferred Revenue

Interest payable, accounts payable and deferred revenue consisted of the following (in thousands) as of:

	September 30, 2014	December 31, 2013
Interest payable	$9,074	$9,263
Accounts payable and accrued liabilities	42,869	20,761
Deferred revenue	20,986	22,739
Total interest payable, accounts payable and deferred revenue	$72,929	$52,763

Douglas Emmett, Inc.
Notes to Consolidated Financial Statements (continued)
(unaudited)

7. Interest Rate Contracts

Cash Flow Hedges of Interest Rate Risk

We make use of interest rate swap and interest rate cap contracts to manage the risk associated with changes in the interest rates on our floating-rate borrowings. When we enter into a floating-rate term loan, we generally enter into an interest rate swap agreement for the equivalent principal amount, for a period covering the majority of the loan term, which effectively converts our floating-rate debt to a fixed-rate basis during that time. In limited instances, we make use of interest rate caps to limit our exposure to interest rate increases on underlying floating-rate debt. We may enter into derivative contracts that are intended to hedge certain economic risks, even though hedge accounting does not apply, or for which we elect to not apply hedge accounting. We do not make use of any other derivative instruments, and we do not speculate in derivatives. See note 5 for the details of our floating-rate debt that we hedge.

Designated Hedges

As of September 30, 2014, the totals of our existing swaps that qualified as highly effective cash flow hedges were as follows:

Interest Rate Derivative	Number of Instruments	Notional (in thousands)
Interest Rate Swaps	7	$1,828,080

As of September 30, 2014, the totals of our Funds' existing swaps that qualified as highly effective cash flow hedges were
as follows:

Interest Rate Derivative	Number of Instruments	Notional (in thousands)
Interest Rate Swaps	1	$325,000

Non-designated Hedges

Derivatives not designated as hedges are not speculative. As of September 30, 2014, we had the following outstanding interest rate derivatives that were not designated for accounting purposes as hedging instruments, but were used to hedge our economic exposure to interest rate risk:

Interest Rate Derivative	Number of Instruments	Notional (in thousands)
Purchased Caps	4	$100,000

Credit-risk-related Contingent Features

We have agreements with each of our derivative counterparties that contain a provision under which we could also be declared in default on our derivative obligations if we default on the underlying indebtedness that we are hedging, including any default where repayment of the indebtedness has not been accelerated by the lender. There have been no events of default with respect to any of our derivatives.

As of September 30, 2014 and December 31, 2013, the fair value of our derivatives in a net liability position, when aggregated by counterparty, was $46.1 million and $67.2 million, respectively, which includes accrued interest, but excludes any adjustment for nonperformance risk related to these agreements. As of September 30, 2014 and December 31, 2013, our Funds did not have any derivatives in a net liability position.

Accounting for Interest Rate Contracts

For hedging instruments designated as cash flow hedges, gain or loss recognition are generally matched to the earnings effect of the related hedged item or transaction, with any resulting hedge ineffectiveness recorded as interest expense. Hedge ineffectiveness is determined by comparing the changes in the fair value or cash flows of the hedge to the changes in the fair value or cash flows of the related hedged item or transaction. All other changes in the fair value of these hedges are recorded in accumulated other comprehensive income (loss) (AOCI), which is a component of equity outside of earnings. Amounts reported in AOCI related to our hedges are then reclassified to interest expense as interest payments are made on the hedged item or transaction. Amounts reported in AOCI related to our Funds' hedges are reclassified to income, including depreciation, from unconsolidated real estate funds, as interest payments are made by our Funds on their hedged items or transactions. Changes in fair value of derivatives not designated as hedges are recorded as interest expense.

We estimate that $32.6 million of our AOCI related to our derivatives designated as cash flow hedges will be reclassified as an increase to interest expense during the next twelve months, and $773 thousand of our AOCI related to our Funds' derivatives designated as cash flow hedges will be reclassified as a decrease to income, including depreciation, from unconsolidated real estate funds, during the next twelve months. Changes in fair value of derivatives not designated as hedges have been recorded as interest expense for all periods.

The table below presents (in thousands) the effect of our derivative instruments on our AOCI and consolidated statements of operations for the nine months ended September 30:

	2014	2013
Derivatives Designated as Cash Flow Hedges:		
Gain (loss) recognized in other comprehensive income (OCI) (effective portion)[(1)]	$(7,059)	$2,151
Gain (loss) from investment in unconsolidated real estate funds recognized in other comprehensive income (OCI) (effective portion)[(1)]	$(1,048)	$1,810
Gain (loss) reclassified from AOCI into interest expense (effective portion)	$(27,576)	$(27,029)
Gain (loss) from investment in unconsolidated real estate funds reclassified from AOCI into Income, including depreciation, from unconsolidated real estate funds (effective portion)	$(751)	$(305)
Gain (loss) reclassified from AOCI into interest expense (ineffective portion and amount excluded from effectiveness testing)	$(50)	$(64)
Gain (loss) on derivatives recorded as interest expense (ineffective portion and amount excluded from effectiveness testing)	$—	$—
Derivatives Not Designated as Cash Flow Hedges:		
Realized and unrealized gain (loss) recorded as interest expense	$—	$(3)

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(1) Gains and losses recognized in AOCI do not impact the income statement. Refer to the reconciliation of our AOCI in Note 8.

Fair Value Measurement

We present our derivatives on the balance sheet at fair value, on a gross basis, excluding accrued interest, using the framework for measuring fair value established by the FASB. See Note 10 for our fair value disclosures. The table below presents (in thousands) the fair values of our derivative instruments as of:

	September 30, 2014	December 31, 2013
Derivative liabilities disclosed as "Interest Rate Contracts":[1]		
Derivatives designated as accounting hedges	$42,628	$63,144
Derivatives not designated as accounting hedges	—	—
Total derivative liabilities	$42,628	$63,144

(1) As of September 30, 2014, we did not have any derivative assets.

8. Equity

Equity Sales, Conversions and Repurchases

During the nine months ended September 30, 2014, approximately 2.2 million units in our operating partnership were exchanged for shares of our common stock, 120 thousand of our operating partnership units were redeemed for cash, for a total purchase price of $2.8 million, for an average price of $23.56 per unit, and options covering 691 thousand shares of our common stock were cash settled for a total cost of $4.5 million, for an average price of $6.55 per option. We did not sell any shares or share equivalents during the nine months ended September 30, 2014. During the nine months ended September 30, 2013, approximately 1.4 million units in our operating partnership were exchanged for shares of our common stock, and 13 thousand of our operating partnership units were redeemed for cash, for a total purchase price of $352 thousand, for an average price of $26.68 per unit. We did not sell any shares or share equivalents during the nine months ended September 30, 2013.

Condensed consolidated statements of equity

The tables below present (in thousands) our condensed consolidated statements of equity:

	Douglas Emmett, Inc. Stockholders' Equity	Noncontrolling Interests	Total Equity
Balance as of January 1, 2014	$1,970,397	$396,811	$2,367,208
Net income	33,728	6,328	40,056
Cash flow hedge adjustment	16,297	3,973	20,270
Contributions	—	250	250
Dividends and distributions	(86,518)	(17,315)	(103,833)
Repurchase of stock options	(4,524)	—	(4,524)
Conversion of operating partnership units	29,555	(29,555)	—
Repurchase of operating partnership units	(1,197)	(1,630)	(2,827)
Equity compensation	—	4,416	4,416
Balance as of September 30, 2014	$1,957,738	$363,278	$2,321,016

	Douglas Emmett, Inc. Stockholders' Equity	Noncontrolling Interests	Total Equity
Balance as of January 1, 2013	$1,979,656	$410,803	$2,390,459
Net income	36,468	5,865	42,333
Cash flow hedge adjustment	25,367	5,992	31,359
Contributions	—	584	584
Dividends and distributions	(76,998)	(15,993)	(92,991)
Conversion of operating partnership units	18,630	(18,630)	—
Repurchase of operating partnership units	(172)	(180)	(352)
Equity compensation	—	4,864	4,864
Balance as of September 30, 2013	$1,982,951	$393,305	$2,376,256

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Noncontrolling Interests

Noncontrolling interests in our operating partnership are interests that are not owned by us. Noncontrolling interests represented approximately 16% of our operating partnership at September 30, 2014. A unit in our operating partnership and a share of our common stock have essentially the same economic characteristics, as they share equally in the total net income or loss distributions of our operating partnership. Investors who own units in our operating partnership have the right to cause our operating partnership to redeem any or all of their units in our operating partnership for an amount of cash per unit equal to the then current market value of one share of common stock, or, at our election, shares of our common stock on a one-for-one basis. Noncontrolling interests also include a one-third interest of a minority partner in a consolidated joint venture which owns an office building in Honolulu, Hawaii.

The table below presents (in thousands) the net income attributable to common stockholders and transfers (to) from the noncontrolling interests:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income attributable to common stockholders	$7,389	$10,751	$33,728	$36,468
Transfers from the noncontrolling interests:				
Increase in common stockholders paid-in capital for redemption of operating partnership units	9,054	100	29,534	18,616
Change from net income attributable to common stockholders and transfers from noncontrolling interests	$16,443	$10,851	$63,262	$55,084

AOCI Reconciliation

The table below presents (in thousands) the changes in our AOCI balance, which consists solely of adjustments related to our cash flow hedges and the cash flow hedges of our unconsolidated Funds for the nine months ended September 30:

	2014	2013
Balance at beginning of period	$(50,554)	$(82,991)
Other comprehensive income (loss) before reclassifications[1]	(8,107)	3,961
Amounts reclassified from accumulated other comprehensive income[2]	28,377	27,398
Net current period other comprehensive income (loss)	20,270	31,359
Less other comprehensive (income) loss attributable to noncontrolling interests	(3,973)	(5,992)
Other comprehensive income (loss) attributable to common stockholders	16,297	25,367
Balance at end of period	$(34,257)	$(57,624)

(1) Includes (i) fair value adjustments to our derivatives designated as cash flow hedges of $(7.1) million and $2.2 million for the nine months ended September 30, 2014 and 2013, respectively, as well as (ii) our share of the fair value adjustments to derivatives designated as cash flow hedges of our unconsolidated Funds of $(1.0) million and $1.8 million for the nine months ended September 30, 2014 and 2013, respectively.

(2) Includes (i) a reclassification from AOCI to interest expense of $27.6 million and $27.1 million for the nine months ended September 30, 2014 and 2013, respectively, of our derivatives that qualified and were designated as cash flow hedges, as well as (ii) a reclassification from AOCI to income, including depreciation, of our unconsolidated real estate funds of $751 thousand and $305 thousand for the nine months ended September 30, 2014 and 2013, respectively, related to derivatives that qualified and were designated as cash flow hedges of our unconsolidated Funds.

(3) See Note 7 for the details of our derivatives that qualified and were designated as cash flow hedges.

(4) See Note 10 for our fair value disclosures.

Equity Compensation

The Douglas Emmett, Inc. 2006 Omnibus Stock Incentive Plan, as amended, our stock incentive plan, is administered by the compensation committee of our board of directors. All officers, employees, directors and consultants are eligible to participate in our stock incentive plan. For more information on our stock incentive plan, please refer to note 11 to the consolidated financial statements in our 2013 Annual Report on Form 10-K.

We grant equity compensation as a part of the annual incentive compensation to our key employees each year, a portion of which is fully vested at the date of grant, and the remainder which vests in three equal annual installments over the three calendar years following the grant date. Certain amounts of equity-based compensation expense are capitalized for employees who provide leasing and construction services.

Total net equity compensation expense for equity grants was $1.3 million and $1.5 million for the three months ended September 30, 2014 and 2013, respectively, and $4.0 million and $4.6 million for the nine months ended September 30, 2014 and 2013, respectively. These amounts do not include capitalized equity compensation totaling $97 thousand and $97 thousand for the three months ended September 30, 2014 and 2013, respectively, and $367 thousand and $304 thousand for the nine months ended September 30, 2014 and 2013, respectively. Total net equity compensation expense is included in general and administrative expenses in the consolidated statements of operations.

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9. Earnings Per Share (EPS)

We calculate basic EPS by dividing the net income attributable to common stockholders for the period by the weighted average number of common shares outstanding during the period. We calculate diluted EPS by dividing the net income attributable to common stockholders and noncontrolling interests in our consolidated operating partnership for the period by the weighted average number of common shares and dilutive instruments outstanding during the period using the treasury stock method. The table below presents the calculation of basic and diluted EPS:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Numerator (in thousands):				
Net income attributable to common stockholders	$7,389	$10,751	$33,728	$36,468
Add back: Net income attributable to noncontrolling interests in our operating partnership	1,362	2,134	6,533	7,261
Numerator for diluted net income attributable to all equity holders	$8,751	$12,885	$40,261	$43,729
Denominator (in thousands):				
Weighted average shares of common stock outstanding - basic	144,361	142,598	143,741	142,540
Effect of dilutive securities [(1)] :				
Operating partnership units and vested long term incentive plan (LTIP) units	27,223	28,323	27,841	28,382
Stock options	4,280	3,205	4,103	3,375
Unvested LTIP units	549	630	497	577
Weighted average shares of common stock and common stock equivalents outstanding - diluted	176,413	174,756	176,182	174,874
Basic earnings per share:				
Net income attributable to common stockholders per share	$0.05	$0.08	$0.23	$0.26
Diluted earnings per share:				
Net income attributable to common stockholders per share	$0.05	$0.07	$0.23	$0.25

(1) Diluted shares are calculated in accordance with GAAP, and represent ownership in our company through shares of common stock, units in our operating partnership and other convertible equity instruments.

10. Fair Value of Financial Instruments

Our estimates of the fair value of financial instruments were determined using available market information and appropriate valuation methods. Considerable judgment is necessary to interpret market data and develop an estimated fair value. The use of different market assumptions or estimation methods may have a material effect on the estimated fair value amounts. The FASB fair value framework includes a hierarchy that distinguishes between assumptions based on market data obtained from sources independent of the reporting entity, and the reporting entity's own assumptions about market-based inputs. The hierarchy is as follows:

Level 1 - inputs utilize unadjusted quoted prices in active markets for identical assets or liabilities.
Level 2 - inputs are observable either directly or indirectly for similar assets and liabilities in active markets.
Level 3 - inputs are unobservable assumptions generated by the reporting entity.

As of September 30, 2014, we did not have any fair value measurements using Level 3 inputs.

Short term financial instruments

The carrying amounts for cash and cash equivalents, tenant receivables, deferred rent receivables, revolving credit lines, interest payable, accounts payable and deferred revenue, security deposits and dividends payable, approximate fair value because of the short-term nature of these instruments.

Secured notes receivable

See Notes 4 and 15 for the details of our secured notes receivable. The fair value of our secured notes receivable is determined using Level 2 inputs based on current market interest rates. The carrying value of our secured notes receivable approximates their fair values at September 30, 2014.

Secured notes payable

See Note 5 for the details of our secured notes payable. We calculate the fair value of our secured notes payable by calculating the credit-adjusted present value of the principal and interest payments using current market interest rates (assuming the loans are outstanding through maturity). We determined that the fair value of our secured notes payable is calculated using Level 2 inputs. The table below presents (in thousands) the estimated fair value of our secured notes payable:

Secured Notes Payable:	September 30, 2014	December 31, 2013
Fair value	$3,237,716	$3,234,993
Carrying value	$3,200,210	$3,201,140

Derivative instruments

See Note 7 for the details of our derivatives. We present our derivatives on the balance sheet at fair value, on a gross basis, excluding accrued interest, without reflecting any net settlement positions with the same counterparty, using the framework for measuring fair value established by the FASB. The valuation of our interest rate swaps and caps is determined using widely accepted valuation methods, including discounted cash flow analysis of the expected future cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities. We incorporate credit valuation adjustments to appropriately reflect both our own nonperformance risk and the respective counterparty's nonperformance risk in the fair value measurements. In adjusting the fair value of our derivative contracts for the effect of nonperformance risk, we considered the impact of netting and any applicable credit enhancements, such as collateral postings, thresholds, mutual puts and guarantees. We determined that the fair value of our derivatives is calculated using Level 2 inputs. The table below presents (in thousands) the estimated fair value of our derivative liabilities:

Derivative Instruments in a liability position:[(1)]	September 30, 2014
Level 1	$—
Level 2	42,628
Level 3	—
Fair Value of Derivative Instruments	$42,628

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(1) As of September 30, 2014, we did not have any derivative instruments in an asset position.

11. Future Minimum Lease Receipts

We lease space to tenants primarily under non-cancelable operating leases that generally contain provisions for a base rent plus reimbursement for certain operating expenses. Operating expense reimbursements are reflected in our consolidated statements of operations as tenant recoveries.

We also lease space to certain tenants under non-cancelable leases that provide for percentage rents based upon tenant revenues. Percentage rental income totaled $125 thousand and $162 thousand for the three months ended September 30, 2014 and 2013, respectively, and $368 thousand and $432 thousand for the nine months ended September 30, 2014 and 2013, respectively.

The table below presents (in thousands) the future minimum base rentals on our non-cancelable office and ground operating leases at September 30, 2014:

Twelve months ending September 30:	
2015	$369,228
2016	331,731
2017	280,913
2018	226,199
2019	178,563
Thereafter	445,366
Total future minimum base rentals	$1,832,000

The above future minimum lease receipts exclude residential leases, which typically have a term of one year or less, as well as tenant reimbursements, amortization of deferred rent receivables, and amortization of acquired above/below-market lease intangibles. Some leases are subject to termination options, generally upon payment of a termination fee. The preceding table assumes that these termination options are not exercised.

12. Future Minimum Lease Payments

We currently lease portions of the land underlying two of our office properties. We expensed ground lease payments of $718 thousand and $547 thousand for the three months ended September 30, 2014 and 2013, respectively and $1.9 million and $1.6 million for the nine months ended September 30, 2014 and 2013, respectively. We currently expect to exercise our right to purchase the land involved in one of these two leases in 2015 for a purchase price of $27.5 million. See Note 4. Because we have the ability to exercise our right to purchase this land, we have excluded payments under this lease from the future minimum rent payments in the table below. The table below presents (in thousands) our minimum ground lease payments as of September 30, 2014:

Twelve months ending September 30:	
2015	$733
2016	733
2017	733
2018	733
2019	733
Thereafter	49,293
Total future minimum lease payments	$52,958

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13. Commitments, Contingencies and Guarantees

Legal Proceedings

We are subject to various legal proceedings and claims that arise in the ordinary course of business. Excluding ordinary, routine litigation incidental to our business, we are not currently a party to any legal proceedings that we believe would reasonably be expected to have a materially adverse effect on our business, financial condition or results of operations.

Concentration of Credit Risk

Our properties are located in Los Angeles County, California and Honolulu, Hawaii. The ability of our tenants to honor the terms of their respective leases is dependent upon the economic, regulatory and social factors affecting the markets in which the tenants operate. We perform ongoing credit evaluations of our tenants for potential credit losses. In addition, we have financial instruments that subject us to credit risk, which consist primarily of accounts receivable, deferred rents receivable and interest rate contracts. We maintain our cash and cash equivalents at high quality financial institutions with investment grade ratings. Interest bearing accounts at each U.S. banking institution are insured by the Federal Deposit Insurance Corporation up to $250 thousand. To date, we have not experienced any losses on our deposited cash.

Asset Retirement Obligations

Conditional asset retirement obligations represent a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement is conditional on a future event that may or may not be within our control. A liability for a conditional asset retirement obligation must be recorded if the fair value of the obligation can be reasonably estimated. Environmental site assessments and investigations have identified twenty properties in our consolidated portfolio, and four properties owned by our Funds, which contain asbestos, and would have to be removed in compliance with applicable environmental regulations if these properties undergo major renovations or are demolished. As of September 30, 2014, the obligations to remove the asbestos from these properties have indeterminable settlement dates, and we are unable to reasonably estimate the fair value of the associated conditional asset retirement obligation.

Guarantees

We made certain environmental and other limited indemnities and guarantees covering customary non-recourse carve outs for a $325.0 million loan of one of our Funds. The loan matures on May 1, 2018, and carries interest that is effectively fixed by an interest rate swap which matures on May 1, 2017. We have also guaranteed the related swap. We have an indemnity from the Fund for any amounts that we would be required to pay under these agreements. As of September 30, 2014, the maximum future payments under the swap agreement were approximately $5.1 million. As of September 30, 2014, all obligations under the loan and swap agreements have been performed by the Fund in accordance with the terms of those agreements.

Tenant Concentrations

For the three and nine months ended September 30, 2014 and 2013, no tenant accounted for more than 10% of our total rental revenue and tenant recoveries.

14. Segment Reporting

Segment information is prepared on the same basis that we review information for operational decision-making purposes. We operate in two business segments: (i) the acquisition, development, ownership and management of office real estate and (ii) the acquisition, development, ownership and management of multifamily real estate. The services for our office segment primarily include rental of office space and other tenant services, including parking and storage space rental. The services for our multifamily segment include rental of apartments and other tenant services, including parking and storage space rental.

Asset information by segment is not reported because we do not use this measure to assess performance or make decisions to allocate resources. Therefore, depreciation and amortization expense is not allocated among segments. General and administrative expenses and interest expense are not included in segment profit as our internal reporting addresses these items on a corporate level.

Segment profit is not a measure of operating income or cash flows from operating activities as measured by GAAP, it is not indicative of cash available to fund cash needs, and should not be considered as an alternative to cash flows as a measure of liquidity. Not all companies may calculate segment profit in the same manner. We consider segment profit to be an appropriate supplemental measure to net income because it can assist both investors and management in understanding the core operations of our properties.
The table below presents (in thousands) the operating activity of our reportable segments:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Office Segment				
Total office revenues	$127,962	$130,339	$388,609	$386,424
Office expenses	(47,636)	(46,494)	(135,657)	(130,525)
Segment profit	80,326	83,845	252,952	255,899
Multifamily Segment				
Total multifamily revenues	20,184	19,347	59,839	57,436
Multifamily expenses	(5,261)	(5,157)	(15,490)	(15,108)
Segment profit	14,923	14,190	44,349	42,328
Total profit from all segments	$95,249	$98,035	$297,301	$298,227

The table below (in thousands) is a reconciliation of the total profit from all segments to net income attributable to common stockholders:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Total profit from all segments	$95,249	$98,035	$297,301	$298,227
General and administrative expense	(6,658)	(6,546)	(20,181)	(20,724)
Depreciation and amortization	(50,111)	(47,402)	(151,249)	(141,528)
Other income	3,769	2,138		