GOVERNMENT PROPERTIES TRUST INC
Form 10-Q
November 06, 2006

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**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, 2006**
**COMMISSION FILE NUMBER 001-31962**

**GOVERNMENT PROPERTIES TRUST, INC.**
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

| | |
|---|---|
| MARYLAND<br>(State or other jurisdiction of<br>incorporation or organization) | 20-0611663<br>(I.R.S. Employer<br>Identification No.) |
| 13625 CALIFORNIA STREET, SUITE 310<br>OMAHA, NEBRASKA 68154<br>(Address of principal executive<br>offices, including zip code) | (402) 391-0010<br>(Registrant s telephone number,<br>including area code) |

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 þ No o

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

As of November 1, 2006, approximately 20.8 million shares of common stock of the registrant were outstanding.

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**GOVERNMENT PROPERTIES TRUST, INC.**
**CONSOLIDATED BALANCE SHEETS**
**(in thousands, except share amounts)**

| | September 30, 2006 (unaudited) | December 31, 2005 |
|---|---|---|
| **ASSETS** | | |
| Real estate at cost: | | |
| Land | $ 37,736 | $ 32,800 |
| Buildings and improvements | 327,904 | 280,861 |
| Tenant origination costs | 76,656 | 60,405 |
| Real estate under development | 2,115 | 16,577 |
| Furniture and equipment | 475 | 456 |
| | 444,886 | 391,099 |
| Accumulated depreciation | (25,091) | (13,295) |
| | 419,795 | 377,804 |
| Cash and cash equivalents | 5,685 | 4,857 |
| Restricted cash escrows | 5,286 | 16,887 |
| Tenant receivables | 9,494 | 6,873 |
| Notes receivable from tenant | 552 | 603 |
| Deferred costs, net | 3,856 | 4,020 |
| Real estate deposits | | 450 |
| Other assets | 928 | 1,583 |
| Total assets | $ 445,596 | $ 413,077 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Liabilities: | | |
| Accounts payable and accrued expenses | $ 6,134 | $ 8,420 |
| Dividends payable | 2,337 | 3,110 |
| Lines of credit | 35,080 | 17,500 |
| Mortgage notes payable | 251,623 | 225,033 |
| Total liabilities | 295,174 | 254,063 |
| Stockholders equity: | | |
| Common stock ($0.01 par value; 50,000,000 shares authorized, 20,773,136 and 20,721,612 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively) | 206 | 206 |
| Additional paid-in capital | 189,918 | 189,123 |
| Accumulated deficit | (40,725) | (30,916) |
| Accumulated other comprehensive income | 1,023 | 601 |
| Total stockholders equity | 150,422 | 159,014 |
| Total liabilities and stockholders equity | $ 445,596 | $ 413,077 |

See accompanying notes.

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**GOVERNMENT PROPERTIES TRUST, INC.**
**CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME**
**(unaudited and in thousands, except per share amounts)**

| | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|---|---|---|---|---|
| **Revenue** | | | | |
| Rental income | $ 11,696 | $ 7,822 | $ 32,527 | $ 18,287 |
| Tenant reimbursements | 698 | 442 | 1,873 | 754 |
| Total revenue | 12,394 | 8,264 | 34,400 | 19,041 |
| **Expenses** | | | | |
| Property operations | 2,017 | 1,343 | 5,720 | 3,322 |
| Real estate taxes | 1,017 | 897 | 2,955 | 1,922 |
| Depreciation and amortization | 4,135 | 2,946 | 11,796 | 6,611 |
| General and administrative | 1,306 | 1,304 | 3,945 | 3,644 |
| Total expenses | 8,475 | 6,490 | 24,416 | 15,499 |
| Operating income | 3,919 | 1,774 | 9,984 | 3,542 |
| Other income (expense) | | | | |
| Interest income | 100 | 249 | 333 | 1,348 |
| Interest expense | (4,269) | (2,755) | (11,668) | (6,226) |
| Amortization of deferred financing fees | (243) | (67) | (671) | (235) |
| Net loss | $ (493) | $ (799) | $ (2,022) | $ (1,571) |
| Earnings per share (basic and diluted) | | | | |
| Net loss | $ (0.02) | $ (0.04) | $ (0.10) | $ (0.08) |
| Distributions declared per share | $ 0.1125 | $ 0.15 | $ 0.375 | $ 0.45 |
| Weighted average shares outstanding (basic and diluted) | 20,636 | 20,578 | 20,624 | 20,565 |
| Net loss | $ (493) | $ (799) | $ (2,022) | $ (1,571) |
| Other comprehensive (loss) income | | | | |
| Unrealized derivative (loss) gain on forward-starting interest rate swaps | (2,410) | 1,563 | 462 | 194 |
| Comprehensive (loss) income | $ (2,903) | $ 764 | $ (1,560) | $ (1,377) |

See accompanying notes.

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**GOVERNMENT PROPERTIES TRUST, INC.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(unaudited and in thousands)**

| | Nine Months Ended September 30, 2006 | 2005 |
|---|---|---|
| **Operating activities** | | |
| Net loss | $ (2,022) | $ (1,571) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation and amortization | 11,796 | 6,611 |
| Amortization of deferred financing fees | 671 | 235 |
| Amortization of premium on mortgage notes payable | (75) | (25) |
| Compensation expense | 550 | 543 |
| Changes in assets and liabilities: | | |
| Tenant receivables | (2,621) | (4,131) |
| Restricted cash escrows | (180) | (2,967) |
| Other assets | 1,078 | (245) |
| Accounts payable and accrued expenses | 2,021 | 3,825 |
| Net cash provided by (used in) operating activities | 11,218 | 2,275 |
| **Investing activities** | | |
| Expenditures for real estate | (36,929) | (170,644) |
| Deposits on future real estate purchases | | (300) |
| Development of real estate assets | (11,578) | (8,277) |
| Restricted cash escrows | 11,781 | (15,359) |
| Note receivable from tenant | 50 | 46 |
| Expenditures for furniture and equipment | (18) | (237) |
| Net cash used in investing activities | (36,694) | (194,771) |
| **Financing activities** | | |
| Financing fees | (507) | (1,581) |
| Net borrowings under lines of credit | 17,580 | |
| Proceeds from mortgage notes payable | 19,950 | 117,582 |
| Principal payments on mortgage notes payable | (2,159) | (1,185) |
| Dividends paid | (8,560) | (9,321) |
| Net cash provided by financing activities | 26,304 | 105,495 |
| Net increase (decrease) in cash and cash equivalents | 828 | (87,001) |
| Cash and cash equivalents, beginning of period | 4,857 | 93,815 |
| Cash and cash equivalents, end of period | $ 5,685 | $ 6,814 |
| **Non-Cash Investing Activity** | | |
| Accounts payable and accrued expenses included in real estate, net | $ 4,220 | $ 2,767 |

| | | |
|---|---|---|
| **Non-Cash Financing Activity** | | |
| Assumption of mortgage note payable included in real estate, net | $ 8,876 | $ 15,753 |

See accompanying notes.

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**GOVERNMENT PROPERTIES TRUST, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

1. **Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements of Government Properties Trust, Inc., a Maryland corporation (the Company ), have been prepared pursuant to Securities and Exchange Commission ( SEC ) rules and regulations and should be read in conjunction with the consolidated financial statements and notes thereto included in the 2005 Form 10-K. The accompanying condensed consolidated financial statements highlight significant changes to the Notes included in the 2005 Form 10-K and present interim disclosures as required by the SEC. The accompanying condensed consolidated financial statements reflect, in the opinion of management, all adjustments considered necessary for a fair presentation of the interim financial statements. All such adjustments are of a normal and recurring nature.

The preparation of the condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles ( GAAP ) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expense during the reporting periods. Our results for the three months and nine months ended September 30, 2006 are not necessarily indicative of our results for any future interim period or for the full fiscal year.

2. **Nature of Business and Operations**

The Company began formal operations with its first property acquisition in December 2002 and, as of September 30, 2006, the Company owned 21 properties located throughout the United States. The Company acquires properties through various operating entities, which are wholly owned by the Company. The Company has elected to be taxed as a real estate investment trust ( REIT ) under the Internal Revenue Code of 1986, as amended. The Company operates in one segment.

3. **Recently Issued Accounting Pronouncements**

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* ( FIN 48 ), to create a single model to address accounting for uncertainty in tax positions. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of this Interpretation on our results of operations and financial position.

4. **Common Stock and Earnings Per Share**

The Company reports earnings per share pursuant to Statement of Financial Accounting Standards No. 128, Earnings Per Share . Basic and diluted loss per share attributable for all periods presented is computed by dividing the loss to common stockholders by the weighted average number of common shares and potential common stock outstanding during the period. The Company had nonvested stock grants of 134,098 and 143,239 shares outstanding during the three months ended September 30, 2006 and 2005, respectively and 134,546 and 157,035 for the nine months ended September 30, 2006 and 2005, respectively, which were not included in the computation of diluted earnings per share because the effect would have been anti-dilutive.

5. **Deferred Costs**

Deferred costs consist of the following (in thousands):

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| Financing costs | $ 5,163 | $ 4,656 |
| Accumulated amortization | (1,307) | (636) |
| | $ 3,856 | $ 4,020 |

6. **Equity Incentive Plan**

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* ( FAS 123(R) ), which replaced FAS 123. FAS 123(R) requires compensation cost related to share-based payment transactions to be recognized in the financial statements. We adopted FAS 123(R) effective January 1, 2006 using the modified-prospective method.

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Because we previously used a fair value based method of accounting for determining compensation expense associated with the issuance of all restricted shares granted, the adoption of this standard did not have a material effect on our results of operations and financial position. Had we adopted FAS 123(R) in prior periods, the impact of that standard would have approximated the impact of FAS 123 as previously disclosed.

The Company has a 2003 Equity Incentive Compensation Plan (the Plan ), which reserved 1,000,000 shares of Common Stock for issuance thereunder. In connection with the original issuance of shares during the first quarter of 2004, the Company adopted the fair value recognition provisions of SFAS No. 123, Accounting for Stock Based Compensation and SFAS No. 148, Accounting for Stock Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123 .

The Company recognizes compensation expense for restricted shares issued based upon the fair market value of the common stock at the grant date. Compensation expense is recognized on a straight-line basis over the service period which is typically the vesting period and is included in general and administrative expense in the accompanying consolidated statement of operations. The Company began issuing restricted shares in 2004. The Company granted 190,045 restricted shares during 2004, 26,198 restricted shares during 2005 and 51,524 restricted shares during the nine months ended September 30, 2006 to members of the Board of Directors, employees and consultants. During 2005 there were 184 restricted shares forfeited. The Company recorded compensation expense related to the restricted stock grants of $185,000 and $181,000 for the three months ended September 30, 2006 and 2005, respectively, and $550,000 and $543,000 for the nine months ended September 30, 2006 and 2005, respectively. As of September 30, 2006, there are 732,417 shares available for grant under the Plan.

7. **Mortgage Notes Payable and Line-of-Credit**

Mortgage notes payable and lines-of-credit consisted of the following (in thousands):

| | September 30, 2006 | | December 31, 2005 | |
|---|---|---|---|---|
| **Mortgage Notes Payable(A),(B),(C)** | | | | |
| Mortgage notes payable to various financial institutions, collateralized by various properties, interest at fixed rates ranging from 5.09% to 8.23% per annum, with principal and interest payable monthly through 2026. The weighted average interest rate at September 30, 2006 and December 31, 2005 was 5.83% and 5.80%, respectively. | $ | 250,268 | $ | 223,601 |
| **Lines of Credit** | | | | |
| Line-of-credit with a financial institution for property acquisitions (maximum borrowing level of $65 million and available through November 20, 2008). The weighted average interest rate at September 30, 2006 and December 31, 2005 was equal to 6.73% and 5.57%, respectively. Advances are collateralized by various properties.**(D)** | $ | 35,080 | $ | 17,500 |
| Line-of-credit with a financial institution for property acquisitions (maximum borrowing level of $10 million and available through April 2007). Advances are unsecured.**(E)** | $ | | $ | |

(A) The mortgages notes payable are subject to various operating covenants. In addition, the Company must periodically fund and maintain escrow accounts, to make future real estate taxes, repairs and maintenance and insurance payments, as well as to fund certain tenant releasing costs. These are included in restricted cash escrows.

(B) Certain of the Company s real estate assets have been pledged as collateral for its mortgages notes payable. The amount of gross assets that have been encumbered is $360.3 million and $309.0 million at September 30, 2006 and December 31, 2005, respectively.

(C) Amounts exclude a premium of $1.4 million at September 30, 2006 and December 31, 2005 related to the above market interest rate on a mortgage assumed.

(D) This line-of-credit facility was obtained in November 2005 and bears an interest rate equal to either (a) a base rate determined by the higher of the prime rate or the federal funds rate plus 1/2 of 1%, or (b) an applicable margin, based upon the Company s total indebtedness to total asset value, plus LIBOR. At September 30, 2006 and December 31, 2005, the margin was LIBOR plus 1.40% and LIBOR plus 1.20%, respectively. Payments are interest only through the term and are payable at least quarterly. The line-of-credit facility contains certain covenants including maintenance of leverage, minimum fixed charge coverage ratios, minimum tangible net worth and limitations on certain indebtedness, guarantees and cash dividends. Advances under the line-of-credit totaled $17.58 million for the nine months ended September 30, 2006 and $17.5 million during the year ended December 31, 2005. In addition, the Company has drawn a total of $9.5 million of Letters of Credit during 2006. The line-of-credit facility is guaranteed by the Company. The amount of gross assets that have been encumbered is $82.0 million at September 30, 2006 and $81.5 million at December 31, 2005. In April 2006, the maximum borrowing level of the line-of-credit was increased from $50 million to $65 million.

(E) This line-of-credit facility was obtained in April 2006 and is subject to the covenants described above in Item (D). Borrowings under this facility bear an interest rate equal to an applicable margin, based upon our total indebtedness to total asset value, plus the three month LIBOR rate. Any borrowings on the credit facility would be priced at LIBOR plus 2.40% as of September 30, 2006. Payments are interest only through the term of the credit facility and are payable monthly.

Total interest paid on the mortgage notes payable and lines-of-credit was $4.3 million and $2.8 million for the three months ended September 30, 2006 and 2005, respectively, and $11.7 million and $6.1 million for the nine months ended September 30, 2006 and 2005, respectively.

8. **Derivative Instruments and Hedging Activities**

Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133), as amended and interpreted, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. As required by SFAS 133, the Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives used to hedge the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives used to hedge the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges.

In the second quarter of 2005, the Company entered into two forward-starting interest rate swap contracts with an aggregate notional amount of $50 million to fix a portion of the interest rate associated with the anticipated issuance of future financings that are expected to occur in the fourth quarter of 2006. In September 2006, the Company cash settled both forward-starting interest rate swap contracts and received cash in the amount of $1,064,000. Concurrently, the Company entered into a rate lock agreement with a financial institution for mortgage debt financing in the total amount of approximately $55.7 million. The mortgage financings are expected to occur during the fourth quarter of 2006. As a result of a cash settlement, the Company has recorded $41,000 of ineffectiveness which has been reflected as a reduction of interest expense in the 2006 statement of operations. The remaining $1,023,000 continues to be reflected in accumulated other comprehensive income as the forecasted transaction remains probable of occurring.

9. **Related Party Transactions**

Genesis, the sponsor of the initial public offering by the predecessor company Gen-Net Lease Income Trust, Inc., paid the Company $310,000 in June 2006 for previous offering costs pursuant to a conditional agreement between Genesis and the Company.

10. **Property Acquisitions**

The Company acquired the following properties during the nine months ended September 30, 2006 and during the year ended December 31, 2005. The results of their operations are included in the Company s consolidated statements of operations from their respective dates of acquisition.

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| Property | Location | Acquisition Cost (in thousands) | Month Acquired |
|---|---|---|---|
| **2005 acquisitions(A):** | | | |
| 1201 Lloyd Boulevard (Portland Property) | Portland, OR | $ 50,653 | March |
| Niagara Center (Buffalo Niagara Center Property) | Buffalo, NY | 71,673 | May |
| Social Security Administration (Buffalo SSA Property) | Buffalo, NY | 5,435 | May |
| Drug Enforcement Administration (Sterling DEA Property)(B) | Sterling, VA | 21,070 | September |
| Internal Revenue Service (Martinsburg IRS Property)(C) | Martinsburg, WV | 30,643 | July |
| Social Security Administration (Dallas SSA Property) | Dallas, TX | 9,583 | September |
| Army Corps of Engineers (Vicksburg MS Property) | Vicksburg, MS | 26,850 | November |
| | | $ 215,907 | |
| **2006 acquisitions(A):** | | | |
| Riverside County (Riverside Property)(D) | Riverside, CA | $ 18,415 | February |
| United States Citizenship and Immigration Service (Harlingen USCIS Property) | Harlingen, TX | 27,330 | May |
| | | $ 45,745 | |

(A) In accordance with SFAS 141, the Company allocated the purchase price for these properties to net tangible and identified intangible assets acquired based on their fair values (including land, buildings, tenant improvements, acquired above and below market leases and the origination cost of acquired in-place leases) and acquired liabilities, and allocated the purchase price based on these assessments, including land at appraised value and buildings at replacement costs. The Company assessed fair value based on estimated cash flow projections that utilize discount and capitalization rates deemed appropriate by management and available market information. Such estimates are subject to refinement as additional valuation information is received. The value of tenant origination costs are amortized over the remaining term of the respective leases.

(B) In connection with the purchase of this property, the Company assumed a first mortgage note in the amount of $15.8 million. Also included in the acquisition cost is an amount of $1.5 million related to the premium recognized on the above market interest rate on the assumed mortgage.

(C) Under terms of the existing lease, the federal government has an option to purchase the Martinsburg IRS Property for approximately $24.8 million. Real estate at cost, net of accumulated depreciation of the Martinsburg IRS Property, was $29.4 million at September 30, 2006.

(D) In connection with the purchase of this property, the Company assumed a first mortgage note in the amount of $8.9 million.

11. **Real Estate Development**

In March 2006, the Company completed the expansion of the Bureau of Public Debt facility in Parkersburg, West Virginia by an additional 102,000 rentable square feet. The cost of the expansion to the Property totaled $22.0 million and has been allocated to buildings and improvements and tenant origination costs in the accompanying Consolidated Balance Sheet as the property was placed into operations on March 15, 2006. At December 31, 2005, approximately $4.1 million of costs capitalized were included in accounts payable and accrued expenses in the accompanying Consolidated Balance Sheets.

12. **Unaudited Pro Forma Condensed Consolidated Financial Information**

The accompanying unaudited Pro Forma Condensed Consolidated Financial Information is presented as if, at January 1, 2005, the Company acquired the properties described in Note 10 Property Acquisitions and the shares outstanding at September 30, 2006 were also outstanding at January 1, 2005. The properties listed as follows began operations during 2005 and therefore their historical results of operations are included in the Pro Forma Condensed Consolidated Financial Information from the date indicated. In management s opinion, all adjustments necessary to reflect the effects of the above transactions have been made.

| | **Date Property Began Operation** |
|---|---|
| Buffalo SSA Property | June 2005 |
| Dallas SSA Property | August 2005 |

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The unaudited Pro Forma Condensed Consolidated Financial Information is not necessarily indicative of what the actual results of operations would have been assuming the above mentioned transactions had occurred at the dates indicated above, nor does it purport to represent our future results of operations.

**Pro Forma Condensed Consolidated Financial Information**

*(Unaudited and in thousands, except per share amounts)*

| | Nine Months Ended September 30, 2006 | 2005 |
|---|---|---|
| Total revenue | $ 35,817 | $ 30,110 |
| Net loss | $ (1,936) | $ (2,161) |
| Loss per diluted common share | $ (0.09) | $ (0.10) |

13. **Subsequent Events**

On October 23, 2006, the Company entered into a definitive merger agreement with Record Realty Trust, an Australian listed property trust (ASX: RRT), whereby a subsidiary of Record Realty Trust will acquire the Company for $10.75 per common share in cash, subject to a potential reduction by an amount not to exceed $0.08 per common share resulting from certain potential contingencies of the Company, and as otherwise provided in the merger agreement. Record Realty Trust is managed by Record Funds Management Limited, a wholly-owned subsidiary of Allco Finance Group (ASX: AFG). The transaction has been unanimously approved by each of the Company s and Record Realty s respective boards of directors. Completion of the merger is currently expected to occur during the first quarter of 2007 and is subject to approval by the Company s stockholders and other customary closing conditions.

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

This report contains forward-looking statements. These forward-looking statements include estimates regarding:

- our estimated general and administrative expense;
- our risk mitigation strategy;
- our policy to reserve for operating expenses and capital costs:
- our distribution policy;
- our operating expenses;
- our adequacy of our available capital for future capital requirements;
- our capital expenditures;
- the impact of changes in interest rates; and
- the completion of our merger agreement with Record Realty Trust.

This report includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that reflect our current views as to future events and financial performance with respect to our operations. These statements can be identified by the fact that they do not relate strictly to historical or current facts. They use words such as aim, anticipate, are confident, estimate, expect, will be, will continue, will likely result, projec believe, look to and other words and terms of similar meaning in conjunction with a discussion of future operating or financial performance.

Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including the risks discussed in Risk Factors and elsewhere in this report.

In addition, we discussed a number of material risks in our annual report on Form 10-K for the year ended December 31, 2005. Those risks continue to be relevant to our performance and financial condition. Moreover, we operate in a very competitive and rapidly changing environment. New risk factors emerge from time to time and it is not possible for management to predict all such risk factors, nor can it assess the impact of all such risk factors on our company s business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Given these risks and uncertainties, investors should not place undue reliance on forward-looking statements as a prediction of actual results.

All forward-looking statements included in this report are based on information available to us on the date hereof. We assume no obligation to update any forward-looking statements.

The following is a discussion of our interim results of operations, financial condition and liquidity and capital resources for the three and nine months ended September 30, 2006 compared to the corresponding periods in 2005. It should be read in conjunction with the Consolidated Financial Statements and Notes thereto included herein and the 2005 Form 10-K.

## OVERVIEW

We primarily invest in single tenant properties under long-term leases to the U.S. government, state governments, local governments, and government-sponsored enterprises. We are a self-managed, self-administered company that has elected to be taxed as a real estate investment trust, or REIT, under the federal tax laws. We believe that we are the only public company solely focused on investing in government-leased properties. We own each of our properties through separate, wholly owned entities. Our business consists of buying and managing recently built or renovated office properties primarily leased to the federal government, acting through the General Services Administration ( GSA ), under long-term leases. At September 30, 2006, we owned 21 primarily GSA-leased properties. These properties are 98% occupied.

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CRITICAL ACCOUNTING POLICIES

Refer to our 2005 Annual Report on Form 10-K for a discussion of our critical accounting policies, which include our revenue recognition of related lease agreements, recording of real estate at depreciated cost, allocation of the purchase price of properties we acquire to net tangible and identified intangible assets and derivative instruments. During the first nine months of 2006, there were no material changes to our critical accounting policies.

RESULTS OF OPERATIONS

***Comparison of three months ended September 30, 2006 to September 30, 2005***

Our results of operations for the three months ended September 30, 2006 compared to the same period in 2005 were significantly affected by our acquisitions in both years. As a result, our results are not comparable from period to period. Therefore, in the table below, we have also separately presented the results of our Same Properties Portfolio. Our Same Properties Portfolio includes the results of twelve properties consisting of approximately 730,000 rentable square feet that were owned for the entire period presented in both years. Our Total Portfolio also includes the operating results of the properties we acquired during 2005 and 2006. These nine properties, referred to as Acquired Properties , consist of approximately 1,171,000 rentable square feet and are collectively referred to as the Acquired Properties.

| | Same Properties Portfolio | | | Acquired Properties | | General & Administrative | | Total Portfolio | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **(in thousands)** | **2006** | **2005** | **Change** | **2006** | **2005** | **2006** | **2005** | **2006** | **2005** | **Change** |
| **Revenue:** | | | | | | | | | | |
| Rental income | $ 5,231 | $ 4,314 | $ 917 | $ 6,465 | $ 3,508 | $ | $ | $ 11,696 | $ 7,822 | $ 3,874 |
| Tenant reimbursements and other | 255 | 298 | (43) | 443 | 144 | | | 698 | 442 | 256 |
| Total revenue | 5,486 | 4,612 | 874 | 6,908 | 3,652 | | | 12,394 | 8,264 | |