PRICE LEGACY CORP
Form 10-Q
November 13, 2002

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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 quarter ended September 30, 2002

Commission File Number 0-20449

PRICE LEGACY CORPORATION

(Exact name of registrant as specified in its charter)

Maryland	**33-0628740**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

17140 Bernardo Center Drive, Suite 300, San Diego, California 92128
(Address of principal executive offices) (Zip Code)

(858) 675-9400
(Registrant's telephone number, 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 ý NO o

The registrant had 37,255,748 shares of common stock, par value $.0001 per share, outstanding at November 8, 2002.

PRICE LEGACY CORPORATION
INDEX TO FORM 10-Q

PART I FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

PRICE LEGACY CORPORATION
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	September 30 2002	December 31 2001
	(unaudited)	
ASSETS		
Real estate assets		
Land and land improvements	**$ 432,551**	$ 419,151
Building and improvements	**674,585**	618,222
Construction in progress	**25,259**	27,471
	1,132,395	1,064,844
Less accumulated depreciation	**(29,040)**	(19,420)
	1,103,355	1,045,424
Investment in real estate joint ventures	**25,406**	24,828
Cash and cash equivalents	**34,435**	28,042
Accounts receivable, net of allowance of $1,827 and $1,680	**4,961**	2,706
Notes receivable	**64,472**	55,167
Deferred rents	**8,602**	6,427
Other assets	**46,157**	30,800

	September 30 2002	December 31 2001
Total assets	**$ 1,287,388**	$ 1,193,394
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Mortgages and notes payable	**$ 494,264**	$ 452,523
Revolving line of credit	**61,000**	31,500
Accounts payable and other liabilities	**43,768**	19,006
Total liabilities	**599,032**	503,029
Commitments		
Minority interests	**595**	595
Stockholders' equity		
Series A preferred stock, cumulative, redeemable, $0.0001 par value, 27,849,771 shares authorized, 27,434,166 and 27,413,467 shares issued and outstanding	**399,615**	399,615
Series B preferred stock, junior, convertible, redeemable, $0.0001 par value, 27,458,855 shares authorized, 19,666,754 shares issued and outstanding	**106,234**	106,234
Common stock, $0.0001 par value, 94,691,374 shares authorized, 37,255,748 and 40,726,191 issued and outstanding	**4**	4
Additional paid-in capital	**196,020**	195,712
Treasury stock at cost, 3,470,927 and 0 shares	**(11,299)**	
Accumulated other comprehensive loss	**(1,001)**	(106)
Accumulated deficit	**(1,812)**	(2,324)
Notes receivable from officers for common shares		(9,365)
Total stockholders' equity	**687,761**	689,770
Total liabilities and stockholders' equity	**$ 1,287,388**	$ 1,193,394

See accompanying notes.

3

PRICE LEGACY CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
(unaudited amounts in thousands, except per share data)

	Third Quarter Three Months Ended September 30		Year-to-Date Nine Months Ended September 30	
	2002	**2001**	**2002**	**2001**
Rental revenues	**$ 30,170**	$ 18,131	**$ 88,705**	$ 51,316
Expenses				
Operating and maintenance	**5,922**	2,344	**16,054**	6,573
Property taxes	**3,560**	2,380	**10,020**	6,531
Depreciation and amortization	**4,503**	2,282	**12,620**	6,194
General and administrative	**4,357**	701	**8,813**	2,391
Asset impairment			**2,528**	

	Third Quarter Three Months Ended September 30		Year-to-Date Nine Months Ended September 30	
Total expenses	**18,342**	7,707	**50,035**	21,689
Operating income	**11,828**	10,424	**38,670**	29,627
Interest and other				
Interest expense	**(6,157)**	(3,816)	**(18,045)**	(10,352)
Interest income	**1,219**	1,425	**3,607**	5,068
Equity in earnings of joint ventures	**318**	375	**632**	717
Total interest and other	**(4,620)**	(2,016)	**(13,806)**	(4,567)
Income before gain on sale of real estate	**7,208**	8,408	**24,864**	25,060
Net gain on sale of real estate		162	**291**	1,321
Income before discontinued operations	**7,208**	8,570	**25,155**	26,381
Discontinued operations:				
Income from operations	**557**	1,196	**2,759**	3,086
Net gain on sale of real estate	**9,991**		**9,148**	
	10,548	1,196	**11,907**	3,086
Net income	**17,756**	9,766	**37,062**	29,467
Dividends to preferred stockholders	**(12,241)**	(8,761)	**(36,549)**	(25,505)
Net income applicable to common stockholders	**$ 5,515**	$ 1,005	**$ 513**	$ 3,962
Basic and diluted net income per common share	**$ .14**	$ .06	**.01**	$ .27
Weighted average common shares outstanding				
Basic	**39,167**	16,698	**40,201**	14,451
Diluted	**39,325**	16,698	**40,442**	14,451
Dividends per preferred share	**$ .35**	$ .35	**$ 1.05**	$ 1.05

See accompanying notes.

4

PRICE LEGACY CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited amounts in thousands)

	Year-to-Date Nine Months Ended September 30	
	2002	**2001**
Operating activities		
Net income	**$ 37,062**	$ 29,467
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**13,415**	7,130

	Year-to-Date Nine Months Ended September 30	
Net gain on sale of real estate	**(9,439)**	(1,321)
Deferred rents	**(2,175)**	(2,088)
Compensation expense related to retirement of officers' notes and common shares	**2,836**	
Asset impairment	**2,528**	
Equity in earnings of joint venture	**(632)**	(717)
Changes in operating assets and liabilities:		
Accounts receivable and other assets	**(9,430)**	(5,361)
Accounts payable and other liabilities	**1,395**	2,315
Net cash provided by operating activities	**35,560**	29,425
Investing activities		
Additions to real estate assets	**(154,586)**	(58,101)
Proceeds from the sale of real estate assets	**69,176**	7,928
Contributions to real estate joint ventures	**(869)**	(2,584)
Distributions from real estate joint ventures	**1,168**	1,438
Advances on notes receivable	**(2,954)**	(30,071)
Repayments on notes receivable	**3,436**	3,040
Purchase of treasury stock	**(1,650)**	
Cash received in merger		5,726
Net cash used in investing activities	**(86,279)**	(72,624)
Financing activities		
Advances from revolving line of credit, mortgages and notes payable	**125,814**	50,328
Repayments of revolving line of credit, mortgages and notes payable	**(40,199)**	(104,877)
Dividends paid	**(28,806)**	(25,209)
Proceeds from exercise of stock options	**303**	4,367
Proceeds from the issuance of preferred stock and warrants		100,000
Payments for common stock under tender offer		(5,653)
Payments for offering costs for merger and tender offer		(2,631)
Net cash provided by financing activities	**57,112**	16,325
Net increase (decrease) in cash and cash equivalents	**6,393**	(26,874)
Cash and cash equivalents at beginning of period	**28,042**	49,996
Cash and cash equivalents at end of period	**$ 34,435**	$ 23,122

PRICE LEGACY CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
(unaudited amounts in thousands)

Year-to-Date
Nine Months Ended
September 30

	2002	2001
Supplemental cash flow information:		
Cash paid for interest	**$ 19,652**	$ 10,622
Supplemental schedule of noncash investing and financing activities:		
Assumption of existing loans to acquire real estate assets	**5,787**	53,841
Accrual of Series B Preferred Stock dividends	**7,743**	
Reduction in note receivable to acquire real estate assets	**3,543**	
Change in other assets and accounts payable for fair value of derivative instruments	**10,368**	
Increase to treasury stock for reduction of officers' loans	**9,649**	
Decrease to officers' loans and interest receivable	**12,485**	
Net adjustment related to disposed real estate asset	**733**	
Reduction in note receivable to acquire interest in real estate joint venture		919
Reduction in Excel Legacy convertible debentures and senior notes for Series A Preferred Stock issued		46,211
Reduction in Excel Legacy note payable for Series B Preferred Stock and warrants issued		9,347
Increase to assets and liabilities in connection with the Merger:		
Real estate assets		183,389
Other assets		77,574
Notes payable		161,560
Other liabilities		32,456

See accompanying notes.

6

PRICE LEGACY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

September 30, 2002

Note 1 Organization and Significant Accounting Policies

Organization

Price Legacy Corporation (Price Legacy) operates as a real estate investment trust (REIT) incorporated in the state of Maryland. Our principal business is to acquire, operate, and develop real property, primarily open-air shopping centers. On September 18, 2001, Price Legacy completed a merger between Price Enterprises, Inc. (PEI) and Excel Legacy Corporation (Excel Legacy) resulting in Excel Legacy becoming a wholly owned subsidiary of PEI. The combined company operates as a REIT under the name Price Legacy Corporation. The results of Excel Legacy are included in our operations beginning September 19, 2001.

Our subsidiaries include Excel Legacy Holdings, Inc., which has elected to be treated as a taxable REIT subsidiary (TRS). Other than some activities related to lodging and health care facilities, a TRS may generally engage in any business. A TRS is subject to federal income tax and state and local income tax, where applicable, as a regular C corporation.

Accounting Principles

We prepared the financial statements following the requirements of the Securities and Exchange Commission (SEC) for interim reporting. As permitted under those rules, certain footnotes or other financial information that are normally required by accounting principles generally accepted in the United States of America (GAAP) can be omitted. Certain prior year data have been reclassified to conform to the 2002 presentation.

We are responsible for the financial statements included in this document. The financial statements include all normal and recurring adjustments that are considered necessary for the fair presentation of our financial position and operating results. You should also read the financial statements and notes in our latest Annual Report on Form 10-K.

Revenues, expenses, assets and liabilities can vary during each quarter of the year. Therefore, the results and trends in these interim financial statements may not be the same as those for the full year.

Real Estate Assets and Depreciation

We record real estate assets at historical costs and adjust them for recognition of impairment losses. In following purchase accounting, we adjusted the historical costs of Excel Legacy's real estate assets to fair value at the time of the merger. Our consolidated balance sheets at September 30, 2002 and December 31, 2001 reflect the new basis of those real estate assets. See Note 2 for additional information on this transaction.

We expense ordinary repairs and maintenance costs incurred, which include building painting, parking lot repairs, etc. We capitalize major replacements and improvements, which include HVAC equipment, roofs, etc., and depreciate them over their estimated useful lives.

We compute real estate asset depreciation on a straight-line basis over their estimated useful lives, as follows:

Land improvements	40 years
Building and improvements	20 to 40 years
Tenant improvements	Lesser of the lease term or 10 years
Fixtures and equipment	3-7 years

We capitalize interest incurred during the construction period of certain assets and this interest is depreciated over the lives of those assets. The following table shows interest expense and the amount capitalized (amounts in thousands):

	Three Months Ended September 30		Nine Months Ended September 30	
	2002	**2001**	**2002**	**2001**
Interest incurred	6,710	4,442	20,081	12,165
Interest capitalized	(424)	(430)	(1,517)	(1,224)

Cash and Cash Equivalents

We consider all highly liquid investments with a maturity of less than three months when purchased to be cash and cash equivalents.

Our cash balances at December 31, 2001 include $1.5 million of restricted funds which represents proceeds from the financing of a construction project. The funds are held in trust and released as work is completed. We did not have any restricted funds at September 30, 2002.

We are required to maintain reserves with certain lenders for capital expenditures, insurance, real estate taxes and debt service. As of September 30, 2002 and December 31, 2001, the aggregate amount of these reserves held by lenders is $11.6 million and $5.2 million, respectively, and is included with cash on the Consolidated Balance Sheets.

Investment in Securities

We review our investments in securities for possible impairment whenever the market value of the securities falls below cost and, in our opinion, such decline represents an other than temporary impairment. Factors considered in this review include:

duration and extent, as well as reasons for which the market value has been less than cost financial condition and near-term prospects of the investee, which includes consideration of proposed transactions known through Board of Directors participation

our ability and intent to retain the investment for a period of time to allow for a recovery in market value

When an other than temporary impairment loss on an individual investment is considered to have occurred, we write down the cost basis of the security, and the charge is recorded in earnings.

Comprehensive Income

In 1999, we adopted Statement of Financial Accounting Standard (SFAS) No. 130 "Reporting Comprehensive Income." This statement requires that all components of comprehensive income be reported in the financial statements in the period in which they are recognized. The components of comprehensive income at September 30, 2002 are as follows:

	Three Months Ended September 30	Nine Months Ended September 30
	2002	**2002**
Net income	$ 17,775	$ 37,062
Unrealized loss on marketable securities	(21)	(37)
Unrealized loss on derivative financial instruments	(857)	(857)
Total comprehensive income	$ 16,897	$ 36,168

Use of Estimates

Preparing financial statements in conformity with GAAP requires that we make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. We continually review our estimates and make adjustments as necessary, but actual results could differ from what we anticipated when we made these estimates.

Derivative Financial Instruments

In January 2001, we adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." In the normal course of business, we may use derivative financial instruments to manage or hedge interest rate risk. When entered into, we formally designate and document the financial instrument as a hedge of a specific underlying exposure, as well as the risk management objectives and strategies for undertaking the hedge transactions. We assess, both at the inception and at least quarterly thereafter, whether the financial instruments that are used in hedging transactions are effective at offsetting changes in either the fair value or cash flows of the related underlying exposure. Because of the high degree of correlation between the hedging instrument and the underlying exposure being hedged, fluctuations in the value of the derivative instruments are generally offset by changes in the fair value or cash flows of the underlying exposures being hedged. Any ineffective portion of a financial instrument's change in fair value is immediately recognized in earnings. Virtually all of our derivatives are straightforward over-the-counter instruments with liquid markets.

To determine the fair value of derivative instruments, we use a variety of methods and assumptions that are based on market conditions and risks existing at each balance sheet date. For the majority of financial instruments including most derivatives, long-term investments and long-term debt, standard market conventions and techniques such as discounted cash flow analysis, option pricing models, replacement cost, and termination cost are used to determine fair value. All methods of assessing fair value result in a general approximation of value, and such value may never actually be realized.

Asset Disposal

In August 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 addresses financial accounting for the impairment or disposal of long-lived assets and is effective in fiscal years beginning after December 15, 2001. We have adopted this standard and report operations from properties sold in 2002 as discontinued operations for the quarter and year-to-date periods ended September 30, 2002 and 2001.

New Accounting Standards

In April 2002, the FASB issued SFAS No. 145, "Rescission of SFAS No. 4, 44, and 64, Amendment of SFAS No. 13, and Technical Corrections." SFAS No. 145 requires, among other things, (i) that the modification of a lease that results in a change of the classification of the lease from capital to operating under the provisions of SFAS No. 13 be accounted for as a sale-leaseback transaction and (ii) the reporting of gains or losses from the early retirement of debt as extraordinary items only if they met the criteria of Accounting Principles Board Opinion No. 30, "Reporting the Results of Operations." The adoption of this statement did not have a material effect on our financial statements.

In July 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS No. 146 replaces current accounting literature and requires the recognition of costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 is effective January 1, 2003, and we do not anticipate the adoption of this statement will have a material effect on our financial statements.

In May 2002, the FASB issued Emerging Issues Task Force (EITF) No. 00-23, "Issues Related to the Accounting for Stock compensation under APB Opinion No. 25 and FASB Interpretation No. 44." EITF No. 00-23 requires nonrecourse notes receivable from officers be accounted for as retired and the collateral shares as repurchased at the shares' market value. We have applied EITF No. 00-23 and discuss it further in Note 11 of this Form 10-Q.

In July 2002, the FASB issued SFAS 147, "Acquisitions of Certain Financial Institutions." SFAS 147 is effective for acquisitions on or after October 1, 2002. We do not anticipate the adoption of this statement will have a material effect on our financial statements.

Note 2 Merger and Significant Event

On March 21, 2001, PEI, PEI Merger Sub, Inc., a Maryland corporation (Merger Sub), and Excel Legacy entered into an Agreement and Plan of Merger (the Merger Agreement). On September 18, 2001, Merger Sub was merged with and into Excel Legacy (the Merger), with Excel Legacy continuing as a wholly-owned subsidiary of PEI. On the effective date of the Merger, each outstanding share of Excel Legacy common stock was exchanged for 0.6667 of a share of PEI common stock, and each option to purchase shares of Excel Legacy common stock was exchanged for an option to purchase 0.6667 shares of PEI common stock. Following the Merger, PEI continues to operate as a REIT under the name Price Legacy Corporation. The Merger was structured to qualify as a tax-free reorganization

and was approved by the stockholders of both PEI and Excel Legacy. The results of Excel Legacy are included in operations beginning September 19, 2001.

The purchase price was calculated based on $4.89 per share for the PEI common stock, which is equal to the closing price of $5.75 per share on March 21, 2001 (the day immediately prior to the public announcement of the Merger), less a 15% discount to reflect the low trading volume of the PEI stock (amounts in thousands, except per share data):

Shares issued		40,376
Price per share	$	4.89
		197,439
Merger related accounting, legal, printing and other costs		1,425
Purchase price	$	198,864

The purchase price resulted in an increase in the book value of the Excel Legacy assets acquired of approximately $26.0 million, which was allocated to real estate and other assets.

Also on March 21, 2001, PEI entered into a Securities Purchase Agreement with Warburg, Pincus Equity Partners, L.P. and certain of its affiliates (Warburg Pincus), pursuant to which PEI agreed to sell to Warburg Pincus for an aggregate purchase price of $100,000,000

- 17,985,612 shares of a new class of preferred stock, 9% Series B Junior Convertible Redeemable Preferred Stock at $5.56 per share, par value $0.0001 per share (the Series B Preferred Stock)

- a warrant to purchase an aggregate of 2.5 million shares of our common stock at an exercise price of $8.25 per share

On April 12, 2001, PEI and Sol Price, a significant stockholder of PEI and Excel Legacy through various trusts, agreed to convert an existing Excel Legacy loan payable to a trust controlled by Sol Price of approximately $9.3 million into 1,681,142 shares of the Series B Preferred Stock and a warrant to purchase 233,679 shares of our common stock at an exercise price of $8.25 per share.

Price Legacy issued the Series B Preferred Stock and warrants to Warburg Pincus and Sol Price concurrently with the completion of the Merger. The Series B Preferred Stock is junior to the Series A Preferred Stock with respect to dividend, liquidation and other rights, and is convertible under certain conditions into Price Legacy common stock at a one-to-one ratio, which may be adjusted under certain circumstances, after 24 months from the date of issuance. The 9% coupon will be paid with additional shares of Series B Preferred Stock at $5.56 per share for the first 45 months from issuance.

In addition, under the terms of the Merger Agreement, PEI commenced a tender offer for all outstanding shares of our common stock (other than those shares held by Excel Legacy and those shares issued in the Merger) at a cash price of $7.00 per share. In connection with the tender offer, 807,583 shares were purchased at a total cost of $5.7 million. Under terms of the Merger Agreement, we also commenced an exchange offer in which holders of Excel Legacy's outstanding debentures and

notes were offered shares of our Series A Preferred Stock in exchange for their debt securities. In connection with the exchange offer, we exchanged approximately $30.4 million in Excel Legacy debentures and $15.8 million in Excel Legacy notes. The tender offer and exchange offer closed concurrently with the Merger.

The exchange of Excel Legacy common stock for Price Legacy common stock in connection with the Merger was accounted for as a purchase of Excel Legacy by Price Legacy. Under purchase accounting, the assets and liabilities of Excel Legacy have been adjusted to fair value.

The following unaudited pro forma information for the three months and year-to-date period ended September 30, 2001 and unaudited actual results for the three months and year-to-date period ended September 30, 2002, have been presented as if the Merger had been completed on January 1, 2001. It also reflects the Series B Preferred Stock dividends and exchange of Excel Legacy senior notes and convertible debentures into Series A Preferred Stock. It does not reflect any application of proceeds from the sale of Series B Preferred Stock. We present pro forma information for comparative purposes only and the pro forma information may not be indicative of our actual results of operations had the Merger been completed on January 1, 2001 (amounts in thousands, except per share data):

	Three Months Ended September 30		**Nine Months Ended September 30**	
	2002	**2001**	**2002**	**2001**
	(actual)	**(pro forma)**	**(actual)**	**(pro forma)**
Total revenue	$ 30,170	$ 16,621	$ 88,705	$ 60,861
Net income	17,756	9,023	37,062	29,021

	Three Months Ended September 30		Nine Months Ended September 30	
Preferred dividends	(12,241)	(14,624)	(36,549)	(38,573)
Net income (loss) applicable to common stockholders	$ 5,515	$ (5,601)	$ 513	$ (9,552)
Weighted average shares outstanding				
Basic	39,167	40,726	40,201	40,726
Diluted	39,325	40,726	40,442	40,726
Income (Loss) per common share				
Basic and diluted	$ .14	$ (.14)	$ .01	$ (.23)

12

Note 3 Net Income Per Share

SFAS No. 128, "Earnings Per Share," requires presentation of two calculations of earnings per common share. Basic earnings per common share equals net income applicable to common stockholders divided by weighted average common shares outstanding during the period. Diluted earnings per common share equals net income applicable to common stockholders divided by the sum of weighted average common shares outstanding during the period plus common stock equivalents. Common stock equivalents are shares assumed to be issued if outstanding stock options and warrants that are dilutive were exercised. All earnings per share amounts have been presented, and where appropriate, restated to reflect these calculations.

	Three Months Ended September		Nine Months Ended September	
	2002	2001	2002	2001
Weighted average shares outstanding	39,167,431			