

ASSOCIATED ESTATES REALTY CORP

Form 10-Q

October 31, 2006

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

OR

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

For the transition period from _____ to _____

Commission File Number 1-12486

Associated Estates Realty Corporation

(Exact name of registrant as specified in its charter)

OHIO

(State or other jurisdiction of
incorporation or organization)

34-1747603

(I.R.S. Employer
Identification Number)

1 AEC Parkway, Richmond Hts., Ohio

(Address of principal executive offices)

44143-1467

(Zip Code)

Registrant's telephone number, including area code **(216) 261-5000**

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

No

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

Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company

(as defined in Rule 12b-2 of the Exchange Act). Yes

No

The number of shares outstanding as of October 27, 2006 was 17,163,292 shares

ASSOCIATED ESTATES REALTY CORPORATION

INDEX

	<u>Page</u>
PART I - FINANCIAL INFORMATION	
ITEM 1	
Consolidated Financial Statements (Unaudited)	
<u>Consolidated Balance Sheets</u> at September 30, 2006 and December 31, 2005	3
<u>Consolidated Statements of Operations</u> for the three and nine month periods ended September 30, 2006 and 2005	4
<u>Consolidated Statement of Shareholders' Equity</u> for the nine month period ended September 30, 2006	5
<u>Consolidated Statements of Cash Flows</u> for the nine month periods ended September 30, 2006 and 2005	6
<u>Notes to Consolidated Financial Statements</u>	7
ITEM 2	
<u>Management's Discussion and Analysis</u> of Financial Condition and Results of Operations	21
ITEM 3	
<u>Quantitative and Qualitative Disclosures About Market Risk</u>	27
ITEM 4	
<u>Controls and Procedures</u>	27
PART II - OTHER INFORMATION	
ITEM 1	
<u>Legal Proceedings</u>	28
ITEM 1A	
<u>Risk Factors</u>	28
ITEM 2	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	28
ITEM 6	
<u>Exhibits</u>	29
<u>SIGNATURES</u>	31

Index

PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

ASSOCIATED ESTATES REALTY CORPORATION

CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

	September 30,	December 31,
(In thousands, except share and per share amounts)	2006	2005
ASSETS		
Real estate assets		
Land	\$ 96,655	\$ 98,070
Buildings and improvements	785,928	809,967
Furniture and fixtures	<u>28,936</u>	<u>31,112</u>
	911,519	939,149
Less: accumulated depreciation	<u>(288,003)</u>	<u>(294,505)</u>
	623,516	644,644
Construction in progress	1,461	1,020
Real estate associated with property held for sale, net	<u>277</u>	<u>273</u>
Real estate, net	625,254	645,937
Cash and cash equivalents	2,392	39,733
Restricted cash	8,180	8,497
Accounts and notes receivable, net		
Rents	1,590	1,277
Affiliates and joint ventures	847	1,909
Other	1,767	3,674
Investments in joint ventures, net	5,321	5,890
Goodwill	1,725	1,725
Other assets, net	11,225	10,584
Other assets associated with property held for sale, net	<u>21</u>	<u>16</u>
Total assets	\$ 658,322	\$ 719,242
LIABILITIES AND SHAREHOLDERS' EQUITY		
Mortgage notes payable	\$ 482,311	\$ 547,790
Lines of credit borrowings	11,470	-
Unsecured debt	<u>25,780</u>	<u>25,780</u>
Total debt	519,561	573,570
Accounts payable, accrued expenses and other liabilities	25,395	22,465
Dividends payable	2,909	3,052
Resident security deposits	3,760	4,121
Funds held on behalf of managed properties		
Affiliates and joint ventures	506	959
Other	1,180	1,101
Accrued interest	1,813	2,800
Other liabilities associated with property held for sale	<u>20</u>	<u>22</u>
Total liabilities	555,144	608,090
Operating partnership minority interest	1,849	2,172
Shareholders' equity		
Preferred shares, without par value; 9,000,000 shares authorized:		
8.70% Class B Series II cumulative redeemable, \$250 per share		
liquidation preference, 232,000 issued and outstanding	58,000	58,000
Common shares, without par value, \$.10 stated value; 41,000,000		
authorized; 22,995,763 issued and 17,113,292 and 17,950,326		
outstanding at September 30, 2006 and December 31, 2005, respectively	2,300	2,300
Paid-in capital	280,524	278,885
Accumulated distributions in excess of accumulated net income	(183,118)	(184,303)

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

Accumulated other comprehensive income	(97)	(25)
Less: Treasury shares, at cost, 5,882,471 and 5,045,437 shares at September 30, 2006 and December 31, 2005, respectively	(56,280)	(45,877)
Total shareholders' equity	<u>101,329</u>	<u>108,980</u>
Total liabilities and shareholders' equity	\$ 658,322	\$ 719,242

The accompanying notes are an integral part
of these consolidated financial statements

Index

ASSOCIATED ESTATES REALTY CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	For the three months		For the nine months	
	ended September 30,		ended September 30,	
(In thousands, except per share amounts)	2006	2005	2006	2005
Revenue				
Property revenue	\$ 35,237	\$ 32,813	\$ 103,654	\$ 96,017
Management and service company revenue:				
Fees, reimbursements and other	2,914	3,172	9,173	8,669
Painting services	<u>216</u>	<u>318</u>	<u>810</u>	<u>511</u>
Total revenue	38,367	36,303	113,637	105,197
Expenses				
Property operating and maintenance	16,674	15,664	49,819	45,499
Depreciation and amortization	8,233	8,208	24,821	24,274
Direct property management and service companies expenses	3,188	3,303	9,911	9,325
Painting services	272	347	1,021	647
General and administrative	<u>2,679</u>	<u>1,994</u>	<u>7,672</u>	<u>6,135</u>
Total expenses	<u>31,046</u>	<u>29,516</u>	<u>93,244</u>	<u>85,880</u>
Operating income	7,321	6,787	20,393	19,317
Interest income	96	56	586	239
Interest expense	(17,383)	(10,754)	(45,205)	(31,217)
(Loss) income before equity in net loss of joint ventures, minority interest and income from discontinued operations	(9,966)	(3,911)	(24,226)	(11,661)
Equity in net loss of joint ventures	(139)	(68)	(387)	(567)
Minority interest in operating partnership	(15)	(16)	(47)	(48)
(Loss) income from continuing operations	(10,120)	(3,995)	(24,660)	(12,276)
Income from discontinued operations:				
Operating income	52	799	208	2,544
Gain on disposition of properties	<u>3,397</u>	<u>17,406</u>	<u>38,120</u>	<u>21,437</u>
Income from discontinued operations	<u>3,449</u>	<u>18,205</u>	<u>38,328</u>	<u>23,981</u>
Net (loss) income	(6,671)	14,210	13,668	11,705

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

Preferred share dividends	(1,262)	(1,261)	(3,785)	(3,868)
Original issuance costs related to redemption of preferred shares	-	-	-	(2,163)
Net (loss) income applicable to common shares	\$ (7,933)	\$ 12,949	\$ 9,883	\$ 5,674
Earnings per common share - basic and diluted:				
(Loss) income from continuing operations applicable to common shares	\$ (.67)	\$ (.27)	\$ (1.67)	\$ (.94)
Income from discontinued operations	.20	.94	2.25	1.23
Net (loss) income applicable to common shares	\$ (.47)	\$.67	\$.58	\$.29
Dividends declared per common share	\$.17	\$.17	\$.51	\$.51
Weighted average number of common shares outstanding - basic and diluted				
	16,892	19,257	17,016	19,478

The accompanying notes are an integral part

of these consolidated financial statements

Index

ASSOCIATED ESTATES REALTY CORPORATION

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

(UNAUDITED)

	Class B	Total Paid-In				Accumulated		
		Cumulative Redeemable Preferred	Common Shares (at \$.10 stated value)	Paid-In Capital	Unearned Compensation	Distributions In Excess of Accumulated Net Income	Accumulated Other Comprehensive Income	Treasury Shares (at cost)
(In thousands, except share amounts)	Total	Shares	value	Capital	Compensation	Net Income	Income	(at cost)
Balance, December 31, 2005	\$ 108,980	\$ 58,000	\$ 2,300	\$ 279,484	\$ (599)	\$ (184,303)	\$ (25)	\$ (45,877)
Comprehensive income:								
Net income	13,668	-	-	-	-	13,668	-	-
Other comprehensive income:								
Change in fair value of hedge instruments	(72)	-	-	-	-	-	(72)	-
Total comprehensive income	13,596	-	-	-	-	13,668	(72)	-
Share-based compensation	760	-	-	1,264	599	10	-	(1,113)
Purchase of 991,786 common shares	(10,259)	-	-	-	-	-	-	(10,259)
Issuance of 87,099 common shares for stock option exercises from treasury shares	745	-	-	(224)	-	-	-	969
Common share dividends	(8,708)	-	-	-	-	(8,708)	-	-
Preferred share dividends	(3,785)	-	-	-	-	(3,785)	-	-
Balance, September 30, 2006	\$ 101,329	\$ 58,000	\$ 2,300	\$ 280,524	\$ -	\$ (183,118)	\$ (97)	\$ (56,280)

The accompanying notes are an integral part
of these consolidated financial statements

Index

ASSOCIATED ESTATES REALTY CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	For the nine months ended September 30,	
	2006	2005
(In thousands)		
Cash flow from operating activities:		
Net income	\$ 13,668	\$ 11,705
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization (including discontinued operations)	25,225	26,703
Loss on fixed asset replacements write-off	143	86
Gain on disposition of properties	(38,120)	(21,437)
Minority interest in operating partnership	47	48
Costs (discount) related to prepayment of debt, net	668	(330)
Share-based compensation	710	209
Equity in net loss of joint ventures	387	567
Distribution from joint ventures	318	-
Net change in assets and liabilities:		
- Accounts and notes receivable	1,593	(2,156)
- Accounts and notes receivable of affiliates and joint ventures	566	3,190
- Accounts payable and accrued expenses	2,787	886
- Other operating assets and liabilities	(1,897)	200
- Restricted cash	1,617	643
- Funds held for non-owned managed properties	79	262
- Funds held for non-owned managed properties of affiliates	(452)	(1,155)
Total adjustments	(6,329)	7,716
Net cash flow provided by operations	7,339	19,421
Cash flow from investing activities:		
Recurring fixed asset additions	(8,787)	(5,640)
Revenue enhancing/non-recurring fixed asset additions	(1,228)	(504)
Acquisition/development fixed asset additions	(256)	(41,670)
Purchase of operating partnership units	(184)	-
Proceeds from disposition of operating properties	44,844	16,164

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

Deposit of sale proceeds to escrow account	(1,300)	(5,077)
Contributions to joint ventures	(137)	=
Net cash flow provided by (used for) investing activities	32,952	(36,727)
Cash flow from financing activities:		
Principal payments on mortgage notes payable	(197,689)	(35,945)
Payment of debt procurement costs	(1,425)	(1,158)
Proceeds from mortgage notes obtained	132,209	55,140
Proceeds from issuance of unsecured trust preferred securities	-	25,780
Line of credit borrowings	71,700	44,250
Line of credit repayments	(60,230)	(49,750)
Redemption of Class A preferred shares	-	(56,250)
Common share dividends paid	(8,851)	(10,046)
Preferred share dividends paid	(3,785)	(4,188)
Operating partnership distributions paid	(50)	(48)
Exercise of stock options	745	342
Purchase of treasury shares under repurchase plan	(10,185)	(8,911)
Other financing activities, net	(71)	(44)
Net cash flow used for financing activities	(77,632)	(40,828)
Decrease in cash and cash equivalents	(37,341)	(58,134)
Cash and cash equivalents, beginning of period	39,733	59,734
Cash and cash equivalents, end of period	\$ 2,392	\$ 1,600
Supplemental disclosure of cash flow information:		
Dividends declared but not paid	\$ 2,909	\$ 3,205
Cash paid for interest	45,478	31,186
Fixed asset replacement and other write-offs	2,338	1,856
Reclassification of original issuance costs related to redemption of preferred shares	-	2,163
Relinquishment of debt related to property disposition	-	10,065
Net change in accounts payable related to recurring fixed asset additions	624	-
Final adjustment to fixed assets related to 2002 non-monetary joint venture exchange	496	-
Fixed asset adjustment for purchase of operating partnership unit	137	-

The accompanying notes are an integral part
of these consolidated financial statements

Index

ASSOCIATED ESTATES REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

UNAUDITED

1. BASIS OF PRESENTATION AND ACCOUNTING POLICIES

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

Except as the context otherwise requires, all references to "we," "our," "us" and the "Company" in this report collectively refer to Associated Estates Realty Corporation and its consolidated subsidiaries.

Business

We are a self-administered and self-managed equity real estate investment trust ("REIT") that specializes in multifamily property management, advisory, development, acquisition, disposition, operation and ownership activities. In addition to rental revenue, we receive certain property and asset management fees, acquisition, disposition and incentive fees, consultation fees, and mortgage servicing fees. Our MIG subsidiary is a registered investment advisor and serves as a real estate advisor to pension funds. We own three taxable REIT subsidiaries (the "Service Companies") that provide management and other services to us and to third parties.

As of September 30, 2006, we owned or property managed 103 apartment communities in ten states consisting of 21,348 units. We own, either directly or indirectly through subsidiaries, or hold ownership interests in 70 of those 103 apartment communities containing 16,145 units in nine states, 12 of which are Affordable Housing communities. We also property manage 33 communities consisting of 5,203 units. Additionally, we asset manage a 186-unit apartment community and a commercial property containing approximately 145,000 square feet.

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared by management in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and applicable rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting only of normal and recurring adjustments) considered necessary for a fair presentation have been included. The reported results of operations are not necessarily indicative of the results that may be expected for the full year. These financial statements should be read in conjunction with the audited financial statements and accompanying notes in our Annual Report on Form 10-K for the year ended December 31, 2005.

Share-Based Compensation

The Amended and Restated 2001 Equity-Based Award Plan (the "Plan") was the only share-based compensation plan in effect on September 30, 2006. The Plan provides for equity award grants to our officers, employees, and directors. Equity awards available under the Plan include stock options, share appreciation rights, restricted shares, deferred shares, and other awards based on common shares. The aggregate number of common shares subject to awards under the Plan is 2,250,000. At September 30, 2006, there were 763,196 common shares available for awards under the Plan. We also have share-based awards outstanding that had been issued under two other plans that have since expired, and outstanding stock option awards that had been issued to our outside directors. For additional information regarding these share-based compensation plans, see Note 17 of the Notes to the Consolidated Financial Statements of our report on Form 10-K for the year ended December

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

31, 2005.

Effective January 1, 2006, we adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised), "Share-Based Payment" ("SFAS 123(R)") using the modified prospective application method. Prior to the adoption of SFAS 123(R), we accounted for share-based compensation using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25 ("APB No. 25"), and accordingly, we recognized no compensation expense for stock option awards.

Under the modified prospective method of SFAS 123(R), share-based compensation cost is recognized on (i) all awards granted on or after January 1, 2006 using the fair-value method, (ii) nonvested stock option awards granted prior to January 1, 2006 based on their grant date fair value as previously calculated under the pro-forma disclosure provisions of SFAS 123 over the remaining requisite service periods, and (iii) nonvested restricted share awards based on their grant date fair value over the remaining service periods. Prior periods were not restated to reflect the impact of adopting this Statement. Additionally, SFAS 123(R) requires us to estimate the amount of expected forfeitures when calculating compensation costs, instead of accounting for forfeitures as they occur, which was our previous method. Forfeiture rates were calculated based on our historical forfeiture activity, which was adjusted for activity that we believe is not representative of expected future activity. The following table reflects the effect on operating results and per share information if we had accounted for share-based compensation in accordance with SFAS 123(R) for the three and nine months ended September 30, 2005:

	For the three months	For the nine months
(In thousands, except per share data)	ended September 30,	ended September 30,
	<u>2005</u>	<u>2005</u>
Net income	\$ 14,210	\$ 11,705
Total share compensation cost recognized	70	237
Total share compensation cost under the fair value method	(176)	(443)
Proforma net income under the fair value method	\$ 14,104	\$ 11,499
Net income applicable to common shares:		
Net income as reported	\$ 12,949	\$ 5,674
Total share compensation cost recognized	70	237
Total share compensation cost under the fair value method	(176)	(443)
Pro forma net income under the fair value method	\$ 12,843	\$ 5,468
Income per common share - basic and diluted:		
Net income as reported	\$.67	\$.29
Total share compensation cost recognized	-	.01
Total share compensation cost under the fair value method	=	(.02)
Pro forma net income under the fair value method	\$.67	\$.28

Our share-based compensation awards consist primarily of restricted shares. We award share-based compensation to our officers and employees as a performance incentive and to align individual goals with those of the Company. We grant share-based awards that vest either at the end of a specified service period, or in equal increments during the service period on each anniversary of the grant date. In accordance with SFAS 123(R), we have elected to recognize compensation cost on these awards on a straight-line basis. In addition to awards containing only service conditions, we issue certain grants in which the number of shares that will ultimately vest and the date at which they will vest is dependant upon the achievement of specified performance goals. Compensation cost for awards with performance conditions is recognized based on our best estimate of the number of awards that will vest and the period of time in which they will vest.

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

During the three and nine months ended September 30, 2006, we recognized total share-based compensation cost of \$242,000 and \$692,000, respectively, in "General and administrative expense". Additionally, we allocated an immaterial amount of equity compensation expense to individual properties which is included in "Property operating and maintenance expense" in the Consolidated Statements of Operations.

Stock Options. We use the Black-Scholes option pricing model to estimate the fair value of share-based awards. The weighted average Black-Scholes assumptions and fair value for the three and nine months ended September 30, 2006 and 2005 were as follows:

	For the three months		For the nine months	
	ended September 30,		ended September 30,	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Expected volatility	-	30.7%	27.7%	30.7%
Risk-free interest rate	-	4.2%	4.6%	4.2%
Expected life of options (in years)	-	7.1	6.0	7.1
Dividend yield	-	7.1%	6.0%	7.1%
Grant-date fair value	-	\$ 1.45	\$ 1.85	\$ 1.45

The expected volatility was based upon the historical volatility of our weekly share closing prices over a period equal to the expected life of the options granted. The risk-free interest rate used was the yield from U.S. Treasury zero-coupon bonds on the date of grant with a maturity equal to the expected life of the options. The expected life of the options was derived using the "simplified" method as allowed under the provisions of the Securities and Exchange Commission's Staff Accounting Bulletin No. 107. The dividend yield was derived using our annual dividend rate as a percentage of the price of our shares on the date of grant.

The following table represents stock option activity for the nine months ended September 30, 2006:

	Number of	Weighted-Average	Weighted-Average
	Stock Options	Exercise Price	Remaining Contract Life
Outstanding at beginning of period	1,996,308	\$ 11.89	
Granted	237,155	\$ 11.30	
Exercised	87,099	\$ 8.55	
Forfeited	13,750	\$ 12.11	
Expired	51,250	\$ 14.71	
Outstanding at end of period	2,081,364	\$ 11.89	5.0 years
Exercisable at end of period	1,486,430	\$ 12.43	3.9 years

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

The aggregate intrinsic value of stock options outstanding and stock options exercisable at September 30, 2006, was \$10.5 million and \$7.5 million, respectively. The aggregate intrinsic value of stock options exercised during the nine months ended September 30, 2006 and 2005 was \$410,000 and \$70,000, respectively. We generally issue shares from treasury upon the exercise of stock options.

Restricted Shares. Restricted shares generally have the same rights as our common shares, except for transfer restrictions and forfeiture provisions. Prior to January 1, 2006, restricted share awards were recorded in shareholders' equity as deferred compensation on the grant date based upon the price of our common shares on the grant date and amortized into expense over the requisite service period based on the straight line method. We generally issue restricted share awards from treasury shares. Upon adoption of SFAS 123(R), we returned the nonvested shares to treasury shares from unearned compensation at their original cost, totaling \$1.5 million. We recorded an immaterial cumulative effect of a change in accounting principle as a result of our change in policy from recognizing forfeitures as they occur to one where we recognize cost after the application of an estimated forfeiture rate. This amount was recorded in "General and administrative expense" in the Consolidated Statements of Operations. Accrued compensation cost of \$561,000 related to nonvested restricted shares at January 1, 2006 was transferred to additional paid in capital from deferred compensation.

The following table represents restricted share activity for the nine months ended September 30, 2006:

	Number of	Weighted Average
	Shares	Grant-Date Fair Value
Nonvested at beginning of period	144,582	\$ 8.96
Granted	75,871	\$ 11.60
Vested	37,802	\$ 8.26
Forfeited	8,218	\$ 9.46
Nonvested at end of period	174,433	\$ 10.24

The weighted average grant-date fair value of restricted shares granted during the nine months ended September 30, 2006 and 2005 was \$11.60 and \$9.73, respectively. The total fair value of restricted shares vested during the nine months ended September 30, 2006 and 2005 was \$451,000 and \$137,000, respectively. At September 30, 2006, there was \$751,000 of unrecognized compensation cost related to nonvested restricted share awards that we expect to recognize over a weighted average period of 1.9 years.

Operating Partnership Minority Interest

In conjunction with the 1998 acquisition of an operating partnership that owned two apartment communities, we issued a total of 522,032 operating partnership units ("OP units"). In September 2006, 13,746 of the OP units were redeemed for cash in the amount of \$184,000, which represented a value of \$13.41 per unit. These units had a recorded amount of \$321,000 when issued. The difference of the cash paid and the recorded amount was \$137,000 which reduced the recorded amount of the underlying real estate. There are 79,277 OP units remaining as of September 30, 2006.

Derivative Instruments and Hedging Activity

During the nine months ended September 30, 2006, we utilized forward contracts with respect to forecasted probable purchases of natural gas used in heating certain of our properties. We utilize the gas forwards to limit the market price risk associated with the forecasted gas purchase. Identification of a forward contract as a qualifying cash-flow hedge requires us to determine that the forecasted transaction(s) is probable, and the hedging relationship between the gas contract and the expected future purchase is expected to be highly effective at the initiation of the hedge and throughout the hedging relationship. We reassess this hedge on a quarterly basis to determine if it continues to be effective and the forecasted transactions are probable. The changes in fair value of the contracts will be recorded in other comprehensive income ("OCI") on the Consolidated Balance Sheets. The amount in OCI will be reclassified into earnings when the cost of the gas affects earnings. If any portion of the hedge is determined to be ineffective, that amount will be recorded into earnings. As of September 30, 2006, this hedge was reported at fair value on the Consolidated Balance Sheet as "Accounts payable, accrued expenses and other liabilities" in the amount of \$106,000. The unrealized gain/loss in the fair value of this hedge is deferred in OCI and will be recognized in earnings as the hedged transaction occurs. The change in net unrealized gain/loss on this hedge reflects a reclassification of net unrealized gain/loss from accumulated OCI to earnings of \$89,000 during the nine months ended September 30, 2006. We estimate the \$97,000 in OCI will be reclassified into earnings over the next six months.

Classification of Fixed Asset Additions

We consider recurring fixed asset additions to a property to be capital expenditures made to replace worn out assets to maintain the property's value. We consider investment/revenue enhancing and/or non-recurring fixed assets to be capital expenditures if such improvements increase the value of the property and/or enables us to increase rents. We consider acquisition and development fixed asset additions to be for the purchase or construction of new properties to be added to our portfolio, or fixed asset additions identified at the time of purchase that are not made until subsequent periods.

Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" - an interpretation of FASB Statement No. 109, "Accounting for Income Taxes" ("FIN 48"). This Interpretation clarifies the accounting for uncertain tax positions and provides guidance for the recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation will become effective for us on January 1, 2007. Although we are assessing the impact of FIN 48, we do not anticipate that it will have a material impact on our financial position, results of operations or cash flows.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108 ("SAB 108") "Considering the Effects of Prior Year Misstatements in Current Year Financial Statements." SAB 108 provides guidance on quantifying financial statement misstatements, including the effects of prior year errors on current year financial statements. SAB 108 is effective for fiscal years ending after November 15, 2006. We do not anticipate that the adoption of SAB 108 will have a material impact on our financial position, results of operations or cash flows.

Reclassifications

Certain reclassifications have been made to the 2005 financial statements to conform to the 2006 presentation.

2. PROPERTIES ACQUIRED

On March 9, 2005, we acquired a 316-unit multifamily community located in Florida. The purchase was funded primarily by mortgage financing on the acquired property and on a previously unencumbered Same Community Market-Rate ("Market-Rate") multifamily property. See Note 4 for further information concerning these mortgage notes. Additionally, this property was part of a reverse Like-Kind Exchange under Section 1031 of the Internal Revenue Code.

3. PROPERTIES SOLD OR HELD FOR SALE

We report the results of operations and gain/loss related to the sale of real estate assets as discontinued operations in accordance with SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"). Real estate assets that are classified as held for sale are also reported as discontinued operations. We generally classify properties as held for sale when all significant contingencies surrounding the closing have been resolved. In many transactions, these contingencies are not satisfied until the actual closing of the transaction. Interest expense included in discontinued operations is limited to interest on mortgage debt specifically associated with properties sold or classified as held for sale.

We classified one property as held for sale at September 30, 2006. The major classes of assets and liabilities related to this property have been reclassified as such in the accompanying Consolidated Balance Sheet at September 30, 2006. "Income from discontinued operations" in the accompanying Consolidated Statements of Operations for the three and nine months ended September 30, 2006 and 2005 includes the operating results for the property classified as held for sale, the operating results and gain recognized on the property sales referenced below, and the operating results for a property sold during the fourth quarter of 2005.

On September 28, 2006, we completed the sale of an Affordable Housing property located in Northeast Ohio. The sale price was a net \$2.9 million and we recorded a gain of \$2.5 million. The proceeds of this sale were used for general corporate purposes. Subsequent to the sale, we entered into a contract to provide property management services for this property.

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

On August 28, 2006, we completed the sale of a Market-Rate congregate care property located in Northeast Ohio. The sale price was \$2.0 million and we recorded a gain of \$865,000. Proceeds of this sale in the amount of \$1.3 million were placed in escrow and were used to repay debt in October 2006. The remaining proceeds were used for other corporate purposes.

On May 15, 2006, we completed the sale of a Market-Rate property located in Northeast Ohio. The sale price was a net \$28.4 million and we recorded a gain of \$23.4 million. In connection with our IPO in 1993, we acquired a Noteholder Interest which was secured by a limited partnership interest in one-half of this property. We had declared the notes to be in default because of nonpayment of interest and principal. On July 16, 2004, we accepted a 98.999% limited partnership interest in the limited partnership that owned the property in full satisfaction of all obligations under the notes. In addition, one of our subsidiaries acquired the remaining 1.001% general partnership interest in that limited partnership held by our President and CEO Jeffrey I. Friedman and a company controlled by him. The subsidiary acquired such partnership interest in return for a promise to pay Mr. Friedman and his controlled company 1.001% of the net sale proceeds derived from any future sale of the property. Pursuant to the terms of the buyout, Mr. Friedman and his controlled company were paid a total of \$127,000 from the proceeds of this sale. The independent members of the Board of Directors approved the terms of the buyout. The proceeds of this sale were used primarily to fund the defeasance of fixed rate mortgage loans. See Note 4 for further information on the defeasance of fixed rate mortgage loans.

On May 10, 2006, we completed the sale of a Market-Rate property located in Northeast Ohio. The sale price was a net \$13.9 million and we recorded a gain of \$11.3 million. The proceeds of this sale were used primarily to fund the defeasance of fixed rate mortgage loans. See Note 4 for further information on the defeasance of fixed rate mortgage loans.

On August 25, 2005, we completed the sale of a Market-Rate property located in Northeast Ohio. The sale price was \$28.0 million and we recorded a gain of \$17.4 million. This property was part of a reverse Like-Kind Exchange under Section 1031 of the Internal Revenue Code. Subsequent to the sale, we entered into a contract to provide property management services for this property.

On June 28, 2005, we completed the sale of a Market-Rate property located in Phoenix, Arizona. The sale price was \$15.5 million and we recorded a gain of \$4.0 million. The net proceeds from this sale of \$5.1 million were deposited directly to escrow with a qualified intermediary as this sale was treated as a Deferred Like-Kind Exchange under Section 1031 of the Internal Revenue Code. On October 11, 2005, these proceeds were used to partially fund the acquisition of a 168-unit Market-Rate property in Atlanta, Georgia.

The following chart summarizes "Income from discontinued operations" for the three and nine months ended September 30, 2006 and 2005.

	For the three months		For the nine months	
	ended September 30,		ended September 30,	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
(In thousands)				
Property revenue	\$ 546	\$ 4,417	\$ 4,395	\$ 14,397
Property operating and maintenance expense	(451)	(2,667)	(3,714)	(8,629)

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

Real estate asset depreciation and amortization	(29)	(675)	(404)	(2,428)
Interest income	4	2	9	5
Interest expense, net ⁽¹⁾	(18)	(278)	(78)	(801)
Operating income	52	799	208	2,544
Gain on disposition of properties	<u>3,397</u>	<u>17,406</u>	<u>38,120</u>	<u>21,437</u>
Income from discontinued operations	\$ 3,449	\$ 18,205	\$ 38,328	\$ 23,981

(1) The nine months ended September 30, 2005, includes a \$330 discount received as a result of prepaying a loan (see Note 4) and a reduction to interest expense of \$144 related to an interest rate swap termination payment.

4. DEBT

Mortgage Notes Payable

During the nine months ended September 30, 2006, we defeased (prepaid) 13 fixed rate mortgage loans totaling \$138.9 million, and incurred \$14.3 million in defeasance costs, which are included in "Interest expense" in the Consolidated Statements of Operations.

On September 14, 2006, we completed the \$132.2 million mortgage refinancing of five Market-Rate properties. The existing mortgages on these properties were defeased with proceeds from the refinancing and are included in the above referenced 13 defeased loans. The new loans were structured as five separate mortgage loans, however each mortgage loan is cross-collateralized and cross-defaulted with the other mortgage loans involved in the refinancing. Each loan has a term of seven years and carries a 6.09% fixed interest rate with interest only payments during the first five years and monthly payments of principal and interest thereafter. These loans include a substitution feature permitting us to substitute another multifamily residential property for the respective mortgaged property in accordance with certain terms and conditions as well as the right to release properties subject to satisfaction of various conditions.

On September 15, 2006, we prepaid three variable rate, conventional mortgages totaling \$54.6 million with proceeds from the September 14, 2006, refinancing, as discussed above, and recognized \$300,000 of expense related to the prepayments. These loans had been secured by three Market-Rate properties.

On August 25, 2005, as discussed in Note 3, we completed the sale of a Market-Rate property located in Northeast Ohio. In connection with this sale, the \$16.1 million mortgage note secured by this property was paid off.

On June 28, 2005, as discussed in Note 3, we completed the sale of a Market-Rate property located in Phoenix, Arizona. In connection with this sale, the \$10.1 million mortgage note secured by this property was assumed by the buyer.

On March 21, 2005, we repaid a \$15.6 million variable rate mortgage note that had been secured by a property in Florida.

On March 9, 2005, we obtained two conventional mortgage loans in connection with the purchase of a property in Florida. One loan, secured by a property in Northeast Ohio, was repaid in December 2005. The other loan, which was secured by the acquired Florida property, was repaid on September 15, 2006, as discussed above.

On February 1, 2005, we repaid \$10.7 million in variable rate debt and prepaid \$5.3 million in zero percent UDAG financing, both of which had been secured by a Market-Rate property. Of the \$16.0 million that was repaid, \$10.7 million matured on February 1, 2005, \$3.1 million would have matured on April 1, 2005 and \$2.2 million would have matured on June 1, 2006. The \$2.2 million that would have matured on June 1, 2006, was paid off at a discount of \$330,000, which was recorded as a reduction to interest expense. We funded the repayment by obtaining a new mortgage loan on the same property in the amount of \$16.1 million. This note was repaid in full in connection with the sale of this property on August 25, 2005.

Lines of Credit

Our \$17.0 million secured line of credit was unavailable at December 31, 2005, because the property securing that credit line had been sold. In February 2006, we identified a replacement property to serve as security for this credit line and amended the loan terms by increasing the credit line to \$17.0 million from \$15.0 million with interest calculated at LIBOR plus 1.5%. This line matures March 1, 2008. Borrowings under the line may be restricted based upon the operating performance of the property. There were borrowings of \$11.5 million outstanding on this line of credit at September 30, 2006.

We also have a \$14.0 million secured line of credit which matures in December 2007. There were no regular borrowings outstanding under this line at September 30, 2006 or December 31, 2005. The interest rate on this line is 1.8% in excess of LIBOR or the one month reference rate. Letters of credit of \$2.7 million were outstanding on this line at September 30, 2006. On October 6, 2006, letters of credit totaling approximately \$2.6 million were canceled, leaving one letter of credit in the amount of \$63,000 outstanding. There were no borrowings outstanding on this line at December 31, 2005.

Unsecured Debt

On March 15, 2005, AERC Delaware Trust (the "Trust"), a newly formed wholly owned subsidiary, sold trust preferred securities for an aggregate amount of \$25.8 million. Associated Estates Realty Corporation ("AERC") owns all of the common securities of the Trust. The Trust used the proceeds to purchase AERC's junior subordinated note due March 30, 2035, which represents all of the Trust's assets. The terms of the trust preferred securities are substantially the same as the terms of the junior subordinated note. Interest on the junior subordinate note is payable at a fixed rate equal to 7.9% per annum through the interest rate payment date in March 2015 and thereafter at a variable rate equal to LIBOR plus 3.25% per annum. AERC may redeem the junior subordinated note at par at any time on and after March 30, 2010. To the extent that AERC

redeems the junior subordinated note, the Trust is required to redeem a corresponding amount of trust preferred securities.

5. GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill

MIG Realty Advisors, Inc. In June 1998, we recorded goodwill in connection with the MIG Realty Advisors, Inc. merger. The goodwill was allocated fully to the Management and Service Operations Segment.

We completed our annual review of goodwill during the three months ended March 31, 2006. In performing this analysis, we use a multiple of revenues to the range of potential alternatives and assign a probability of the various alternatives under consideration by management. Based on this analysis, we have determined that goodwill was not impaired as of March 31, 2006. As such, there were no changes to the carrying amount of goodwill during the nine months ended September 30, 2006. Should the estimates used to determine alternatives or the probabilities of the occurrence thereof change, an impairment may result which could materially impact our results of operations for the period in which it is recorded.

Intangible Assets

Property Acquisitions. In accordance with SFAS 141, "Business Combinations", we allocate a portion of the total purchase price of a property acquisition to any intangible assets identified, such as existing leases and tenant relationships. The intangible assets are amortized over the remaining lease terms or estimated life of the tenant relationship, which is approximately twelve to sixteen months. Due to the short term nature of residential leases, we believe that existing lease rates approximate market rates, and therefore, no allocation is made for above/below market leases.

6. TRANSACTIONS WITH AFFILIATES AND JOINT VENTURES

We provide management and other services to (and are reimbursed for certain expenses incurred on behalf of) certain non-owned properties in which our Chief Executive Officer ("CEO") and/or other related parties have varying ownership interests. The entities which own these properties, as well as other related parties, are referred to as "affiliates." We also provide similar services to joint venture properties.

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

In the normal course of business, we have advanced funds on behalf of affiliates and joint ventures and held funds for the benefit of affiliates and joint ventures.

We held two notes of equal amounts payable by our CEO aggregating \$3.4 million, both of which were paid in full on April 25, 2005. The average interest rate payable on these notes during 2005 was approximately 4.5%.

Merit Painting Services ("Merit"), a subsidiary of ours, has provided services to JAS Construction, Inc. ("JAS") related to property rehabilitation and other work from time to time. JAS is owned by a son of our CEO. Reported revenue related to work performed by Merit for JAS is included in the table below.

Summarized affiliate and joint venture transaction activity was as follows:

(In thousands)	For the three months ended September 30,		For the nine months ended September 30,	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Property management fee and other				
miscellaneous service revenue	\$ 128	\$ 235	\$ 462	\$ 674
Painting service revenue related to JAS Construction	2 87		273	117
Other affiliate and joint venture painting service revenue	2 47		9	76
Expenses incurred on behalf of and reimbursed by ⁽¹⁾	268	340	890	971
Interest income on notes due from CEO	-	-	-	47

⁽¹⁾ Primarily payroll and employee benefits, reimbursed at cost.

(In thousands)	September 30,	December 31,
	<u>2006</u>	<u>2005</u>
Accounts and notes receivable from affiliates and joint ventures:		
Funds advanced	\$ 528	\$ 633
JAS Construction, Inc.	26	392
Property management fees, insurance and		
miscellaneous receivables	<u>293</u>	<u>884</u>
Total due from affiliates and joint ventures	\$ 847	\$ 1,909
Funds held on behalf of affiliates and joint ventures	\$ 506	\$ 959

7. SHARES

On July 27, 2005, our Board of Directors authorized the repurchase of up to \$50.0 million of our common shares. On October 20, 2006, our Board of Directors expanded their authorization to include the repurchase of our Class B Series II Preferred Shares. As of September 30, 2006, we had repurchased 2,803,925 common shares under this plan at a cost of \$27.6 million.

During the nine months ended September 30, 2006, a total of 37,802 restricted shares had vested and were issued from treasury shares. Effective January 1, 2006, we adopted SFAS 123(R). This Statement requires that restricted shares are recognized as issued shares when they become vested. In accordance with previous generally accepted accounting principles, we had recognized restricted shares as issued shares when they were initially granted. As a result of the adoption of this Statement, we returned to treasury 144,582 restricted shares which were nonvested at January 1, 2006. See Note 1 for additional information related to the adoption of SFAS 123(R).

8. EARNINGS PER SHARE

Earnings per share ("EPS") has been computed pursuant to the provisions of SFAS 128, "Earnings per Share." There were 2.1 million options to purchase common shares outstanding at September 30, 2006 and 2005. None of the options were included in the calculation of diluted earnings per share for the periods presented as their inclusion would be antidilutive to the net loss applicable to common shares from continuing operations.

The exchange of operating partnership minority interests into common shares was also not included in the computation of diluted EPS because we plan to settle these OP units in cash.

9. INTERIM SEGMENT REPORTING

We have four reportable segments: (1) Acquisition/Disposition Multifamily Properties; (2) Same Community Market-Rate ("Market-Rate") Multifamily Properties; (3) Affordable Housing Multifamily Properties; and (4) Management and Service Operations. We have identified these segments based upon how management makes decisions regarding resource allocation and performance assessment. The Acquisition/Disposition properties represent acquired or developed properties which have not yet reached stabilization (we consider a property stabilized when its occupancy rate reaches 93.0% and we have owned the property for one year), and properties that have been sold or are classified as held for sale in accordance with SFAS 144. The Market-Rate properties are same community (owned during the entirety of the comparison periods) conventional multifamily residential apartments. The Affordable Housing properties are multifamily properties for which the rents are subsidized and certain aspects of the operations are regulated by HUD pursuant to Section 8 of the National Housing Act of 1937. The Management and Service Operations provide management and advisory services to the Acquisition/Disposition, Market-Rate and Affordable Housing properties that we own, as well as to third party clients and properties. All of our segments are located in the United States.

The accounting policies of the reportable segments are the same as those described in the "Basis of Presentation and Significant Accounting Policies" in our Annual Report on Form 10-K for the year ended December 31, 2005. We evaluate the performance of our reportable segments

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

based on Net Operating Income ("NOI"). NOI is determined by deducting property operating and maintenance expenses from property revenue for the Acquisition/Disposition (excluding amounts classified as discontinued operations), Market-Rate and Affordable Housing segments and deducting direct property management and service companies expenses and painting services expenses from Management and Service Company revenue for the Management and Service Operations segment. We consider NOI to be an appropriate supplemental measure of our performance because it reflects the operating performance of our real estate portfolio and management and service companies at the property and management and service company level and is used to assess regional property level performance. NOI should not be considered (i) as an alternative to net income (determined in accordance with GAAP), (ii) as an indicator of financial performance, (iii) as cash flow from operating activities (determined in accordance with GAAP) or (iv) as a measure of liquidity; nor is it necessarily indicative of sufficient cash flow to fund all of our needs. Certain other real estate companies may define NOI in a different manner.

Segment information for the three and nine months ended September 30, 2006 and 2005 is as follows:

<u>For the three months ended September 30, 2006</u>					
	Acquisition/ Disposition	Market-Rate	Affordable Housing	Management and Service Operations	Total Consolidated
(In thousands)					
Total segment revenue	\$ 530	\$ 32,340	\$ 2,389	\$ 5,072	\$ 40,331
Elimination of intersegment revenue	-	(7)	(15)	(1,942)	(1,964)
Consolidated revenue	530	32,333	2,374	3,130	38,367
Equity in net loss of joint ventures	-	(106)	(33)	-	(139)
Operating income from discontinued operations	52	-	-	-	52
*NOI	239	17,140	1,184	(330)	18,233
Total assets	\$ 63,385	\$ 569,870	\$ 7,352	\$ 17,715	\$ 658,322

*Intersegment revenue and expenses have been eliminated in the computation of NOI for each of the segments.

<u>For the nine months ended September 30, 2006</u>					
	Acquisition/ Disposition	Market-Rate	Affordable Housing	Management and Service Operations	Total Consolidated
(In thousands)					
Total segment revenue	\$ 5,016	\$ 91,669	\$ 7,031	\$ 15,855	\$ 119,571
Elimination of intersegment revenue	-	(26)	(36)	(5,872)	(5,934)
Consolidated revenue	5,016	91,643	6,995	9,983	113,637
Equity in net loss of joint ventures	-	(271)	(116)	-	(387)
Operating income from discontinued operations	208	-	-	-	208
*NOI	2,846	47,771	3,218	(949)	52,886
Total assets	\$ 63,385	\$ 569,870	\$ 7,352	\$ 17,715	\$ 658,322

*Intersegment revenue and expenses have been eliminated in the computation of NOI for each of the segments.

For the three months ended September 30, 2005

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

				Management	
	Acquisition/		Affordable	and Service	Total
(In thousands)	Disposition	Market-Rate	Housing	Operations	Consolidated
Total segment revenue	\$ -	\$ 30,542	\$ 2,309	\$ 5,716	\$ 38,567
Elimination of intersegment revenue	-	(27)	(11)	(2,226)	(2,264)
Consolidated revenue	-	30,515	2,298	3,490	36,303
Equity in net loss of joint ventures	-	(30)	(38)	-	(68)
Operating income from discontinued operations	799	-	-	-	799
*NOI	-	15,925	1,224	(160)	16,989
Total assets	\$ 86,415	\$ 587,312	\$ 7,767	\$ 27,318	\$ 708,812

*Intersegment revenue and expenses have been eliminated in the computation of NOI for each of the segments.

For the nine months ended September 30, 2005					
				Management	
	Acquisition/		Affordable	and Service	Total
(In thousands)	Disposition	Market-Rate	Housing	Operations	Consolidated
Total segment revenue	\$ 2,398	\$ 86,814	\$ 6,900	\$ 15,863	\$ 111,975
Elimination of intersegment revenue	-	(77)	(18)	(6,683)	(6,778)
Consolidated revenue	2,398	86,737	6,882	9,180	105,197
Equity in net loss of joint ventures	-	(469)	(98)	-	(567)
Operating income from discontinued operations	2,544	-	-	-	2,544
*NOI	1,467	45,596	3,455	(792)	49,726
Total assets	\$ 86,415	\$ 587,312	\$ 7,767	\$ 27,318	\$ 708,812

*Intersegment revenue and expenses have been eliminated in the computation of NOI for each of the segments.

A reconciliation of total NOI to total consolidated net (loss) income for the three and nine months ended September 30, 2006 and 2005 is as follows:

	For the three months		For the nine months	
	ended September 30,		ended September 30,	
(In thousands)	2006	2005	2006	2005
Total NOI for reportable segments	\$ 18,233	\$ 16,989	\$ 52,886	\$ 49,726
Depreciation and amortization	(8,233)	(8,208)	(24,821)	(24,274)
General and administrative expense	(2,679)	(1,994)	(7,672)	(6,135)
Interest income	96	56	586	239
Interest expense	(17,383)	(10,754)	(45,205)	(31,217)
Equity in net loss of joint ventures	(139)	(68)	(387)	(567)
Minority interest in operating partnership	(15)	(16)	(47)	(48)
Income from discontinued operations:				
Operating income	52	799	208	2,544

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

Gain on disposition of properties	<u>3,397</u>	<u>17,406</u>	<u>38,120</u>	<u>21,437</u>
Income from discontinued operations	<u>3,449</u>	<u>18,205</u>	<u>38,328</u>	<u>23,981</u>
Consolidated net (loss) income	\$ (6,671)	\$ 14,210	\$ 13,668	\$ 11,705

10. CONTINGENCIES

Legal Proceedings

We are subject to legal proceedings, lawsuits and other claims, including proceedings by government authorities (collectively "Litigation"). Litigation is subject to uncertainties and outcomes are difficult to predict. Consequently, we are unable to estimate ultimate aggregate monetary liability or financial impact with respect to the Litigation matters described in the following paragraphs as of September 30, 2006, and no accruals have been made for these matters other than those identified in the following paragraphs. We believe that other Litigation will not have a material adverse impact on us after final disposition. However, because of the uncertainties of litigation, one or more lawsuits could ultimately result in a material obligation.

Pending Lawsuits

On or about April 14, 2002, Melanie and Kyle Kopp commenced an action against us in the Franklin County, Ohio Court of Common Pleas seeking undetermined damages, injunctive relief and class action certification. This case arose out of our Suredeposit program. This program allows cash short prospective residents to purchase a bond in lieu of paying a security deposit. The bond serves as a fund to pay those resident obligations that would otherwise have been funded by the security deposit. Plaintiffs allege that the non-refundable premium paid for the bond is a disguised form of security deposit, which is otherwise required to be refundable in accordance with Ohio's Landlord-Tenant Act. Plaintiffs further allege that certain pet deposits and other nonrefundable deposits required by us are similarly security deposits that must be refundable in accordance with Ohio's Landlord-Tenant Act. On or about January 15, 2004, the plaintiffs filed a motion for class certification. We subsequently filed a motion for summary judgment. Both motions are pending before the Court. We intend to vigorously defend ourselves against these claims.

Government Investigations

On or about August 7, 2002, the Maryland Attorney General served us with a subpoena seeking information concerning certain of our leasing practices in connection with our Maryland properties. The subpoena sought extensive information going back a number of years, including information about our Suredeposit programs and certain non-refundable deposits. We understand that other landlords operating in Maryland have been served with similar subpoenas. The Maryland Attorney General has now completed its review of the information we furnished and based upon that information contends that certain of our leasing practices are in violation of Maryland's landlord tenant laws. Any issues with the Attorney General regarding the SureDeposit program have already been resolved without any material impact on our financial results. We

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

are attempting to reach an out of court settlement with the Maryland Attorney General for the purpose of resolving this matter and we have recorded an estimated loss contingency for that purpose, which is included in "Accounts payable, accrued expenses and other liabilities" in the Consolidated Balance Sheets and "General and administrative expense" in the Consolidated Statements of Operations. We are subject to additional exposure if we are unable to resolve this matter for the amount we recorded as a loss contingency. We are unable at this time to reasonably estimate the amount of additional loss.

On or about December 22, 2003, the Montgomery County, Maryland Office of Landlord Tenant Affairs commenced an investigation into possible violations of state and county Landlord-Tenant laws involving two properties operated by us located in Montgomery County, Maryland. The matters being investigated are for the most part the same leasing practices being investigated by the Maryland Attorney General. We are attempting to resolve those matters with Montgomery County simultaneously with settling matters with the Maryland Attorney General. Montgomery County recently commenced additional investigations concerning other leasing practices in Montgomery County and we have recorded an estimated loss contingency for that purpose which is included in "Accounts payable, accrued expenses and other liabilities" in the Consolidated Balance Sheets and "General and administrative expense" in the Consolidated Statements of Operations. We are subject to additional exposure if we are unable to resolve this matter for the amount we recorded as a loss contingency. We are unable at this time to reasonably estimate the amount of additional loss.

11. GUARANTEES

We are a 49.0% partner in the joint venture partnership that owns Idlewylde Apartments, an 843-unit multifamily community, located in Atlanta, Georgia. In connection with the \$42.0 million mortgage loan encumbering this property, we have guaranteed certain obligations of the partnership including environmental indemnification obligations and typical non-recourse carveouts. Although we have not recorded a liability for a potential loss, we are required by GAAP to estimate the fair value of this guaranty. We have estimated the fair value of the guaranty to be \$290,000, and this amount is included as an asset in "Investments in joint ventures, net" and as a liability in "Accounts payable, accrued expenses and other liabilities" in the accompanying Consolidated Balance Sheet. In addition, we routinely guaranty mortgage debt of our wholly owned subsidiaries.

12. SUBSEQUENT EVENTS

Mortgage Notes Payable

During October 2006, we prepaid debt totaling \$1.2 million with funds that had been placed in escrow in connection with the August 28, 2006 sale of a Market-Rate congregate care property.

Share Repurchase Program

On October 20, 2006, our Board of Directors expanded their July 27, 2005 authorization to repurchase up to \$50.0 million of our common shares to include the repurchase of our Class B Series II Preferred Shares. As of September 30, 2006, there was \$22.4 million still available for purchase under this authorization.

Index

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

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included in Part I, Item 1 of this report on Form 10-Q. This discussion may contain forward-looking statements based on current judgments and current knowledge of management, which are subject to certain risks, trends and uncertainties that could cause actual results to vary from those projected, including but not limited to, expectations regarding our 2006 performance, which are based on certain assumptions. Accordingly, readers are cautioned not to place undue reliance on forward-looking statements which speak only as of the dates of the document. These forward-looking statements are intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The words "expects", "projects", "believes", "plans", "anticipates", and similar expressions are intended to identify forward-looking statements. Investors are cautioned that these forward-looking statements involve risks and uncertainty, that could cause actual results to differ from estimates or projections contained in these forward-looking statements, including without limitation the following:

- changes in the economic climate in the markets in which we own and manage properties, including interest rates, our ability to consummate the sale of properties pursuant to our current plan, the overall level of economic activity, the availability of consumer credit and mortgage financing, unemployment rates and other factors;
- risks of a lessening of demand for the multifamily units that we own or manage;
- competition from other available multifamily units and change in market rental rates;
- increases in property and liability insurance costs;
- changes in real estate taxes and other operating expenses (e.g., cleaning, utilities, repairs and maintenance costs, insurance and administrative costs, security, landscaping, staffing and other general costs);
- weather and other conditions that might adversely affect operating expenses;
- expenditures that cannot be anticipated such as utility rate and usage increases, unanticipated repairs, and real estate tax valuation reassessments or millage rate increases;
- inability to control operating expenses or achieve increases in revenue;
- the results of litigation filed or to be filed against us;
- changes in tax legislation;

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

- risks of personal injury claims and property damage related to mold claims because of diminished insurance coverage;
- catastrophic property damage losses that are not covered by our insurance;
- risks associated with property acquisitions such as environmental liabilities, among others;
- changes in government regulations affecting our properties, the rent of which are subsidized and certain aspects of which are regulated by the United States Department of Housing and Urban Development ("HUD") and other properties that we manage;
- inability to renew current contracts with HUD for rent subsidized properties at existing rents;
- changes in or termination of contracts relating to third party management and advisory business;
- risks related to our joint ventures; and
- risks related to the perception of residents and prospective residents as to the attractiveness, convenience and safety of our properties or the neighborhoods in which they are located.

Overview. We are engaged primarily in the ownership and operation of multifamily residential units. We also provide asset and property management services to third party owners of multifamily residential units for which we are paid fees. Our primary source of cash and revenue from operations is rents from the leasing of owned apartment units. Approximately 91.2% of our consolidated revenue was generated from the leasing of these owned units for the nine months ended September 30, 2006, and approximately 88.4% of the rental revenue generated by these owned properties during the nine months ended September 30, 2006 was related to the Market-Rate properties. The operating performance of the properties, particularly the Market-Rate properties, is affected by factors such as interest rates, unemployment rates, and the supply and demand of rental housing in particular markets. Rental revenue collections are a combination of rental rates and occupancy levels which have increased in 2006, and rent concessions which have decreased in 2006. We attempt to adjust these factors from time to time, based on market conditions, in order to maximize rental revenue. Indicators that we use in measuring these factors include physical occupancy and net collected rent. These indicators are more fully described in the Results of Operations comparison. Additionally, we consider property net operating income to be an important indicator of our overall performance. Property net operating income (property operating revenue less property operating and maintenance expenses) is a measure of the profitability of our properties, which has the largest impact of all of our sources of income and expense on our financial condition and operating results. See Note 9 of the Notes to Consolidated Financial Statements presented in Part I, Item 1 of this report on Form 10-Q for additional information regarding property net operating income and total net operating income, in addition to a reconciliation of total net operating income to consolidated net (loss) income in accordance with GAAP.

2006 Expectations.

- **Portfolio performance** - We expect to increase our Market-Rate property NOI by approximately 4.75% to 5.25% in 2006. For the nine months ended September 30, 2006, our Market-Rate property NOI increased 4.8% while our Market-Rate operating margins declined 0.5%. For the year, we expect operating margins to remain relatively flat compared to 2005.

- **Interest expense and general and administrative expense** - We expect total interest expense before defeasance costs and other prepayment costs to decrease approximately \$2.8 million by utilizing sale proceeds to pay down debt or by refinancing at lower interest rates. Total defeasance costs and other prepayment costs for 2006 are expected to be approximately \$19.3 million. During the nine months ended September 30, 2006, we defeased or prepaid sixteen loans aggregating \$193.5 million and recognized related costs of approximately \$14.6 million. Additionally, general and administrative expenses are expected to increase approximately 20.0% primarily as a result of NOI based performance bonuses, severance, legal accruals and the impact on deferred directors shares resulting from our share price appreciation. As a result of these costs, for the nine months ended September 30, 2006, general and administrative expenses were approximately 25.0% higher than the general and administrative expenses for the nine months ended September 30, 2005.
- **Property sales** - We plan to sell between \$75 and \$100 million of properties in 2006. For the nine months ended September 30, 2006, we sold \$47.2 million of properties.
- **Share buyback** - During the nine months ended September 30, 2006, we repurchased 985,225 of our common shares for an approximate total cost of \$10.2 million. Under our Board of Directors' 2005 Authorization to repurchase up to \$50.0 million of our common shares, we had \$22.4 million still available to purchase as of September 30, 2006. Additionally, on October 20, 2006, our Board of Directors authorized expanding the share buyback to include repurchasing our preferred shares as well as our common shares.

LIQUIDITY AND CAPITAL RESOURCES

Cash Flows and Liquidity. Significant sources and uses of cash in the nine months ended September 30, 2006 and 2005, are summarized as follows:

Cash Sources (Uses):

(In thousands)	For the nine months	
	ended September 30,	
	<u>2006</u>	<u>2005</u>
Net cash provided by operating activities	\$ 7,339	\$ 19,421
Property acquisition and/or development expenditures	(256)	(41,670)
Property disposition proceeds, net	43,544	11,087
Recurring and non-recurring capital expenditures	(10,015)	(6,144)
(Decrease) increase in mortgage notes	(65,480)	19,195
Increase in unsecured debt	-	25,780
Increase (decrease) in lines of credit borrowing	11,470	(5,500)
Cash dividends and operating partnership distributions paid	(12,686)	(14,282)
Purchase of treasury shares	(10,185)	(8,911)

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

Our primary sources of liquidity are cash flow provided by operations, short term borrowings on our lines of credit and proceeds from property sales. Cash provided by operations in 2006 decreased compared to 2005 primarily due to the payment of \$14.3 million of defeasance costs, which were funded by secured borrowings and property sales. Excluding these costs, cash flow from operations would have increased slightly in 2006 primarily due to changes in accounts payable and accounts receivable resulting from the timing of cash payments.

We obtained cash from the following additional sources during 2006:

- \$43.5 million in proceeds from the disposition of four operating properties, net;
- \$11.5 million in line of credit borrowings; and
- \$745,000 in proceeds related to stock option exercises.

We utilized cash for the following additional purposes during 2006:

- \$10.3 million in capital additions;
- \$65.5 million reduction in mortgage notes primarily due to the defeasance or prepayment of 16 mortgage loans;
- \$12.7 million in dividends and distributions paid; and
- \$10.2 million to repurchase our common shares.

At September 30, 2006, there were total borrowings of \$11.5 million and letters of credit of \$2.7 million outstanding on our two secured lines of credit leaving \$16.8 million available for additional borrowings. On October 6, 2006, letters of credit totaling \$2.6 million were canceled, leaving one letter of credit in the amount of \$63,000 outstanding.

In February 2006, we completed an agreement that increased our \$15.0 million line of credit to a \$17.0 million line and identified a replacement property to serve as security for this line. In October 2005, the property that previously secured this line was sold. As a result of that sale, the line was not available to us until the replacement security was identified in February 2006.

During the nine months ended September 30, 2006, we defeased (prepaid) 13 fixed rate mortgage loans totaling \$138.9 million and prepaid three variable rate conventional mortgages totaling \$54.6 million. We recorded \$14.6 million in defeasance and other prepayment costs related to these transactions, which are included in "Interest expense" in the Consolidated Statements of Operations.

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

During October 2006, we prepaid debt totaling \$1.2 million employing funds that had been placed in escrow in connection with the August 28, 2006 sale of a Market-Rate congregate care property.

We anticipate funding approximately \$3.2 million for recurring, investment/revenue enhancing and non-recurring capital expenditures for the remainder of 2006. These expenditures are expected to be funded from cash flow provided by operating activities and the sale of properties.

Any future multifamily property acquisitions or developments would be financed with the most appropriate sources of capital, which may include the assumption of mortgage indebtedness, bank and other institutional borrowings, the exchange of properties, undistributed earnings, secured or unsecured debt financings, or the issuance of shares or units exchangeable into common shares.

We anticipate that we will meet our liquidity requirements for the remainder of 2006 generally through net cash provided by operations and property sales' proceeds. We believe that these and other sources, such as secured borrowings (primarily the lines of credit) should be sufficient to meet operating requirements, capital additions, mortgage amortization payments and the payment of dividends in accordance with REIT requirements. We anticipate that we will continue paying quarterly dividends and that we will sustain our current dividend rate.

Guarantees. We routinely guaranty mortgage debt of our wholly owned subsidiaries. Additionally, we had one guaranty at September 30, 2006, related to a mortgage loan secured by one of our joint venture properties. See Note 11 of the Notes to Consolidated Financial Statements presented in Part I, Item 1 of this report on Form 10-Q for information related to this guaranty.

Off-Balance Sheet Investments and Financing Commitments. At September 30, 2006, we had investments in two joint ventures that each own a multifamily apartment community. The operations of these properties are similar to the operations of our wholly owned portfolio. These investments enable us to exercise influence over the operations of the properties and share in their profits, while earning additional fee income. We account for our investments in unconsolidated joint ventures under the equity method of accounting as we exercise significant influence, but do not control these entities. These investments are initially recorded at cost as investments in joint ventures and subsequently adjusted for equity in earnings and cash contributions and distributions.

We have one guaranty obligation related to our joint ventures, which was previously discussed under Guarantees. Both of the joint venture properties were encumbered by debt at September 30, 2006.

Dispositions. On September 28, 2006, we completed the sale of an Affordable Housing property located in Northeast Ohio. The sale price was a net \$2.9 million and we recorded a gain of \$2.5 million. The proceeds of this sale were used for general corporate purposes. Subsequent to the

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

sale, we entered into a contract to provide property management services for this property.

On August 28, 2006, we completed the sale of a Market-Rate congregate care property located in Northeast Ohio. The sale price was \$2.0 million and we recorded a gain of \$865,000. The proceeds of this sale were used for general corporate purposes and to repay the debt on the property.

On May 15, 2006, we completed the sale of a Market-Rate property located in Northeast Ohio. The sale price was a net \$28.4 million and we recorded a gain of \$23.4 million. The proceeds of this sale were used primarily to fund the defeasance of fixed rate mortgage loans.

On May 10, 2006, we completed the sale of a Market-Rate property located in Northeast Ohio. The sale price was a net \$13.9 million and we recorded a gain of \$11.3 million. The proceeds of this sale were used primarily to fund the defeasance of fixed rate mortgage loans.

We classified one property as held for sale at September 30, 2006. We tested this property in accordance with SFAS 144 and determined that it was not impaired. The results of operations for this property are included in "Income from discontinued operations" in the Consolidated Statements of Operations for all periods presented.

Management and Service Operations. During the nine months ended September 30, 2006, management contracts on two third-party owned properties were canceled. Also, three properties owned by third parties were sold and, as a result of the sales, the management contracts were canceled. Total annualized revenue related to these management contracts was approximately \$726,000. We recorded a disposition fee of \$198,000 during the third quarter of 2006 as a result of the sale of one of the properties. Additionally, subsequent to the sale of an Affordable Housing property in September 2006, we entered into a management contract with the buyer of the property to provide property management services. We anticipate a total of \$30,000 in annual fee revenue related to this property.

RESULTS OF OPERATIONS

Comparison of the three and nine months ended September 30, 2006 to the three and nine months ended September 30, 2005

In the following discussion, Market-Rate properties represents wholly owned Same Community Market-Rate properties that we have owned during the entirety of the comparison periods. For the three and nine month comparison periods, there were 55 and 54 Market-Rate properties, respectively. Affordable Housing properties represents 11 properties subject to HUD regulations. Acquired/Disposed properties represents recently acquired properties, properties classified as held for sale, and all sold properties. For the three and nine month comparison periods, there

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

were one and two acquired properties, respectively, and one held for sale property.

Overall, the net loss from continuing operations for 2006 increased in both comparison periods primarily due to increases in interest expense (primarily due to defeasance costs) and property operating and maintenance expenses during 2006. These increases were partially offset by an increase in property revenue during 2006.

The following chart reflects the amount and percentage change in line items that are relevant to the changes in overall operating performance when comparing the three and nine months ended September 30, 2006 to the three and nine months ended September 30, 2005:

	Increase (decrease) in		Increase (decrease) in	
	three month comparison		nine month comparison	
	period ended		period ended	
	September 30, 2006		September 30, 2006	
	to September 30, 2005		to September 30, 2005	
(Amounts in thousands)				
Property revenue	\$ 2,424	7.4%	\$ 7,637	8.0%
Property operating and maintenance expenses:				
Real estate taxes and insurance	518	11.5%	1,348	10.1%
Repairs and maintenance	187	5.9%	1,213	14.1%
Personnel	167	4.1%	810	6.7%
Utilities	127	6.0%	577	8.9%
Property operating and maintenance expenses	1,010	6.5%	4,320	9.5%
General and administrative expense	685	34.4%	1,537	25.0%
Interest expense ⁽¹⁾	6,629	61.6%	13,988	44.8%
Income from discontinued operations	(14,756)	(81.1)%	14,347	59.8%

⁽¹⁾ Changes in interest expense were impacted by \$7.5 million and \$14.6 million of defeasance and other prepayment costs for the three and nine months ended September 30, 2006, respectively.

Index

Property Revenue. Property revenue is impacted by a combination of rental rates, rent concessions and occupancy levels. We measure these factors using indicators such as physical occupancy (number of units occupied divided by total number of units at the end of the period) and

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

average monthly net collected rent per unit (gross potential rents less vacancies and concessions divided by total number of units). This information is presented in the following table for the three and nine months ended September 30, 2006 and 2005 (information for the three and nine months ended September 30, 2005 reflect results based upon the operating properties and their respective segments as of September 30, 2006):

	For the three months ended			
	September 30, 2006		September 30, 2005	
		Average Monthly		Average Monthly
	Physical	Net Collected	Physical	Net Collected
	<u>Occupancy</u>	<u>Rent Per Unit</u>	<u>Occupancy</u>	<u>Rent Per Unit</u>
Acquisition Properties	97.6%	\$ 1,054	N/A	N/A
Market-Rate	95.3%	\$ 761	94.1%	\$ 717
Affordable Housing	99.5%	\$ 649	99.5%	\$ 642

	For the nine months ended			
	September 30, 2006		September 30, 2005	
		Average Monthly		Average Monthly
	Physical	Net Collected	Physical	Net Collected
	<u>Occupancy</u>	<u>Rent Per Unit</u>	<u>Occupancy</u>	<u>Rent Per Unit</u>
Acquisition Properties	92.8%	\$ 1,124	98.1%	\$ 1,101
Market-Rate	95.4%	\$ 735	94.0%	\$ 696
Affordable Housing	99.5%	\$ 646	99.5%	\$ 640

Property revenue increased in 2006 during both comparison periods primarily as a result of increased occupancy and a combination of rental rate increases and an overall reduction in concessions being offered in the Market-Rate segment and increases of \$532,000 and \$2.6 million for the three and nine month comparison periods, respectively, related to the properties acquired in 2005. Additionally, we initiated several new cost reimbursement programs in 2004 and 2005 which were phased-in throughout 2005. The programs were fully implemented by late 2005. The results from these reimbursement programs also contributed to the increase in property revenue.

Property Operating and Maintenance Expenses. Property operating and maintenance expenses increased primarily as a result of increases in real estate tax expense, repair and maintenance expense, personnel expense, and utilities expense in both comparison periods. Real estate taxes increased in both comparison periods primarily due to estimated increases in assessed property values and millage rates in 2006 and a decrease in refunds received related to prior year taxes of approximately \$278,000 in 2006 compared to 2005. Insurance increased primarily as a result of property coverage principally in the Southeast. Repairs and maintenance expenses increased in both comparison periods primarily due to increases in maintenance project costs, unit preparation costs, landscaping costs, and trash removal costs. The increase in personnel expense was primarily due to salary increases and benefit costs in both comparison periods. Utilities increased during both comparison periods primarily due to increases in the cost per unit of natural gas in the first half of 2006 compared to the same period in 2005 which was partially offset by reduced consumption.

General and Administrative Expense. General and administrative expense increased primarily due to salary increases and benefit costs during both comparison periods, an increase of \$242,000 and \$653,000 for the three month and nine month periods, respectively, in directors' compensation and an increase of \$179,000 and \$481,000 for the three and nine month periods, respectively, in share-based compensation. The increase in directors' compensation was primarily the result of increases in the deferred portion of the directors' compensation, which is held as share units and valued using the closing price of our common shares at the end of each period. Additionally, during the second and third quarters

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

of 2006, we recorded a loss contingency that is discussed in Note 10 of the Notes to Consolidated Financial Statements

Index

presented in Part 1, Item 1 of this report on Form 10-Q. For additional information on share-based compensation, see Note 1 of the Notes to Consolidated Financial Statements presented in Part I, Item 1 of this report on Form 10-Q.

Interest Expense. Interest expense increased in 2006 during the three month comparison period primarily due to \$7.2 million in costs recorded related to the defeasance of five mortgage loans and \$300,000 in costs recorded related to the prepayment of three mortgage loans. Interest expense increased in 2006 during the nine month comparison period primarily due to \$14.6 million in costs recorded related to the defeasance and prepayment of sixteen mortgage loans. The increases in both comparison periods were partially offset by reduced interest expense resulting from lower weighted average interest rates and a reduction in total debt outstanding in 2006 compared to 2005.

Income from Discontinued Operations. Discontinued operations includes the operating results of the property that has been classified as held for sale and the properties that were sold during 2006 and 2005. For further details on "Income from discontinued operations," see Note 3 of the Notes to Consolidated Financial Statements presented in Part I, Item 1 of this report on Form 10-Q.

CONTINGENCIES

For a discussion of contingencies, see Note 10 of the Notes to Consolidated Financial Statements presented in Part I, Item 1 of this report on Form 10-Q.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

During the nine months ended September 30, 2006, we entered into forward contracts to manage our exposure to fluctuations in natural gas prices. We do not expect to use these contracts for trading or other speculative purposes. These contracts have been designated as cash flow hedges and the changes in the fair values are not material to our financial condition or results of operations. Additionally, we are exposed to interest rate changes associated with variable rate debt as well as refinancing risk on our fixed-

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

rate debt. We occasionally use derivative instruments to manage our exposure to interest rates. See our Form 10-K "Item 7A Qualitative and Quantitative Disclosures About Market Risk" for a more complete discussion of interest rate sensitive assets and liabilities.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures. We have evaluated the design and operation of our disclosure controls and procedures to determine whether they are effective in ensuring that the disclosure of required information is timely made in accordance with the Securities Exchange Act of 1934 ("Exchange Act") and the rules and forms of the Securities and Exchange Commission. This evaluation was made under the supervision and with the participation of management, including our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), as of the end of the period covered by this report on Form 10-Q. The CEO and CFO have concluded, based on their review, that our disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e), are effective to ensure that information required to be disclosed in reports that we file under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Changes in Internal Control over Financial Reporting. There were no changes in our internal control over financial reporting during the third quarter of 2006 that materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

We believe that because of its inherent limitations, internal control over financial reporting may not always prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Index

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

For information related to legal proceedings, see Note 10 of the Notes to Consolidated Financial Statements presented in Part I, Item 1 of this Report on Form 10-Q.

ITEM 1A. RISK FACTORS

See "Risk Factors" in Part I, Item 1A of our report on Form 10-K for the year ended December 31, 2005.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

<u>Issuer Purchases of Equity Securities for the three months ended September 30, 2006</u>				
<u>Period</u>	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid Per Share</u>	<u>Total Number of Shares Purchased As Part of Publicly Announced Plans or Programs</u>	<u>Approximate</u>
				<u>Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs (in thousands)</u>
July 1 through				
July 31	13	\$ 13.39	-	\$ 22,433
August 1 through				
August 31	176	\$ 13.62	-	\$ 22,433
September 1 through				
September 30	20	\$ 15.12	-	\$ 22,433
Total	209	\$ 13.75	-	

On July 27, 2005, our Board of Directors authorized the repurchase of up to \$50.0 million of our common shares. On October 20, 2006, our Board of Directors expanded this authorization to include the repurchase of our Class B Series II Preferred Shares. Additionally, we have a policy which allows employees to pay their portion of the payroll taxes related to restricted share vesting by surrendering shares equal in value on the day of vesting to the amount of taxes due.

Index

ITEM 6. EXHIBITS

<u>Number</u>	<u>Title</u>	<u>Filed herewith or incorporated herein by reference</u>
3.1	Amendment to Second Amended and Restated Articles of Incorporation	Exhibit 3.1 to Form 8-K filed December 8, 2004.
3.2	Second Amended and Restated Articles of Incorporation, as amended by the Company.	Exhibit 3.2 to Form 8-K filed December 8, 2004.
3.3	Amended and Restated Code of Regulations of the Company.	Exhibit 3.3 to Form 10-Q filed August 1, 2006.
4.1	Specimen Common Share Certificate.	Exhibit 3.1 to Form S-11 filed September 2, 1993 (File No. 33-68276 as amended).
4.2	Specimen 8.70% Class B Series II Cumulative Redeemable Preferred Shares	Exhibit 4.3 to Form 8-A filed December 8, 2004.
4.3	Deposit Agreement by and among Associated Estates Realty Corporation and National City Bank and Depository Receipts	Exhibit 4.5 to Form 8-A filed December 8, 2004
4.4	Form of Indemnification Agreement.	Exhibit 4.2 to Form S-11 filed September 2, 1993 (File No. 33-68276 as amended).
4.5	Form of Promissory Note and Form of Mortgage and Security Agreement dated May 10, 1999 from AERC to The Chase Manhattan Bank.	Exhibit 4.5 to Form 10-Q filed August 13, 1999.
4.5a	Form of Promissory Note and Form of Mortgage and Security Agreement dated September 10, 1999 from AERC to The Chase Manhattan Bank.	Exhibit 4.5a to Form 10-Q filed November 12, 1999.
4.5b	Form of Promissory Note and Form of Mortgage and Security Agreement dated November 18, 1999 from AERC to The Chase Manhattan Bank.	Exhibit 4.5b to Form 10-K filed March 15, 2000.
4.9	Second Amended and Restated Loan Agreement dated April 19, 2002 between Associated Estates Realty Corporation and National City Bank.	Exhibit 4.13a to Form 10-Q filed August 13, 2002.
4.9a	Third Amended and Restated Loan Agreement dated November 1, 2005 between Associated Estates Realty Corporation and National City Bank.	Exhibit 4.9a to Form 10-K filed March 1, 2006.
4.9a(i)	Amendment No. 1 to Third Amended and Restated Loan Agreement dated May 15, 2006 between Associated Estates Realty Corporation and National City Bank	Exhibit 4.9a(i) to Form 10-Q filed August 1, 2006.
4.9b	First Amendment to Second Amended and Restated Loan Agreement dated May 14, 2002 between Associated Estates Realty Corporation and National City Bank.	Exhibit 4.13b to Form 10-Q filed August 13, 2002.
4.9c	Second Amendment to Second Amended and Restated Loan Agreement dated April 17, 2003 between Associated Estates Realty Corporation and National City Bank.	Exhibit 4.13c to Form 10-Q filed August 1, 2003.
4.9d	Third Amendment to Second Amended and Restated Loan Agreement dated July 15, 2003 between Associated Estates Realty Corporation and National City Bank.	Exhibit 4.13d to Form 10-Q filed November 20, 2003.
4.9e	Fourth Amendment to Second Amended and Restated Loan Agreement dated September 7, 2004 between Associated Estates Realty Corporation and National City Bank.	Exhibit 4.13e to Form 10-Q filed November 2, 2004.
4.11	Loan Agreement dated July 22, 2003 between The Huntington National Bank and MIG/Orlando Development, Ltd.	Exhibit 4.15 to Form 10-Q filed November 20, 2003.
4.12	Amended and Restated Loan Agreement dated February 20, 2006 between The Huntington National Bank and MIG/Orlando Development, Ltd.	Exhibit 4.12 to Form 10-Q filed May 2, 2006.
	Certain of the Registrant's assets are subject to mortgage obligations each of which individually relates to indebtedness totaling less than 10.0% of the total assets of the Registrant. The Registrant hereby agrees to furnish a copy of such	

Edgar Filing: ASSOCIATED ESTATES REALTY CORP - Form 10-Q

agreements to the Commission upon its request.

The Registrant issued unsecured debt in the form of Trust Preferred Securities on March 15, 2005 in a private placement in an amount less than 10.0% of the total assets of the Registrant. The Registrant hereby agrees to furnish a copy of the Purchase Agreement dated March 15, 2005 between Associated Estates Realty Corporation, AERC Delaware Trust and Taberna Preferred Funding 1, Ltd. and a specimen Preferred Securities Certificate to the Commission upon its request.

10 Associated Estates Realty Corporation Directors' Deferred Compensation Plan.	Exhibit 10 to Form 10-Q filed November 14, 1996.
10.1 Stock Option Plan.	Exhibit 10.2 to Form S-11 filed September 2, 1993 (File No. 33-68276 as amended).
10.2 Amended and Restated Employment Agreement between the Company and Jeffrey I. Friedman.	Exhibit 10.1 to Form 10-Q filed May 13, 1996.
10.3 Equity-Based Incentive Compensation Plan.	Exhibit 10.4 to Form 10-K filed March 29, 1995.
10.4 Form of Restricted Agreement dated by and among the Company and Its Independent Directors.	Exhibit 10.9 to Form 10-K filed March 28, 1996.
10.8 Form of Share Option Agreement by and among the Company and Its Independent Directors.	Exhibit 10.14 to Form 10-K filed March 30, 1993.
10.9 Partnership Interests Purchase Agreement dated July 17, 2004 by and among Jeffrey I. Friedman and JIFCO, an Ohio Corporation and Winchester, Inc., an Ohio Corporation	Exhibit 10.21 to Form 10-K filed February 25, 2005.
10.10 Associated Estates Realty Corporation Amended and Restated 2001 Equity-Based Plan (as amended on May 4, 2005). Incorporated by reference to Appendix 1 to the Definitive Proxy Statement filed March 28, 2005.	Exhibit 99.01 to Form S-8 filed May 26, 2005.
10.11 Form of Equity Award Agreement	Exhibit 10.11 to Form 10-Q filed August 2, 2005.
10.12 Long Term Incentive Compensation Plan	Exhibit 10.12 to Form 10-Q filed November 1, 2005.
31 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes Oxley Act.	Exhibit 31 to Form 10-Q filed herewith.
31.1 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes Oxley Act.	Exhibit 31.1 to Form 10-Q filed herewith.
32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes Oxley Act.	Exhibit 32 to Form 10-Q filed herewith.

Index

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ASSOCIATED ESTATES REALTY CORPORATION

October 31, 2006

(Date)

/s/ Lou Fatica

Lou Fatica, Vice President,

Chief Financial Officer and Treasurer