

ASSOCIATED ESTATES REALTY CORP  
Form 10-Q  
November 03, 2009

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, 2009

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 44143-1467**

*(Address of principal executive offices)*

**(216) 261-5000**

*(Registrant's telephone number, including area code)*

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (subsection 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

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

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

The number of shares outstanding as of October 26, 2009 was 16,704,871 shares.

ASSOCIATED ESTATES REALTY CORPORATION

Index

|   | <b>Page</b> |
|---|-------------|
| <b>PART I FINANCIAL INFORMATION</b>   |             |
| ITEM 1 Consolidated Financial Statements (Unaudited)  | -           |
| <u>Consolidated Balance Sheets</u> at September 30, 2009 and December 31, 2008                                      | 3           |
| <u>Consolidated Statements of Operations</u> for the three and nine month periods ended September 30, 2009 and 2008 | 4           |
| <u>Consolidated Statements of Cash Flows</u> for the nine month periods ended September 30, 2009 and 2008           | 5           |
| <u>Notes to Consolidated Financial Statements</u>   | 6           |
| ITEM 2 <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                 | 17          |
| ITEM 3 <u>Quantitative and Qualitative Disclosures</u> About Market Risk  | 23          |
| ITEM 4 <u>Controls and Procedures</u>   | 23          |
| <b>PART II OTHER INFORMATION</b>  |             |
| ITEM 1 <u>Legal Proceedings</u>   | 24          |
| ITEM 1A <u>Risk Factors</u>   | 24          |
| ITEM 2 <u>Unregistered Sales of Equity Securities</u> and Use of Proceeds   | 24          |
| ITEM 6 <u>Exhibits</u>  | 25          |
| <b>SIGNATURES</b>   | 27          |

**PART 1. FINANCIAL INFORMATION**  
**ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS**

**ASSOCIATED ESTATES REALTY CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**  
**(UNAUDITED)**

(In thousands, except share amounts)

| <b>ASSETS</b>  | September 30,<br>2009 | December 31,<br>2008 |
|--|-----------------------|----------------------|
| Real estate assets   |                       |                      |
| Land   | \$ 107,815            | \$ 110,220           |
| Buildings and improvements   | 795,178               | 812,443              |
| Furniture and fixtures   | 29,279                | 29,315               |
|  | 932,272               | 951,978              |
| Less: accumulated depreciation   | (294,293)             | (280,541)            |
|  | 637,979               | 671,437              |
| Construction in progress   | 3,158                 | 745                  |
| Real estate associated with property held for sale, net  | -                     | 1,666                |
| Real estate, net   | 641,137               | 673,848              |
| Cash and cash equivalents  | 4,061                 | 3,551                |
| Restricted cash  | 7,530                 | 6,873                |
| Accounts and notes receivable, net   |                       |                      |
| Rents  | 1,138                 | 1,320                |
| Affiliates   | 308                   | 606                  |
| Other  | 1,631                 | 1,842                |
| Goodwill   | 1,725                 | 1,725                |
| Other assets, net  | 10,325                | 10,131               |
| <b>Total assets</b>  | <b>\$ 667,855</b>     | <b>\$ 699,896</b>    |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                       |                      |
| Mortgage notes payable   | \$ 488,369            | \$ 510,201           |
| Unsecured revolving credit facility  | 12,000                | 21,500               |
| Unsecured debt   | 25,780                | 25,780               |
| Total debt   | 526,149               | 557,481              |
| Accounts payable, accrued expenses and other liabilities   | 26,858                | 26,217               |
| Dividends payable  | 2,995                 | 2,920                |
| Resident security deposits   | 3,010                 | 3,360                |
| Accrued interest   | 2,248                 | 2,468                |
| <b>Total liabilities</b>   | <b>561,260</b>        | <b>592,446</b>       |
| Noncontrolling redeemable interest   | 1,829                 | 1,829                |
| Shareholders' equity   |                       |                      |
| Preferred shares, without par value; 9,000,000 shares authorized;<br>8.70% Class B Series II cumulative redeemable, \$250 per share<br>liquidation preference, 232,000 issued and 193,050 outstanding<br>at September 30, 2009 and December 31, 2008, respectively | 48,263                | 48,263               |
| Common shares, without par value, \$.10 stated value; 41,000,000<br>authorized; 22,995,763 issued and 16,704,871 and 16,556,221<br>outstanding at September 30, 2009 and December 31, 2008, respectively   | 2,300                 | 2,300                |
| Paid-in capital  | 282,897               | 282,501              |
| Accumulated distributions in excess of accumulated net income  | (162,405)             | (159,595)            |
| Accumulated other comprehensive loss   | (1,965)               | (2,899)              |
| Less: Treasury shares, at cost, 6,290,892 and 6,439,542 shares<br>at September 30, 2009 and December 31, 2008, respectively  | (64,324)              | (64,949)             |
| <b>Total shareholders' equity</b>  | <b>104,766</b>        | <b>105,621</b>       |
| <b>Total liabilities and shareholders' equity</b>  | <b>\$ 667,855</b>     | <b>\$ 699,896</b>    |

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



**ASSOCIATED ESTATES REALTY CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(UNAUDITED)**

|   | Three Months Ended |                   | Nine Months Ended |                  |
|---|--------------------|-------------------|-------------------|------------------|
|   | September 30,      |                   | September 30,     |                  |
|   | 2009               | 2008              | 2009              | 2008             |
| <i>(In thousands, except per share amounts)</i>   |                    |                   |                   |                  |
| <b>Revenue</b>  |                    |                   |                   |                  |
| Property revenue  | \$ 32,255          | \$ 33,077         | \$ 96,217         | \$ 95,467        |
| Management and service company revenue:   |                    |                   |                   |                  |
| Fees, reimbursements and other  | 232                | 428               | 1,057             | 1,378            |
| Construction and other services   | 379                | 547               | 730               | 872              |
| Total revenue   | 32,866             | 34,052            | 98,004            | 97,717           |
| <b>Expenses</b>   |                    |                   |                   |                  |
| Property operating and maintenance  | 13,999             | 14,413            | 41,566            | 40,789           |
| Depreciation and amortization   | 8,502              | 9,304             | 26,297            | 26,726           |
| Direct property management and service company expense  | 210                | 420               | 918               | 1,213            |
| Construction and other services   | 465                | 578               | 999               | 1,098            |
| General and administrative  | 3,831              | 3,668             | 10,136            | 10,379           |
| Total expenses  | 27,007             | 28,383            | 79,916            | 80,205           |
| Operating income  | 5,859              | 5,669             | 18,088            | 17,512           |
| Interest income   | 6                  | 16                | 41                | 122              |
| Interest expense  | (8,665)            | (9,012)           | (25,586)          | (26,624)         |
| (Loss) income before gain on insurance recoveries, equity in net loss of joint ventures and income from discontinued operations | (2,800)            | (3,327)           | (7,457)           | (8,990)          |
| Gain on insurance recoveries  | -                  | -                 | 544               | -                |
| Equity in net loss of joint ventures  | -                  | (28)              | -                 | (72)             |
| (Loss) income from continuing operations  | (2,800)            | (3,355)           | (6,913)           | (9,062)          |
| Income from discontinued operations:  |                    |                   |                   |                  |
| Operating income (loss)   | -                  | 325               | 568               | (678)            |
| Gain on disposition of properties   | (2)                | -                 | 15,411            | 45,203           |
| Income from discontinued operations   | (2)                | 325               | 15,979            | 44,525           |
| <b>Net (loss) income</b>  | <b>(2,802)</b>     | <b>(3,030)</b>    | <b>9,066</b>      | <b>35,463</b>    |
| Net income attributable to noncontrolling redeemable interest   | (14)               | (13)              | (40)              | (40)             |
| <b>Net (loss) income attributable to AERC</b>   | <b>(2,816)</b>     | <b>(3,043)</b>    | <b>9,026</b>      | <b>35,423</b>    |
| Preferred share dividends   | (1,049)            | (1,201)           | (3,149)           | (3,603)          |
| Allocation to participating securities  | -                  | -                 | (457)             | (755)            |
| <b>Net (loss) income applicable to common shares</b>  | <b>\$ (3,865)</b>  | <b>\$ (4,244)</b> | <b>\$ 5,420</b>   | <b>\$ 31,065</b> |
| <b>Earnings per common share - basic and diluted:</b>   |                    |                   |                   |                  |
| (Loss) income from continuing operations applicable to common shares  | \$ (0.23)          | \$ (0.28)         | \$ (0.61)         | \$ (0.78)        |
| Income from discontinued operations   | -                  | 0.02              | 0.94              | 2.70             |
| Net (loss) income applicable to common shares   | \$ (0.23)          | \$ (0.26)         | \$ 0.33           | \$ 1.92          |
| <b>Dividends declared per common share</b>  | <b>\$ 0.17</b>     | <b>\$ 0.17</b>    | <b>\$ 0.51</b>    | <b>\$ 0.51</b>   |
| <b>Weighted average number of common shares outstanding - basic and diluted</b>   | <b>16,539</b>      | <b>16,298</b>     | <b>16,500</b>     | <b>16,222</b>    |

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

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

| <i>(In thousands)</i>   | Nine Months Ended<br>September 30, |                 |
|---|------------------------------------|-----------------|
|   | 2009                               | 2008            |
| <b>Cash flow from operations:</b>                                       |                                    |                 |
| Net income  | \$ 9,066                           | \$ 35,463       |
| Adjustments to reconcile net income to net cash provided by operations: |                                    |                 |
| Depreciation and amortization (including discontinued operations)       | 26,771                             | 28,376          |
| Loss on fixed asset replacements write-off                              | 16                                 | 85              |
| Gain on disposition of properties                                       | (15,411)                           | (45,203)        |
| Gain on insurance recoveries  | (544)                              | -               |
| Amortization of deferred financing costs and other                      | 925                                | 984             |
| Share-based compensation  | 1,479                              | 1,448           |
| Equity in net loss of joint ventures                                    | -                                  | 72              |
| Net change in assets and liabilities:                                   |                                    |                 |
| Accounts and notes receivable   | 1,108                              | 1,135           |
| Accounts payable and accrued expenses                                   | 2,038                              | (2,260)         |
| Other operating assets and liabilities                                  | (1,915)                            | (2,252)         |
| Restricted cash   | (656)                              | 364             |
| Total adjustments   | 13,811                             | (17,251)        |
| Net cash flow provided by operations                                    | 22,877                             | 18,212          |
| <b>Cash flow from investing activities:</b>                             |                                    |                 |
| Recurring fixed asset additions   | (6,240)                            | (7,145)         |
| Revenue enhancing/non-recurring fixed asset additions                   | (3,065)                            | (1,291)         |
| Acquisition/development fixed asset additions                           | (1,939)                            | (34,484)        |
| Net proceeds from disposition of operating properties                   | 32,714                             | 88,348          |
| Net cash flow provided by investing activities                          | 21,470                             | 45,428          |
| <b>Cash flow from financing activities:</b>                             |                                    |                 |
| Principal amortization payments on mortgage notes payable               | (2,186)                            | (2,112)         |
| Principal repayments of mortgage notes payable                          | (72,096)                           | (42,851)        |
| Payment of debt procurement costs                                       | (686)                              | (601)           |
| Proceeds from mortgage notes obtained                                   | 52,450                             | -               |
| Revolving credit facility borrowings                                    | 131,900                            | 93,075          |
| Revolving credit facility repayments                                    | (141,400)                          | (98,575)        |
| Common share dividends paid   | (8,452)                            | (8,305)         |
| Preferred share dividends paid  | (3,149)                            | (3,603)         |
| Operating partnership distributions paid                                | (40)                               | (40)            |
| Exercise of stock options   | -                                  | 1,843           |
| Purchase of preferred and/or treasury shares                            | (178)                              | (220)           |
| Net cash flow used for financing activities                             | (43,837)                           | (61,389)        |
| Increase in cash and cash equivalents                                   | 510                                | 2,251           |
| Cash and cash equivalents, beginning of period                          | 3,551                              | 1,549           |
| <b>Cash and cash equivalents, end of period</b>                         | <b>\$ 4,061</b>                    | <b>\$ 3,800</b> |
| Supplemental disclosure of cash flow information:                       |                                    |                 |
| Dividends declared but not paid   | \$ 2,995                           | \$ 2,905        |
| Cash paid for interest, net of capitalized interest                     | 24,913                             | 28,941          |
| Net change in accounts payable related to fixed asset additions         | 739                                | 1,230           |
| Assumption of debt in connection with property acquisition              | -                                  | 45,002          |

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

**ASSOCIATED ESTATES REALTY CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**UNAUDITED**

**1. BASIS OF PRESENTATION AND ACCOUNTING POLICIES**

*Except as the context otherwise requires, all references to "we," "our," "us," "AERC" 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") specializing in multifamily property management, advisory, development, acquisition, disposition, operation and ownership activities. Our primary source of income is rental revenue. Additional income is derived primarily from property and asset management fees.

As of September 30, 2009, our property portfolio consisted of: (i) 48 apartment communities containing 12,108 units in seven states that are wholly owned, either directly or indirectly through subsidiaries; (ii) one apartment community that we manage for a third party owner consisting of 258 units; and (iii) a 186-unit apartment community and a commercial property containing approximately 145,000 square feet that we asset manage for a government sponsored pension fund.

**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 statement, 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, 2008. We have evaluated all subsequent events through November 3, 2009, which is the date the financial statements were issued.

**Segment Reporting**

All of our properties are multifamily communities that have similar economic characteristics. Management evaluates the performance of our properties on an individual basis. We previously reported separate segments primarily due to the different operating characteristics related to our Affordable Housing properties and to segregate third party fee management income. However, with our exit from the ownership and management of our Affordable Housing properties and our exit in 2009 from substantially all third party fee management, our multifamily properties now provide approximately 98.2% of our consolidated revenue for the nine months ended September 30, 2009. As a result, we determined that it would be appropriate to have only one reportable segment, which will be multifamily properties.

**Noncontrolling Redeemable Interest**

In December 2007, the Financial Accounting Standards Board ("FASB") issued guidance which establishes and expands accounting and reporting standards for minority interests in a subsidiary and the deconsolidation of a subsidiary and also requires minority interests to be recharacterized as noncontrolling interests. This guidance was effective for us January 1, 2009, and as such, the operating partnership minority interest reported in our Annual Report on Form 10-K for the year ended December 31, 2008, has been recharacterized as "Noncontrolling redeemable interest" for all periods presented.

**Share-Based Compensation**

During the three and nine months ended September 30, 2009, we recognized total share-based compensation cost of \$ 432,000 and \$1.5 million, respectively, in "General and administrative expense" in the Consolidated Statements of Operations. During the three and nine months ended September 30, 2008, we recognized total share-based compensation cost of \$484,000 and \$1.4 million, respectively, in "General and administrative expense."

*Stock Options.* During the nine months ended September 30, 2009, there were 58,000 options awarded and no options exercised. During the nine months ended September 30, 2008, there were no stock options awarded and 180,021 stock options were exercised. 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 options awarded during the nine months ended September 30, 2009, were as follows:

|                                     |    |       |
|-------------------------------------|----|-------|
| Expected volatility                 |    | 39.1% |
| Risk-free interest rate             |    | 2.6%  |
| Expected life of options (in years) |    | 6.4   |
| Dividend yield                      |    | 8.4%  |
| Grant-date fair value               | \$ | 1.38  |

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 bonds on the date of grant with a maturity approximating the expected life of the options. The expected life of the options was derived using our historical experience for similar awards. The dividend yield was derived using our annual dividend rate as a percentage of the price of our shares on the date of grant.

*Restricted Shares.* The following table represents restricted share activity for the nine months ended September 30, 2009:

|                                  | Number of<br>Shares |    | Weighted<br>Average<br>Grant Date<br>Fair Value |
|----------------------------------|---------------------|----|---|
| Nonvested at beginning of period | 189,867             | \$ | 11.33   |
| Granted                          | 184,070             | \$ | 5.37  |
| Vested                           | 110,793             | \$ | 9.23  |
| Forfeited                        | 2,018               | \$ | 10.06   |
| Nonvested at end of period       | 261,126             | \$ | 9.74  |

At September 30, 2009, there was \$2.0 million of unrecognized compensation cost related to nonvested restricted share awards that we expect to recognize over a weighted average period of 2.0 years. Pursuant to the terms of the Company's Elective Deferred Compensation Program, certain of our officers elected to defer the receipt of all or a portion of the restricted shares granted them during the nine months ended September 30, 2009.



**Derivative Instruments and Hedging Activities**

We record all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives used to hedge the exposure to changes in the fair value of an asset, liability or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives used to hedge the exposure to variability in expected future cash flows or other types of forecasted transactions are considered cash flow hedges.

For derivatives designated as fair value hedges, changes in the fair value of the derivative and the hedged item related to the hedged risk are recognized in earnings. For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of the derivative is initially reported in other comprehensive income (outside of earnings) and subsequently reclassified to earnings when the hedged transaction affects earnings, and the ineffective portion of changes in the fair value of the derivative is recognized directly in earnings. Hedge ineffectiveness is measured by comparing the changes in fair value or cash flows of the derivative hedging instrument with the changes in fair value or cash flows of the designated hedged item or transaction. For derivatives not designated as hedges, changes in fair value are recognized in earnings.

We do not use derivatives for trading or speculative purposes. Further, we have a policy of only entering into contracts with major financial institutions based upon their credit ratings and other factors. When viewed in conjunction with the underlying and offsetting exposure that the derivatives are designed to hedge, we have not sustained a material loss from these hedges.

We have utilized interest rate swaps and caps to add stability to interest expense and to manage our exposure to interest rate movements. Interest rate swaps designated as cash flow hedges involve the receipt of variable-rate amounts in exchange for fixed-rate payments over the life of the agreements without exchange of the underlying principal amount. Interest rate caps designated as cash flow hedges involve the receipt of variable-rate amounts if interest rates rise above a certain level in exchange for an up front premium.

Interest Rate Hedge Activity: During 2007, we executed two interest rate swaps to hedge the cash flows of existing variable rate debt. No hedge ineffectiveness on these cash flow hedges was recognized during the nine months ended September 30, 2009. Amounts reported in "Accumulated other comprehensive loss" related to derivatives will be reclassified to "Interest expense" as interest payments are made on our variable-rate debt. During the next twelve months, we estimate that approximately \$1.9 million will be reclassified from "Accumulated other comprehensive loss" as an increase to "Interest expense." The following table presents the notional amounts of the swaps as of September 30, 2009:

| <i>(Dollar amount in thousands)</i> | Number of   |    | Notional |
|-------------------------------------|-------------|----|----------|
| Interest Rate Derivative            | Instruments |    | Amounts  |
| Interest rate swaps                 | 2           | \$ | 63,000   |

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The following table presents the fair value of our derivative financial instruments as well as their classification on the Consolidated Balance Sheets (see Note 7 for additional information regarding the fair value of these derivative instruments):

| <i>(In thousands)</i>                          | Fair Value of Derivative Instruments                     |            |  |            |
|--|--|------------|--|------------|
|  | As of September 30, 2009                                 |            | As of December 31, 2008                                  |            |
|  | Balance Sheet Location                                   | Fair Value | Balance Sheet Location                                   | Fair Value |
| Derivatives designated as hedging instruments: |  |            |  |            |
| Interest rate swaps                            | Accounts payable, accrued expenses and other liabilities | \$ 1,965   | Accounts payable, accrued expenses and other liabilities | \$ 2,899   |

The following table presents the effect of our derivative financial instruments on the Consolidated Statements of Operations (see Note 5 for additional information regarding the effect of these derivative instruments on total comprehensive income):

| <i>(In thousands)</i>                          | The Effect of Derivative Instruments on the Consolidated Statements of Operations |                    |                    |  |  |  |
|--|---|--------------------|--------------------|--|--|--|
|  | Amount of Gain or (Loss) Recognized in OCI on Derivative (Effective Portion)      |                    |                    | Location of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) | Amount of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) |  |
|  | Three Months Ended  | Nine Months Ended  | Three Months Ended |  | Nine Months Ended  |  |
|  | September 30, 2009  | September 30, 2009 | September 30, 2009 | September 30, 2009   |  |  |
| Derivatives in Cash Flow Hedging Relationships | \$ (440)  | \$ (655)           | Interest expense   | \$ 625   | \$ 1,589   |  |

We have agreements with each of our derivative counterparties that contain a provision where if we either default or are capable of being declared in default on any of our indebtedness, then such counterparty can declare us to be in default on our derivative obligations.

We have an agreement with a derivative counterparty that incorporates the loan covenant provisions of our indebtedness with a lender affiliate of the derivative counterparty. Failure to comply with the loan covenant provisions would result in our being in default on any derivative instrument obligations covered by the agreement.

As of September 30, 2009, the fair value of derivatives in a net liability position, which includes accrued interest but excludes any adjustment for nonperformance risk, related to these agreements was \$2.2 million. As of September 30, 2009, we have not posted any collateral related to these agreements. If we had breached any of these provisions at September 30, 2009, we would have been required to settle our obligations under the agreements at their termination value of \$2.2 million.

### **Classification of Fixed Asset Additions**

We define recurring fixed asset additions to a property to be capital expenditures made to replace worn out assets to maintain the property's value. Revenue enhancing/non-recurring fixed asset additions are defined as capital expenditures that increase the value of the property and/or enable us to increase rents. Acquisition/development fixed asset additions are defined as capital expenditures 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.

### **Reclassifications**

Certain reclassifications have been made to the 2008 financial statements to conform to the 2009 presentation.

## **2. DEVELOPMENT AND DISPOSITION ACTIVITY**

### **Development Activity**

We recently commenced construction of a 60-unit expansion of the existing 240-unit River Forest apartment community located in the Richmond, Virginia metropolitan market area. Construction in progress related to this development was \$2.0 million at September 30, 2009 and includes capitalized interest costs on funds used in construction and real estate taxes and insurance. Capitalized interest costs for the three and nine months ended September 30, 2009 were \$41,000 and \$66,000, respectively.

### **Disposition Activity**

We report the results of operations and gain/loss related to the sale of real estate assets as discontinued operations. Real estate assets that are classified as held for sale are also reported as discontinued operations. We classify properties as held for sale when all significant contingencies surrounding the closing have been resolved. In most 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.

On June 17, 2009, we completed the sale of Chestnut Ridge apartments, a 468-unit property located in Pittsburgh, Pennsylvania. The sales price was \$29.8 million and we recorded a gain of \$13.1 million.

On January 9, 2009, we completed the sale of Bay Club apartments, a 96-unit property located in Northeast Ohio. The sales price was \$4.1 million and we recorded a gain of \$2.3 million.

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"Income from discontinued operations" in the accompanying Consolidated Statements of Operations for the three and nine months ended September 30, 2009 and 2008, includes the operating results for the properties sold in 2009 and prior years, as well as the gains recognized on properties sold during each reporting period. The following table summarizes "Income from discontinued operations:"

| <i>(In thousands)</i>                      | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |           |
|--|-------------------------------------|----------|------------------------------------|-----------|
|  | 2009                                | 2008     | 2009                               | 2008      |
| <b>REVENUE</b>                             |                                     |          |                                    |           |
| Property revenue                           | \$ -                                | \$ 1,292 | \$ 2,021                           | \$ 7,850  |
| <b>EXPENSES</b>                            |                                     |          |                                    |           |
| Property operating and maintenance         | -                                   | 479      | 948                                | 3,868     |
| Depreciation and amortization              | -                                   | 298      | 474                                | 1,650     |
| Total expenses                             | -                                   | 777      | 1,422                              | 5,518     |
| Operating income                           | -                                   | 515      | 599                                | 2,332     |
| Interest income                            | -                                   | -        | -                                  | 5         |
| Interest expense (1)                       | -                                   | (190)    | (31)                               | (3,015)   |
| Gain on disposition of properties          | (2)                                 | -        | 15,411                             | 45,203    |
| <b>Income from discontinued operations</b> | \$ (2)                              | \$ 325   | \$ 15,979                          | \$ 44,525 |

(1) Interest expense for the nine months ended September 30, 2008 includes \$2.0 million of defeasance and other prepayment costs.

**3. DEBT**

The following table identifies our total debt outstanding and weighted average interest rates:

| <i>(Dollar amounts in thousands)</i> | September 30, 2009     |                                   | December 31, 2008      |                                   |
|--------------------------------------|------------------------|-----------------------------------|------------------------|-----------------------------------|
|                                      | Balance<br>Outstanding | Weighted Average<br>Interest Rate | Balance<br>Outstanding | Weighted Average<br>Interest Rate |
| <b>FIXED RATE DEBT</b>               |                        |                                   |                        |                                   |
| Mortgages payable - CMBS             | \$ 116,000             | 7.7%                              | \$ 154,685             | 7.7%                              |
| Mortgages payable - other (1)        | 337,385                | 5.8%                              | 320,516                | 5.8%                              |
| Unsecured borrowings                 | 25,780                 | 7.9%                              | 25,780                 | 7.9%                              |
| <b>Total fixed rate debt</b>         | 479,165                | 6.4%                              | 500,981                | 6.5%                              |
| <b>VARIABLE RATE DEBT</b>            |                        |                                   |                        |                                   |
| Mortgages payable                    | 34,984                 | 4.7%                              | 35,000                 | 1.6%                              |
| Unsecured revolving credit facility  | 12,000                 | 1.8%                              | 21,500                 | 3.7%                              |
| <b>Total variable rate debt</b>      | 46,984                 | 4.0%                              | 56,500                 | 2.4%                              |
| <b>Total debt</b>                    | \$ 526,149             | 6.2%                              | \$ 557,481             | 6.1%                              |

(1) Includes \$63.0 million of variable rate debt swapped to fixed as of September 30, 2009 and December 31, 2008.

**Mortgage Notes Payable**

The following table provides information on loans repaid at par as well as loans obtained during 2009:

| <i>(Dollar amounts in thousands)</i><br>Property | Loans Repaid |          | Loans Obtained |          | Maturity   |
|--|--------------|----------|----------------|----------|------------|
|  | Amount       | Rate     | Amount         | Rate     |            |
| Saw Mill Village                                 | \$ 11,119    | 7.5%     | \$ 17,220      | 6.0%     | April 2016 |
| Georgetown Park                                  | 16,000       | 1.6% (1) | -              | N/A      | N/A        |
| Chestnut Ridge                                   | 19,000       | 1.4% (1) | -              | N/A      | N/A        |
| Oaks at Hampton                                  | 25,977       | 7.5%     | -              | N/A      | N/A        |
| Steeplechase at Shiloh                           | -            | N/A      | 13,790         | 4.7% (1) | March 2016 |
| Courtney Chase                                   | -            | N/A      | 21,440         | 4.7% (1) | March 2016 |
|  | \$ 72,096    | 4.6% (2) | \$ 52,450      | 5.1% (2) |            |

(1) Denotes variable rate loans. Variable rates on loans obtained are as of September 30, 2009.

(2) Represents weighted average interest rate for the loans listed.

During 2008, 2007 and 2006, we defeased 21 CMBS loans. These loans were defeased pursuant to the terms of the underlying loan documents. In accordance with GAAP, we removed those financial assets and the mortgage loans from our financial records. All risk of loss associated with these defeasances have been transferred from us to the successor borrower and any ongoing relationship between the successor borrower and us was deemed inconsequential at the time of completion of the respective transfers. However, we subsequently learned that certain defeasance transactions, completed prior to June 2007, could enable us to receive a refund of a portion of the costs incurred in connection with the transaction. During the first quarter of 2009, we received refunds of \$563,000, which were included as a reduction to interest expense. It is possible that we may receive additional refunds in the future, however such amounts cannot be estimated due to the uncertainty of future payments, and we believe that any amounts we may receive would not be material to our consolidated financial position, cash flow or results of operations.

**4. GOODWILL AND OTHER INTANGIBLE ASSETS****Goodwill**

In June 1998, we recorded goodwill in connection with the MIG Realty Advisors, Inc. merger. We have a policy of completing our annual review of goodwill during the first quarter of each year and more frequently if events or changes in circumstances indicate that the carrying value may not be recoverable. The review that was completed during the three months ended March 31, 2009 determined that goodwill was not impaired and no other events have occurred which would require that goodwill be reevaluated and as such there were no changes to the carrying value of goodwill as of September 30, 2009. 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. Should the estimates used to determine alternatives or the probabilities of the occurrence thereof change, impairment may result which could materially impact our results of operations for the period in which it is recorded.

**Intangible Assets**

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 12 to 16 months. Due to the short term nature of residential leases, we believe that existing lease rates approximate market rates; therefore, no allocation is made for above/below market leases.

**5. SHAREHOLDERS' EQUITY**

The following table provides a reconciliation of activity in Shareholders' equity accounts:

| <i>(In thousands)</i>   | Nine Months<br>Ended<br>September 30,<br>2009 | Twelve Months<br>Ended<br>December 31,<br>2008 |
|---|---|--|
| <b>Noncontrolling redeemable interest</b>                                 |   |  |
| Balance outstanding at beginning of period                                | \$ 1,829                                      | \$ 1,829                                       |
| Balance outstanding at end of period                                      | \$ 1,829                                      | \$ 1,829                                       |
| <b>Preferred shares</b>   |   |  |
| Balance outstanding at beginning of period                                | \$ 48,263                                     | \$ 55,213                                      |
| Purchase and retirement of Class B Cumulative Redeemable Preferred Shares | -   | (6,950)  |
| Balance outstanding at end of period                                      | 48,263  | 48,263   |
| <b>Common shares (at \$.10 stated value)</b>                              |   |  |
| Balance outstanding at beginning and end of period                        | 2,300   | 2,300  |
| <b>Paid-in capital</b>  |   |  |
| Balance outstanding at beginning of period                                | 282,501                                       | 281,152  |
| Share based compensation  | 396   | 1,294  |
| Shares issued from treasury for stock option exercises                    | -   | (88)   |
| Purchase and retirement of Class B Cumulative Redeemable Preferred Shares | -   | 143  |
| Balance outstanding at end of period                                      | 282,897                                       | 282,501  |
| <b>Accumulated distributions in excess of accumulated net income</b>      |   |  |
| Balance outstanding at beginning of period                                | (159,595)                                     | (180,436)                                      |
| Net income  | 9,066   | 34,680   |
| Net loss attributable to noncontrolling redeemable interest               | (40)  | (53)   |
| Share based compensation  | 5   | 8  |
| Purchase and retirement of Class B Cumulative Redeemable Preferred Shares | -   | 2,146  |
| Common share dividends declared   | (8,692)                                       | (11,285)                                       |
| Preferred share dividends declared  | (3,149)                                       | (4,655)  |
| Balance outstanding at end of period                                      | (162,405)                                     | (159,595)                                      |
| <b>Accumulated other comprehensive loss</b>                               |   |  |
| Balance outstanding at beginning of period                                | (2,899)                                       | (1,050)  |
| Change in fair value of hedge instruments                                 | 934   | (1,849)  |
| Balance outstanding at end of period                                      | (1,965)                                       | (2,899)  |
| <b>Treasury shares (at cost)</b>  |   |  |
| Balance outstanding at beginning of period                                | (64,949)                                      | (67,393)                                       |
| Purchase of common shares   | (178)   | (221)  |
| Share based compensation  | 803   | 734  |
| Shares issued from treasury for stock option exercises                    | -   | 1,931  |
| Balance outstanding at end of period                                      | (64,324)                                      | (64,949)                                       |
| <b>Total shareholders' equity</b>   | <b>\$ 104,766</b>                             | <b>\$ 105,621</b>                              |

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The following table identifies total comprehensive income:

| <i>(In thousands)</i>                     | Nine Months Ended<br>September 30, |           |
|---|------------------------------------|-----------|
|   | 2009                               | 2008      |
| Comprehensive income:                     |                                    |           |
| Net income attributable to AERC           | \$ 9,026                           | \$ 35,423 |
| Other comprehensive income (loss):        |                                    |           |
| Change in fair value of hedge instruments | 934                                | (275)     |
| Total comprehensive income                | \$ 9,960                           | \$ 35,148 |

**6. EARNINGS PER SHARE**

In June 2008, the FASB issued guidance which clarifies that nonvested awards containing nonforfeitable dividend rights are participating securities and are therefore required to be included in the computations of basic and diluted earnings per share. This guidance was effective for us January 1, 2009, and requires retrospective application to all periods presented.

There were 1.4 million options to purchase common shares outstanding at September 30, 2009 and 2008. The dilutive effect of these options were not 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 noncontrolling interests into common shares was also not included in the computation of diluted EPS because we intend to settle these OP units in cash.

The following table presents a reconciliation of basic and diluted earnings per common share:

| <i>(In thousands)</i>   | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |             |
|---|-------------------------------------|------------|------------------------------------|-------------|
|   | 2009                                | 2008       | 2009                               | 2008        |
| <b>Numerator - basic and diluted:</b>                                     |                                     |            |                                    |             |
| (Loss) income from continuing operations                                  | \$ (2,800)                          | \$ (3,355) | \$ (6,913)                         | \$ (9,062)  |
| Net income attributable to noncontrolling redeemable interest             | (14)                                | (13)       | (40)                               | (40)        |
| Preferred share dividends   | (1,049)                             | (1,201)    | (3,149)                            | (3,603)     |
| (Loss) income from continuing operations applicable to common shares      | \$ (3,863)                          | \$ (4,569) | \$ (10,102)                        | \$ (12,705) |
| Income from discontinued operations                                       | \$ (2)                              | \$ 325     | \$ 15,979                          | \$ 44,525   |
| Allocation to participating securities                                    | -                                   | -          | (457)                              | (755)       |
| Income from discontinued operations applicable to common shares           | \$ (2)                              | \$ 325     | \$ 15,522                          | \$ 43,770   |
| <b>Denominator - basic and diluted:</b>                                   | 16,539                              | 16,298     | 16,500                             | 16,222      |
| <b>Net income (loss) applicable to common shares - basic and diluted:</b> |                                     |            |                                    |             |
| (Loss) income from continuing operations applicable to common shares      | \$ (0.23)                           | \$ (0.28)  | \$ (0.61)                          | \$ (0.78)   |
| Income from discontinued operations                                       | -                                   | 0.02       | 0.94                               | 2.70        |
| Net income (loss) applicable to common shares - basic and diluted         | \$ (0.23)                           | \$ (0.26)  | \$ 0.33                            | \$ 1.92     |

## 7. FAIR VALUE

Fair value determined in accordance with GAAP should be based on the assumptions that market participants would use when pricing certain assets or liabilities. Inputs used in determining fair value should be from the highest level available in the following hierarchy:

Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that we have the ability to access;

Level 2 inputs may include quoted prices for similar assets and liabilities in active markets, as well as interest rates and yield curves that are observable at commonly quoted intervals; and

Level 3 inputs are unobservable inputs for the asset or liability that are typically based on an entity's own assumptions as there is little, if any, related market activity.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the fair value measurement will fall within the lowest level input that is significant to the fair value measurement in its entirety.

The following table presents the financial liabilities that we measured at fair value on a recurring basis as of September 30, 2009:

| <i>(In thousands)</i> | Level 1 | Level 2  | Level 3 | Total    |
|-----------------------|---------|----------|---------|----------|
| Interest rate swaps   | \$ -    | \$ 1,965 | \$ -    | \$ 1,965 |

We incorporate credit valuation adjustments to appropriately reflect both our own nonperformance risk and that of the respective counterparty in the fair value measurements. The credit valuation adjustments utilize Level 3 inputs, such as estimates of current credit spreads, to evaluate the likelihood of default by either the respective counterparty or us. However, we determined that as of September 30, 2009, the impact of the credit valuation adjustments were not significant to the overall valuation of the swaps. See "Derivative Instruments and Hedging Activities" in Note 1 for additional information regarding the swaps.

Rents, accounts and notes receivable, other assets, accounts payable, accrued expenses and other liabilities are carried at amounts that reasonably approximate corresponding fair values.

Mortgage notes payable, revolving debt and other unsecured debt with an aggregate carrying value of \$526.1 million and \$557.5 million at September 30, 2009, and December 31, 2008, respectively, have an estimated aggregate fair value of \$538.1 million and \$549.0 million, respectively. Estimated fair value is based on interest rates available to us as of the dates reported on for issuance of debt with similar terms and remaining maturities. Considerable judgment is necessary to interpret market data and develop estimated fair values. Accordingly, the estimates presented herein are not necessarily indicative of the amounts we could realize on disposition of the financial instruments. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

## 8. GAIN ON INSURANCE RECOVERIES

In June 2009, we settled a wind storm damage insurance claim involving 13 of our central Ohio properties for the aggregate sum of \$906,000, net of our deductible. In accordance with GAAP, we recorded this settlement as a gain on insurance recoveries. The roofs of five of these properties sustained extensive damage and were replaced. We reported a gain on insurance recoveries of \$544,000 in the Consolidated Statements of Income for the nine months ended September 30, 2009, which represents insurance proceeds to be received net of the carrying value of the assets written off and costs incurred to make repairs.



## 9. 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 matter described in the following paragraph as of September 30, 2009, and no accrual has been made for this matter. 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 allowed 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 nonrefundable 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. On or about September 3, 2008, the court granted our motion for summary judgment thereby dismissing all Plaintiff claims against us. However, Plaintiff subsequently appealed the court's ruling to the Ohio Court of Appeals for the 10<sup>th</sup> District, which dismissed the appeal on technical grounds. The technical issues have now been resolved, Plaintiff has refiled its appeal and we are now awaiting the Court of Appeals decision.

## 10. SUBSEQUENT EVENTS

### Dividends

On November 2, 2009, we paid a dividend of \$0.17 per common share to shareholders of record on October 15, 2009, which was declared on September 15, 2009.

**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 2009 performance which are based on certain assumptions. Accordingly, readers are cautioned not to place undue reliance on forward-looking statements that speak only as of the date 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;
- our ability to refinance debt on favorable terms at maturity;
- our ability to defease or prepay debt pursuant to our current plan;
- risks of a lessening of demand for the multifamily units that we own or manage;
- competition from other available multifamily units and changes in market rental rates;
- increases in property and liability insurance costs;
- unanticipated increases in real estate taxes and other operating expenses;
- weather conditions that 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;
- our 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;
- 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;
- our ability to acquire properties at prices consistent with our investment criteria;
- risks associated with property acquisitions such as environmental liabilities, among others;
- changes in or termination of contracts relating to third party management and advisory business; 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. Our primary source of cash and revenue from operations is rents from the leasing of owned apartment units, which represented 98.2% of our consolidated revenue for the nine months ended September 30, 2009.

The operating performance of our properties is affected by general economic trends including, but not limited to, factors such as household formation, job growth, unemployment rates, population growth, immigration, the supply of new multifamily rental communities and the supply of other housing alternatives, such as condominiums, single and multifamily rental homes and owner occupied single and multifamily homes. Additionally, our performance may be affected by access to, and the cost of capital.

Rental revenue collections are a combination of rental rates, occupancy levels and rent concessions. We attempt to adjust these factors to adapt to changing market conditions, thus allowing us to maximize rental income. Indicators that we use in measuring these factors include physical occupancy and net collected rent per unit. These indicators are more fully described in the Results of Operations comparison. Additionally, we consider property Net Operating Income ("NOI") to be an important indicator of our overall performance. Property NOI (property operating revenue less property operating and maintenance expenses) is a measure of the profitability of our properties and has the largest impact on our financial condition and operating results.

**Updated 2009 Expectations.**

**Portfolio performance** Our guidance reflects Same Community property NOI decreasing in the range of -3.5% to -2.5% in 2009.

**Property acquisitions, sales and development** Our updated guidance reflects no property acquisitions, rather than the \$80.0 million we originally anticipated. We completed the disposition of two properties for \$33.9 million through September 30, 2009, and we expect no further property sales during 2009. We also began construction of a 60-unit expansion of our River Forest apartment community, which is located in the Richmond, Virginia metropolitan area.

The cost of this expansion project is expected to be approximately \$7.0 million. We expect to incur approximately \$5.0 million in costs related to this development during 2009, with the remaining \$2.0 million to be expended in 2010.

**Debt repayment** We have already repaid all our loans maturing in 2009.

**Forecast Qualification.** The uncertainties caused by the current economic turndown and the unprecedented financial crisis complicate our ability to forecast future performance and disposition/acquisition activity. We believe that the apartment industry is better situated to weather the recession and financial crisis than other real estate sectors, because people will normally choose shelter over discretionary spending such as going to the mall or hotel stays and because government sponsored agencies such as Fannie Mae and Freddie Mac continue to provide needed financing and refinancing credit facilities, which are otherwise unavailable to other commercial real estate sectors.

**LIQUIDITY AND CAPITAL RESOURCES**

Cash Flows and Liquidity. Significant sources and uses of cash during the nine months ended September 30, 2009 and 2008 are summarized as follows:

| <i>(In thousands)</i>   | Nine Months Ended |                       |
|---|-------------------|-----------------------|
|   | 2009              | September 30,<br>2008 |
| Net cash provided by operations                                     | \$ 22,877         | \$ 18,212             |
| Fixed assets:   |                   |                       |
| Property/land acquisitions and development expenditures, net        | (1,939)           | (34,484)              |
| Net property disposition proceeds                                   | 32,714            | 88,348                |
| Recurring, revenue enhancing and non-recurring capital expenditures | (9,305)           | (8,436)               |
| Debt:   |                   |                       |
| Decrease in mortgage notes  | (21,832)          | (44,963)              |
| Decrease in revolving credit facility borrowings                    | (9,500)           | (5,500)               |
| Cash dividends and operating partnership distributions paid         | (11,641)          | (11,948)              |

Our primary sources of liquidity are cash flow provided by operations, short-term borrowings on our unsecured revolving credit facility (the "revolver") and proceeds from property sales. We believe that we are well positioned to weather the recent turmoil in the financial markets. Four mortgage loans totaling approximately \$72.2 million were scheduled to mature in 2009. During the first half of 2009, we repaid \$52.5 million of the maturing debt with funds from new mortgage loans that mature in 2016 and we utilized short term funding from our revolver for the remaining \$19.7 million. The revolver borrowing was repaid with funds received from the sale of a 468-unit property located in Pennsylvania in June 2009. As of September 30, 2009, our revolver had \$138.0 million available for borrowing and matures on March 11, 2011.

While we expect rental revenue to remain flat or decline due to increased concessions in some of our markets, we anticipate that cash flow provided by operations for the remainder of the year should remain consistent with current levels and should be adequate to fund our cash needs, other than the \$5.0 million that we anticipate spending in 2009 to develop a 60-unit expansion of a Richmond, Virginia property, which we intend to fund with borrowings on our revolver.

Cash flow provided by operations increased during 2009 compared to 2008 primarily due to changes in accounts payable and accrued expenses, which was primarily a result of the payment of liabilities in 2008 related to funds held for managed properties and our exit from the affordable housing management business.

In addition to the development costs of \$5.0 million, we anticipate funding approximately \$3.4 million for recurring, revenue enhancing and nonrecurring capital expenditures for the remainder of 2009. These expenditures are expected to be funded largely from cash flow provided by operations.

Any future multifamily property acquisitions or developments would be financed with the most appropriate sources of capital, which may include secured or unsecured debt financings, borrowings on the revolver, the assumption of mortgage indebtedness, bank and other institutional borrowings, the exchange of properties, undistributed earnings and debt or equity issuances under our effective shelf registration.

We anticipate that we will meet our 2009 liquidity requirements through cash flow provided by operations. We believe that this and other sources, such as the revolver, 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 our regular quarterly dividends in cash.

**RESULTS OF OPERATIONS***Comparison of the three and nine months ended September 30, 2009 to the three and nine months ended September 30, 2008.*

Our Same Community portfolio represents properties that we have owned for all of the comparison periods. For the three month comparison period ended September 30, 2009 and 2008, the Same Community portfolio consisted of all 48 owned properties containing 12,108 units. For the nine month comparison period ended September 30, 2009 and 2008, the Same Community portfolio consisted of 46 properties containing 11,572 units, and Acquired properties represents two properties acquired in April 2008.

The net loss from continuing operations decreased \$555,000 and \$2.1 million during the three and nine month comparison periods, respectively. The decrease in the three month comparison period was primarily due to a reduction in depreciation and amortization expense. The decrease in the nine month comparison period was primarily due to a reduction in interest expense and the gain on insurance recoveries.

NOI for the Same Community portfolio decreased during both the three and nine month comparison periods. The decrease in both comparison periods was primarily attributable to reductions in property revenue at our Southeast properties resulting from increases in rent concessions and vacancy losses.

The following table presents property NOI results:

|                            | Three Months Ended September 30, |                 |                         | Nine Months Ended September 30, |                 |                         |
|----------------------------|----------------------------------|-----------------|-------------------------|---------------------------------|-----------------|-------------------------|
|                            | 2009                             | 2008            | Increase/<br>(Decrease) | 2009                            | 2008            | Increase/<br>(Decrease) |
| <i>(In thousands)</i>      | Property<br>NOI                  | Property<br>NOI |                         | Property<br>NOI                 | Property<br>NOI |                         |
| Same Community Properties: |                                  |                 |                         |                                 |                 |                         |
| Midwest                    | \$ 10,506                        | \$ 10,256       | \$ 250                  | \$ 31,221                       | \$ 30,215       | \$ 1,006                |
| Mid-Atlantic               | 3,462                            | 3,427           | 35                      | 7,191                           | 7,069           | 122                     |
| Southeast                  | 4,288                            | 4,981           | (693)                   | 12,927                          | 15,289          | (2,362)                 |
| Total Same Community       | 18,256                           | 18,664          | (408)                   | 51,339                          | 52,573          | (1,234)                 |
| Acquired Properties        | -                                | -               | -                       | 3,312                           | 2,105           | 1,207                   |
| Total Property NOI         | \$ 18,256                        | \$ 18,664       | \$ (408)                | \$ 54,651                       | \$ 54,678       | \$ (27)                 |

NOI is determined by deducting property operating and maintenance expenses from property revenue (excluding amounts classified as discontinued operations) for our properties and deducting direct property management and service company expenses and construction and other services expenses from management and service company revenue for the management and service operations. 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 an alternative to 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. Other real estate companies may define NOI in a different manner.

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A reconciliation of NOI to total consolidated net (loss) income attributable to AERC is as follows:

| <i>(In thousands)</i>   | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |           |
|---|-------------------------------------|------------|------------------------------------|-----------|
|   | 2009                                | 2008       | 2009                               | 2008      |
| Property NOI  | \$ 18,256                           | \$ 18,664  | \$ 54,651                          | \$ 54,678 |
| Service company NOI   | 22                                  | 8          | 139                                | 165       |
| Construction and other services NOI                           | (86)                                | (31)       | (269)                              | (226)     |
| Depreciation and amortization                                 | (8,502)                             | (9,304)    | (26,297)                           | (26,726)  |
| General and administrative expense                            | (3,831)                             | (3,668)    | (10,136)                           | (10,379)  |
| Interest income   | 6                                   | 16         | 41                                 | 122       |
| Interest expense  | (8,665)                             | (9,012)    | (25,586)                           | (26,624)  |
| Gain on insurance recoveries                                  | -                                   | -          | 544                                | -         |
| Equity in net loss of joint ventures                          | -                                   | (28)       | -                                  | (72)      |
| Income from discontinued operations:                          |                                     |            |                                    |           |
| Operating income (loss)                                       | -                                   | 325        | 568                                | (678)     |
| Gain on disposition of properties                             | (2)                                 | -          | 15,411                             | 45,203    |
| Income from discontinued operations                           | (2)                                 | 325        | 15,979                             | 44,525    |
| Net (loss) income   | (2,802)                             | (3,030)    | 9,066                              | 35,463    |
| Net income attributable to noncontrolling redeemable interest | (14)                                | (13)       | (40)                               | (40)      |
| Consolidated net (loss) income attributable to AERC           | \$ (2,816)                          | \$ (3,043) | \$ 9,026                           | \$ 35,423 |

The following chart reflects the amount and percentage change in line items that are relevant to the changes in overall operating performance:

| <i>(In thousands)</i>                      | Increase (decrease) when<br>comparing the three months<br>ended September 30, 2009<br>to September 30, 2008 |          | Increase (decrease) when<br>comparing the nine months<br>ended September 30, 2009<br>to September 30, 2008 |         |
|--|---|----------|--|---------|
|  | \$  | %        | \$   | %       |
| Property revenue                           | (822)   | (2.5)%   | 750  | 0.8%    |
| Property operating and maintenance expense | (414)   | (2.9)%   | 777  | 1.9%    |
| Depreciation and amortization              | (802)   | (8.6)%   | (429)  | (1.6)%  |
| Interest expense                           | (347)   | (3.9)%   | (1,038)  | (3.9)%  |
| Gain on insurance recoveries               | -   | N/A      | 544  | N/A     |
| Income from discontinued operations        | (327)   | (100.6)% | (28,546)   | (64.1)% |

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*Property revenue.* Property revenue is impacted by a combination of rental rates, rent concessions and occupancy levels, i.e., net collected rent per unit. Physical occupancy at the end of each period and net collected rent per unit are presented in the following tables:

|                            | Physical Occupancy                  |       |                                    |       |
|----------------------------|-------------------------------------|-------|------------------------------------|-------|
|                            | Three Months Ended<br>September 30, |       | Nine Months Ended<br>September 30, |       |
|                            | 2009                                | 2008  | 2009                               | 2008  |
| Same Community Properties: |                                     |       |                                    |       |
| Midwest                    | 96.0%                               | 97.0% | 96.0%                              | 97.0% |
| Mid-Atlantic               | 94.0%                               | 96.3% | 95.3%                              | 95.3% |
| Southeast                  | 91.3%                               | 92.3% | 91.3%                              | 92.3% |
| Total Same Community       | 94.6%                               | 95.8% | 94.7%                              | 95.6% |
| Acquired Properties        | N/A                                 | N/A   | 91.8%                              | 98.1% |

|                            | Average Monthly Net Collected Rent Per Unit |          |                                    |          |
|----------------------------|---|----------|------------------------------------|----------|
|                            | Three Months Ended<br>September 30,         |          | Nine Months Ended<br>September 30, |          |
|                            | 2009  | 2008     | 2009                               | 2008     |
| Same Community Properties: |   |          |                                    |          |
| Midwest                    | \$ 790                                      | \$ 792   | \$ 785                             | \$ 775   |
| Mid-Atlantic               | \$ 1,165                                    | \$ 1,169 | \$ 1,260                           | \$ 1,240 |
| Southeast                  | \$ 880                                      | \$ 947   | \$ 876                             | \$ 946   |
| Total Same Community       | \$ 858                                      | \$ 876   | \$ 847                             | \$ 856   |
| Acquired Properties        | N/A   | N/A      | \$ 988                             | \$ 1,014 |

The following table presents property revenue results:

|                            | Three Months Ended September 30, |                  |                         | Nine Months Ended September 30, |                  |                         |
|----------------------------|----------------------------------|------------------|-------------------------|---------------------------------|------------------|-------------------------|
|                            | 2009                             | 2008             | Increase/<br>(Decrease) | 2009                            | 2008             | Increase/<br>(Decrease) |
| <i>(In thousands)</i>      | Property Revenue                 | Property Revenue |                         | Property Revenue                | Property Revenue |                         |
| Same Community Properties: |                                  |                  |                         |                                 |                  |                         |
| Midwest                    | \$ 18,860                        | \$ 18,910        | \$ (50)                 | \$ 56,181                       | \$ 55,463        | \$ 718                  |
| Mid-Atlantic               | 5,288                            | 5,412            | (124)                   | 10,838                          | 10,604           | 234                     |
| Southeast                  | 8,107                            | 8,755            | (648)                   | 24,196                          | 26,197           | (2,001)                 |
| Total Same Community       | 32,255                           | 33,077           | (822)                   | 91,215                          | 92,264           | (1,049)                 |
| Acquired Properties        | -                                | -                | -                       | 5,002                           | 3,203            | 1,799                   |
| Total Property Revenue     | \$ 32,255                        | \$ 33,077        | \$ (822)                | \$ 96,217                       | \$ 95,467        | \$ 750                  |

The slight decrease in property revenue for the Midwest portfolio during the three month comparison period is primarily due to an increase in vacancy losses, while net rents remained constant. The increase in property revenue for the Midwest portfolio during the nine month comparison period is primarily a result of an increase in net rents while vacancy losses remained consistent. Property revenue in the Mid-Atlantic properties increased during the nine month comparison period primarily due to net rent increases which were partially offset by an increase in the amount of vacancy losses; however, during the three month comparison period vacancy losses were greater than net rent increases resulting in a reduction in property revenue. Property revenue for the Southeast portfolio decreased during 2009 in both comparison periods primarily due to reductions in net rent and increases in the amount of vacancy losses.

*Property operating and maintenance expenses.* Property operating and maintenance expenses decreased in 2009 during the three month comparison period primarily as a result of reductions in repairs and maintenance expenses. Property operating and maintenance expenses increased in 2009 for the nine comparison period primarily as a result of increases in personnel and utilities expenses related to the properties acquired in 2008.

*Depreciation and amortization.* Depreciation and amortization expense decreased during both comparison periods primarily due to a decrease in amortization of intangible assets in 2009 related to properties acquired in 2008 that are now fully amortized.

*Interest expense.* Interest expense decreased in 2009 during the nine month comparison period primarily due to the receipt in the first quarter of 2009 of refunds totaling \$563,000 in defeasance costs in connection with certain previously defeased loans and decreased interest expense of \$200,000 for borrowings on our revolver.

*Income from Discontinued Operations.* Discontinued operations include the operating results and gains related to the sales of two properties sold in 2009 and 15 properties that were sold during 2008. Defeasance/prepayment costs recognized in 2008 totaling \$2.0 million were included in discontinued operations. For further details on "Income from discontinued operations," see Note 2 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 9 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**

We are exposed to interest rate changes associated with variable rate debt and the refinancing risk on our fixed-rate debt. Based on our variable rate debt outstanding at September 30, 2009 and 2008, an interest rate change of 100 basis points would impact interest expense approximately \$470,000 and \$495,000 on an annual basis, respectively. We occasionally use derivative instruments to manage our exposure to interest rates. See Note 1 of the Notes to Consolidated Financial Statements presented in Part I, Item 1 of this report on Form 10-Q for additional information regarding derivative instruments and "Item 7A Qualitative and Quantitative Disclosures About Market Risk" of our Annual Report on Form 10-K for the year ended December 31, 2008, 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 operations 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 (i) recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) accumulated and communicated to management, including the principal executive and principal financial officers, as appropriate, to allow timely decisions regarding disclosure.



*Changes in Internal Control over Financial Reporting.* There were no changes in our internal control over financial reporting during the third quarter of 2009 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.

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

For information related to legal proceedings, see Note 9 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 Annual Report on Form 10-K for the year ended December 31, 2008.

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

Issuer Purchases of Equity Securities for the Three Months Ended September 30, 2009

| Period                           | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased As Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs (in thousands) |
|----------------------------------|----------------------------------|------------------------------|--|---|
| July 1 through July 31           | -                                | \$ -                         | -  | \$ 26,288   |
| August 1 through August 31       | 107                              | 8.15                         | -  | 26,288  |
| September 1 through September 30 | 3                                | 8.77                         | -  | 26,288  |
| Total                            | 110                              | \$ 8.17                      | -  |   |

In December 2008, our Board of Directors authorized the repurchase of up to \$25.0 million of our common and/or preferred shares. This authorization is in addition to the \$1.3 million remaining on our \$50.0 million authorization, which was originally approved by our Board of Directors in July 2005 and October 2006. Additionally, we have a policy, which allows employees to pay their portion of the income taxes related to restricted share vesting by surrendering a number of shares to us equal in value on the day of vesting to the amount of taxes due up to the minimum statutory withholding amount.

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### ITEM 6. EXHIBITS

| Number | Title  | Filed herewith or incorporated herein by reference |
|--------|--|--|
| 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.   | Exhibit 3.2 to Form 10-Q filed July 31, 2007.      |
| 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 4.1 to Form 10-Q filed herewith.           |
| 4.1a   | Amended and Restated Shareholders Rights Agreement dated December 30, 2008.  | Exhibit 4.1 to Form 8-K filed December 30, 2008.   |
| 4.2    | Specimen 8.70% Class B Series II Cumulative Redeemable Preferred Shares.   | Exhibit 4.2 to Form 10-Q filed herewith.           |
| 4.2a   | Specimen Depositary Share representing 1/10 of one share of 8.70% Class B Series II Cumulative Redeemable Preferred Shares.  | Exhibit 4.2a to Form 10-Q filed herewith.          |
| 4.3    | Deposit Agreement by and among Associated Estates Realty Corporation and National City Bank and Depositary Receipts.   | Exhibit 4.5 to Form 8-A filed December 8, 2004.    |
| 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.    |
| 4.13   | Credit Agreement Dated As of April 24, 2007 among Associated Estates Realty Corporation, as Borrower and National City Bank as Administrative Agent, Lead Arranger, and Book Manager and The Several Lenders From Time to Time Parties Hereto, as Lenders.   | Exhibit 4.13 to Form 10-Q filed July 31, 2007.     |
| 4.15   | First Amendment to Credit Agreement dated March 20, 2008 by and among Associated Estates Realty Corporation (the Borrower), National City Bank and other banks and financial institutions (the Lenders) and National City Bank (the Administrative Agent).   | Exhibit 4.15 to Form 10-Q filed May 6, 2008.       |
| 4.16   | Joinder to Subsidiary Guaranty dated March 20, 2008 for the benefit of National City Bank, as agent for itself and certain other lenders, with respect to a loan from the Lenders to Associated Estates Realty Corporation.  | Exhibit 4.16 to Form 10-Q filed May 6, 2008.       |
|        | <p>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 agreements to the Commission upon its request.</p> <p>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.</p> |  |
| 10     | Associated Estates Realty Corporation Directors' Deferred Compensation Plan.   | Exhibit 10 to Form 10-Q filed November 14, 1996.   |



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| Number | Title  | Filed herewith or<br>incorporated herein<br>by reference                          |
|--------|--|---|
| 10a    | Associated Estates Realty Corporation Directors' Deferred Compensation Plan (January 1, 2005 Restatement).   | Exhibit 10a to Form 10-K filed February 25, 2009.                                 |
| 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 by and among the Company and its Independent Directors.   | Exhibit 10.9 to Form 10-K filed March 28, 1996.                                   |
| 10.5   | Form of Indemnification Agreement.   | Exhibit 4.2 to Form S-11 filed September 2, 1993 (File No. 33-68276 as amended).  |
| 10.6   | Amended 2008 Equity-Based Award Plan.  | Exhibit 10.1 to Form 8-K filed May 13, 2008.                                      |
| 10.7   | Amendment to Associated Estates Realty Corporation 2008 Equity-Based Award Plan.   | Exhibit 10.7 to Form 10-K filed February 25, 2009.                                |
| 10.7a  | Amendment to Associated Estates Realty Corporation Amended and Restated Equity-Based Award Plan.   | Exhibit 10.7a to Form 10-K filed February 25, 2009.                               |
| 10.7b  | Associated Estates Realty Corporation Supplemental Executive Retirement Plan (Restated).   | Exhibit 10.7b to Form 10-K filed February 25, 2009.                               |
| 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.                                  |
| 10.10  | 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.                                |
| 10.13  | Associated Estates Realty Corporation Elective Deferred Compensation Plan.   | Exhibit 10.13 to Form 10-Q filed July 31, 2007.                                   |
| 10.14  | Agreement of Purchase and Sale dated August 31, 2007 between River Forest Properties, LLC, and Associated Estates Realty Corporation.  | Exhibit 10.14 to Form 10-Q filed August 5, 2008.                                  |
| 10.15  | Agreement of Purchase and Sale dated August 31, 2007 between Belvedere Properties, LLC, and Associated Estates Realty Corporation.   | Exhibit 10.15 to Form 10-Q filed August 5, 2008.                                  |
| 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.   |



**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

November 3, 2009  
(Date)

/s/ Lou Fatica  
Lou Fatica, Vice President  
Chief Financial Officer and Treasurer