

PRICE LEGACY CORP  
Form 10-Q  
November 13, 2002

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

**For the quarter ended September 30, 2002**

**Commission File Number 0-20449**

**PRICE LEGACY CORPORATION**

(Exact name of registrant as specified in its charter)

|                                                                            |                                         |
|----------------------------------------------------------------------------|-----------------------------------------|
| <b>Maryland</b>                                                            | <b>33-0628740</b>                       |
| (State or other jurisdiction of<br>incorporation or organization)          | (I.R.S. Employer<br>Identification No.) |
| <b>17140 Bernardo Center Drive, Suite 300, San Diego, California 92128</b> |                                         |
| (Address of principal executive offices)                                   | (Zip Code)                              |

**(858) 675-9400**

(Registrant's telephone number, including area code)

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

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

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**PRICE LEGACY CORPORATION  
INDEX TO FORM 10-Q**

**PART I FINANCIAL INFORMATION**

3

**ITEM 1 FINANCIAL STATEMENTS**

3

|                                                                                                     |    |
|-----------------------------------------------------------------------------------------------------|----|
| CONSOLIDATED BALANCE SHEETS                                                                         | 3  |
| CONSOLIDATED STATEMENTS OF INCOME                                                                   | 4  |
| CONSOLIDATED STATEMENTS OF CASH FLOWS                                                               | 5  |
| NOTES TO CONSOLIDATED FINANCIAL STATEMENTS                                                          | 7  |
| <b>ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</b> | 22 |
| <b>ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</b>                            | 33 |
| <b>ITEM 4 CONTROLS AND PROCEDURES</b>                                                               | 34 |
| <b>PART II OTHER INFORMATION</b>                                                                    | 35 |
| <b>ITEM 1 LEGAL PROCEEDINGS</b>                                                                     | 35 |
| <b>ITEM 6 EXHIBITS AND REPORTS ON FORM 8-K</b>                                                      | 35 |

## PART I FINANCIAL INFORMATION

## ITEM 1 FINANCIAL STATEMENTS

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

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

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

See accompanying notes.

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

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

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

See accompanying notes.

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

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

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

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

Year-to-Date  
Nine Months Ended  
September 30

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

## PRICE LEGACY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)

September 30, 2002

**Note 1 Organization and Significant Accounting Policies****Organization**

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

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

**Accounting Principles**

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

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

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

### *Real Estate Assets and Depreciation*

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

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

7

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

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

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

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

### *Cash and Cash Equivalents*

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

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

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

### *Investment in Securities*

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

duration and extent, as well as reasons for which the market value has been less than cost

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financial condition and near-term prospects of the investee, which includes consideration of proposed transactions known through Board of Directors participation

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

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

8

### *Comprehensive Income*

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

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

### *Use of Estimates*

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

### *Derivative Financial Instruments*

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

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

9

### *Asset Disposal*

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

### *New Accounting Standards*

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

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

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

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

### **Note 2 Merger and Significant Event**

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

10

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

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

|                                                            |            |
|------------------------------------------------------------|------------|
| Shares issued                                              | 40,376     |
| Price per share                                            | \$ 4.89    |
|                                                            | <hr/>      |
|                                                            | 197,439    |
| Merger related accounting, legal, printing and other costs | 1,425      |
|                                                            | <hr/>      |
| Purchase price                                             | \$ 198,864 |

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

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

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

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

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

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

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

11

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

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

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

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

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

12

### Note 3 Net Income Per Share

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

|                                                       | Three Months Ended September |            | Nine Months Ended September |            |
|-------------------------------------------------------|------------------------------|------------|-----------------------------|------------|
|                                                       | 2002                         | 2001       | 2002                        | 2001       |
| Weighted average shares outstanding                   | 39,167,431                   | 16,698,123 | 40,201,106                  | 14,451,126 |
| Effect of dilutive securities:                        |                              |            |                             |            |
| Employee stock options                                | 157,399                      |            | 241,111                     |            |
| Weighted average shares outstanding assuming dilution | 39,324,830                   | 16,698,123 | 40,442,217                  | 14,451,126 |

There are 19,666,754 shares of Series B Preferred Stock outstanding and 1,900,510 shares payable as a dividend at September 30, 2002, which may be exchanged on a one-to-one basis into common stock, subject to adjustment, after September 18, 2003 if certain events occur.

### Note 4 Real Estate Assets

#### Acquisitions

During the first nine months of 2002, we acquired the following properties:

| Location            | Description     | Date Acquired | Purchase Price (000's) | Mortgage (000's) |
|---------------------|-----------------|---------------|------------------------|------------------|
| Ocala, FL           | Shopping Center | 5/3/02        | \$ 7,163               | \$               |
| Fort Lauderdale, FL | Pad             | 6/4/02        | 700                    |                  |
| Phoenix, AZ         | Shopping Center | 6/6/02        | 9,816                  | 5,787(1)         |
| Columbia, SC (1)    | Shopping Center | 6/7/02        | 8,035                  |                  |
| Greenville, SC      | Shopping Center | 6/28/02       | 29,500                 |                  |
| Sterling, VA (2)    | Shopping Center | 8/30/02       | 76,192                 | 49,500(2)        |

(1) Mortgage assumed

(2) Amount financed with purchase

We funded these acquisitions using proceeds from tax-deferred exchange transactions on properties we sold in 2001 and 2002, by mortgage financing, by borrowing on our unsecured line of credit, and assuming mortgages.

13

During the first nine months of 2001, we acquired the following properties:

| Location           | Description     | Date Acquired | Purchase Price (000's) | Mortgage Assumed (000's) |
|--------------------|-----------------|---------------|------------------------|--------------------------|
| Walnut Creek, CA   | Land            | 1/4/01        | \$ 2,816               | \$                       |
| Anaheim, CA        | Land            | 1/29/01       | 23,288                 |                          |
| Tempe, AZ          | Shopping Center | 5/18/01       | 23,914                 | 14,137                   |
| Mesa, AZ           | Shopping Center | 5/18/01       | 31,367                 | 21,360                   |
| Greensburg, IN (1) | Shopping Center | 6/28/01       | 19,300                 | 18,300                   |

(1) Capital Lease

We funded these acquisitions using the proceeds from tax-deferred exchange transactions on properties we sold in 2000 and by assuming mortgages.

#### Dispositions

During the first nine months of 2002, we sold the following properties for a net gain of \$9.4 million:

| Location                        | Description              | Date Sold | Sales Price (000's) |
|---------------------------------|--------------------------|-----------|---------------------|
| Hollywood, FL                   | Land                     | 1/31/02   | \$ 1,410            |
| Tucson/Marana, AZ               | Land                     | 1/31/02   | 684                 |
| Hollywood, FL                   | Land                     | 4/19/02   | 1,028               |
| San Diego/Pacific Beach, CA (1) | Self Storage Development | 6/1/02    | 11,632              |
| Walnut Creek, CA (1)            | Self Storage Development | 6/1/02    | 7,708               |
| San Juan Capistrano, CA (1)     | Self Storage Development | 6/1/02    | 6,918               |
| Glen Burnie, MD                 | Shopping Center          | 6/21/02   | 15,200              |
| San Diego/Murphy Canyon, CA     | Self Storage             | 8/29/02   | 29,688              |
| Solana Beach, CA                | Self Storage             | 8/29/02   | 16,282              |
| Azusa, CA                       | Self Storage             | 9/30/02   | 6,537               |

(1) Our equity in the development was exchanged for notes receivable with a participating interest

During the first nine months of 2001, we sold the following properties for a net gain of \$1.3 million:

| Location | Description | Date Sold | Sales Price (000's) |
|----------|-------------|-----------|---------------------|
|----------|-------------|-----------|---------------------|

|                         |                 |         |          |
|-------------------------|-----------------|---------|----------|
| Aurora, CO              | Retail Building | 1/11/01 | \$ 1,592 |
| Sacramento/Bradshaw, CA | Office Building | 6/1/01  | 5,125    |
| San Diego/Southeast, CA | Retail Building | 9/5/01  | 1,680    |

We used the proceeds from the sale of properties to purchase additional properties in tax-deferred exchange transactions.

#### ***Destination Villages LLC***

We own a 55% interest in Destination Villages LLC. Destination Villages, LLC owns a Bermuda limited liability company that owns a hospitality project located in Bermuda, Daniel's Head Village

Resort (Daniel's Head). Daniel's Head was closed in the fourth quarter of 2001, primarily due to low occupancy rates as a result of the terrorist events in the United States that occurred on September 11, 2001. The project was encumbered by a \$6.0 million loan with a Bermuda bank. In March 2002, we informed the Bermuda bank that we did not intend to reopen this project due to large projected operating losses and instead intended to sell the project to an identified buyer. This resulted in a default of the loan. On March 27, 2002, the Bermuda bank exercised its rights under Bermuda law and put the project in "receivership", which gives the bank the right to negotiate directly with this buyer as well as other potential buyers. We no longer have involvement in the operations of Daniel's Head and it is not included in our consolidated financial statements. For additional information on Daniel's Head, please refer to "Item 1 Legal Proceedings" located elsewhere in this Form 10-Q.

#### **Note 5 Asset Impairment**

We record real estate assets at historical costs and adjust them for recognition of impairment losses. During the second quarter ended June 30, 2002, we recognized an impairment loss of \$2.5 million on our Inglewood, CA property. The tenant, House 2 Home, filed for bankruptcy and vacated, and the property is no longer generating income. The loss was determined based on the estimated fair value of the property.

#### **Note 6 Discontinued Operations**

Included in the Consolidated Statements of Operations are the discontinued operations of our property at Glen Burnie, MD, and our self storage properties in San Diego/Murphy Canyon, CA, Solana Beach, CA and Azusa, CA which were sold during the year. Discontinued operations are summarized as follows (amounts in thousands):

|                                 | Third Quarter<br>Three Months Ended<br>September 30 |          | Year-to-Date<br>Nine Months Ended<br>September 30 |          |
|---------------------------------|-----------------------------------------------------|----------|---------------------------------------------------|----------|
|                                 | 2002                                                | 2001     | 2002                                              | 2001     |
| Rental revenue                  | \$ 858                                              | \$ 1,790 | \$ 4,306                                          | 5,532    |
| Expenses                        |                                                     |          |                                                   |          |
| Operating and maintenance       | 5                                                   | 46       | 124                                               | 663      |
| Property taxes                  | 3                                                   | 40       | 108                                               | 258      |
| Depreciation and amortization   | 164                                                 | 312      | 796                                               | 936      |
| Interest expense                | 129                                                 | 196      | 519                                               | 589      |
|                                 | 301                                                 | 594      | 1,547                                             | 2,446    |
| Income from operations          | 557                                                 | 1,196    | 2,759                                             | 3,086    |
| Net gain on sale of real estate | 9,991                                               |          | 9,148                                             |          |
| Net income                      | \$ 10,548                                           | \$ 1,196 | \$ 11,907                                         | \$ 3,086 |

**Note 7 Investments in Unconsolidated Real Estate Joint Ventures**

As of September 30, 2002 and December 31, 2001, we had the following investments in unconsolidated joint ventures, which we account for under the equity method of accounting (amounts in thousands):

| Joint Venture                | Ownership % | September 30<br>2002 | December 31<br>2001 |
|------------------------------|-------------|----------------------|---------------------|
| Orlando Business Park LLC    | 50%         | \$ 16,020            | \$ 16,000           |
| Old Mill District Shops, LLC | 50%         | 3,383                | 3,340               |
| 3017977 Nova Scotia Company  | 55%         | 3,148                | 2,822               |
| Blackstone Ventures I        | 50%         | 2,578                | 2,288               |
| Other                        | Various     | 277                  | 378                 |
| Total                        |             | \$ 25,406            | \$ 24,828           |

Cash distributions and profits are typically allocated based on the above ownership percentages, adjusted for certain preferred returns for capital contributions which are made in excess of each partners' ownership percentages. The Orlando Business Park LLC assets consist primarily of land held for sale. The other joint ventures are primarily in the business of operating real estate. Their accounting principles are consistent with ours.

Summarized unaudited financial information for the joint ventures is as follows (amounts in thousands):

| As of                           | Total Assets         |                     | Debt                 |                     | Total Equity         |                     |
|---------------------------------|----------------------|---------------------|----------------------|---------------------|----------------------|---------------------|
|                                 | September 30<br>2002 | December 31<br>2001 | September 30<br>2002 | December 31<br>2001 | September 30<br>2002 | December 31<br>2001 |
|                                 | (Unaudited)          |                     |                      |                     |                      |                     |
| Orlando Business Park LLC (1)   | \$ 26,432            | \$ 26,069           | \$ 10,937            | \$ 10,136           | \$ 15,445            | \$ 15,879           |
| Old Mill District Shops, LLC    | 24,007               | 23,300              | 17,939               | 17,243              | 5,817                | 5,976               |
| 3017977 Nova Scotia Company (1) | 6,382                | 6,775               | 5,123                | 5,499               | 1,116                | 1,115               |
| Blackstone Ventures I           | 11,135               | 11,075              | 8,797                | 8,153               | 2,167                | 2,721               |
| Other (1)                       | 277                  | 378                 |                      |                     | 277                  | 378                 |
|                                 | \$ 68,233            | \$ 67,597           | \$ 42,796            | \$ 41,031           | \$ 24,822            | \$ 26,069           |

| Quarter ended September 30      | Total Revenues |       | Net Income (Loss) |       | Company's Share of Net Income (Loss) |      |
|---------------------------------|----------------|-------|-------------------|-------|--------------------------------------|------|
|                                 | 2002           | 2001  | 2002              | 2001  | 2002                                 | 2001 |
|                                 | (Unaudited)    |       |                   |       |                                      |      |
| Orlando Business Park LLC (1)   | \$             | \$    | N/A               | \$    | N/A                                  | \$   |
| Old Mill District Shops, LLC    | 646            | 131   | (338)             | (103) | (169)                                | (42) |
| 3017977 Nova Scotia Company (1) | 387            | N/A   | 24                | N/A   | 13                                   | N/A  |
| Blackstone Ventures I           | 320            | 372   | 490               | 19    | 474                                  | 71   |
| Other (1)                       |                | N/A   |                   | N/A   |                                      | N/A  |
| Westcol Center, LLC (2)         | N/A            | 1,151 | N/A               | 351   | N/A                                  | 175  |

|  |    |       |    |       | Company's Share of<br>Net<br>Income (Loss) |
|--|----|-------|----|-------|--------------------------------------------|
|  | \$ | 1,353 | \$ | 1,654 | \$ 176                                     |
|  | \$ |       | \$ | 267   | \$ 218                                     |
|  |    |       |    |       | \$ 204                                     |

- (1) Joint ventures acquired from Excel Legacy in the Merger.
- (2) We sold our 50% share of this joint venture in December 2001 for \$13.5 million and recognized no gain or loss on the sale.

16

## Note 8 Notes Receivable

We had \$52.2 million in notes receivable outstanding at September 30, 2002 related to various projects. The notes bear interest ranging from 9.5% to 15.0% per year and are collateralized by the related projects or other real estate. Of these notes, \$47.2 million involve entities controlled by one individual. Repayment of the notes is anticipated to occur from the completion of various development projects or other events. The largest note is for approximately \$22.8 million related to a development project in Scottsdale, AZ. The remaining notes are each less than \$10.0 million. The notes do not require cash payments on the interest until specified future dates, typically when the projects are completed or sold. The notes mature on various dates between 2002 and the earlier of the sale of the related projects, or 2003 to 2004. We also have \$12.3 million in notes receivable related to the sale of our self storage development properties. These notes bear interest at 12% per year and are due May 1, 2003 or earlier, depending on stabilization of the properties. We do not recognize interest income on notes secured by development projects until the projects begin operations.

17

## Note 9 Debt

### Mortgages and Notes Payable

We had the following mortgages and notes payable outstanding at September 30, 2002 and December 31, 2001 (amounts in thousands):

|                                                                                                                                                                                                                                          | September 30<br>2002 | December 31<br>2001 |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------|---------------------|
| Mortgages on five properties in Florida bearing fixed rates of interest ranging from 8.18% to 9.00%. The loans are collateralized by the properties and mature February 2009 and January 2010                                            | \$ 160,513           | \$ 161,517          |
| Mortgage payable bearing interest at LIBOR plus 98 basis points (2.79% at September 30, 2002). The mortgage is collateralized by five of our properties and matures June 2004                                                            | 121,375              | 121,375             |
| Mortgages and notes payable on nine properties bearing interest ranging from 3.93% to 9.00%. The loans are collateralized by the properties and mature on various dates between April 2003 and February 2017                             | 102,619              | 62,928              |
| Revolving \$100.0 million credit facility bearing interest at LIBOR plus 188 basis points (3.69% at September 30, 2002), maturing September 2004                                                                                         | 61,000               | 31,500              |
| Construction loan outstanding on a \$46.0 million facility bearing interest at LIBOR plus 310 basis points (4.91% at September 30, 2002). The loan is due December 2002 and collateralized by a retail center in Newport, KY (see below) | 38,500               | 26,706              |
| Capital lease arrangements with an individual on three properties. The capital leases have effective interest rates ranging from 4.02% to 7.77% and mature on various dates between June 2004 and June 2005                              | 34,032               | 29,872              |
|                                                                                                                                                                                                                                          | 21,945               | 21,675              |

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|                                                                                                                                                                                                                                                                                  | September 30<br>2002 | December 31<br>2001 |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------|---------------------|
| Mortgage on a property in Orlando, FL bearing interest at LIBOR plus 225 basis points (4.06% at September 30, 2002). The loan is collateralized by the property and matures April 2003                                                                                           |                      |                     |
| Note payable collateralized by IMAX equipment, without recourse, no interest. The note is due on demand                                                                                                                                                                          | 5,451                | 5,451               |
| Convertible Debentures and Senior Notes (see below)                                                                                                                                                                                                                              | 5,091                | 5,095               |
| Note payable outstanding on a \$4.7 million facility related to Newport, KY (see below), bearing interest at Prime plus 50 basis points (5.25% at September 30, 2002), due March 2003                                                                                            | 4,737                | 4,737               |
| Construction loans payable to a bank bearing interest at a 90-day LIBOR rate plus 275 basis points. The developments were sold and the loans of \$14.2 million were assumed by a third party in May 2002, but we remain a guarantor on the loans until they mature in April 2003 |                      | 7,167               |
| Note payable to an individual bearing interest at 12.50%, repaid April 2002                                                                                                                                                                                                      |                      | 6,000               |
| <b>Total</b>                                                                                                                                                                                                                                                                     | <b>\$ 555,263</b>    | <b>\$ 484,023</b>   |

We have a 69% interest in Newport on the Levee, LLC (Newport) that is developing a retail project in Newport, KY, of which the majority of construction was completed in October 2001. In addition to the \$38.5 million, \$4.7 million and \$5.5 million notes in the above table, the City of Newport has issued two series of public improvement bonds. The Series 2000a tax exempt bonds total \$44.2 million and are broken down as follows: (a) \$18.7 million maturing 2018 with interest at 8.375%; (b) \$20.5 million maturing 2027 with interest at 8.5%; and (c) \$5.0 million maturing 2027 with interest at 8.375%. The Series 2000b bonds are taxable and have a par amount of \$11.6 million with interest at

18

11% due 2009. The bonds are guaranteed by us, by Newport, and the third party co-developers of the project. Newport has drawn on \$43.7 million of the bonds at September 30, 2002.

Summarized debt information for our unconsolidated joint ventures and the amount guaranteed by us at September 30, 2002 was as follows:

| Joint Venture                | September 30<br>2002 | Debt<br>Guaranteed |
|------------------------------|----------------------|--------------------|
| Orlando Business Park, LLC   | \$ 10,937            | \$ 10,937          |
| Old Mill District Shops, LLC | 17,939               | 14,401             |
| Blackstone Ventures I        | 8,797                | 8,797              |
| 3017977 Nova Scotia Company  | 5,123                | 5,123              |
|                              | <b>\$ 42,796</b>     | <b>\$ 39,258</b>   |

We also have guaranteed a \$12.8 million note payable related to a development project in Scottsdale, AZ in which we have a \$22.8 million note receivable with a participating interest.

In connection with the sale of three self storage development properties in June 2002, we agreed to guarantee \$14.2 million of debt the buyer assumed associated with the properties until April 2003, when the debt matures.

#### Convertible Debentures

Prior to the Merger, Excel Legacy had \$33.2 million in convertible debentures outstanding. As part of the Merger, \$30.4 million of the debentures were exchanged for Series A Preferred Stock, with \$2.8 million of debentures remaining. We redeemed the debentures in full in October 2002.

**Senior Notes**

Prior to the Merger, Excel Legacy had \$18.1 million in senior notes outstanding. As part of the Merger, \$15.8 million of the notes were exchanged for Series A Preferred Stock, with \$2.3 million of notes remaining. We redeemed the notes in full in October 2002.

**Note 10 Financial Instruments: Derivatives and Hedging**

In the normal course of business, we are exposed to the effect of changes in interest rates. We limit these risks by following established risk management policies and procedures including the use of derivatives. For interest rate exposures, derivatives are used primarily to manage the cost of borrowing obligations.

We have a policy of only entering into derivative 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 those instruments nor do we anticipate any material adverse effect on our net income or financial position in the future from the use of derivatives.

To manage interest rate risk, we may employ options, forwards, swaps, caps and floors, or a combination thereof, depending on the underlying exposure. We undertake a variety of borrowings from lines of credit to medium and long-term financings. To manage overall costs, we currently use derivative instruments to cap our exposure to variability in interest rates or to convert a portion of our variable-rate debt to fixed-rate debt. In July 2002, we paid \$3.4 million for forward-starting, LIBOR-based interest rate caps with a combined notional value of \$152 million and a strike of 7.0% to cap our

19

exposure to interest rate variability on anticipated floating-rate debt. The interest rate caps are effective July 1, 2004, and continue through 2009 to 2010.

We also use derivatives to protect the fair value of existing or anticipated fixed-rate debt. As of September 30, 2002, we had five amortizing swaps with approximately \$161 million current notional value protecting the fair value of approximately \$161 million fixed-rate debt from changes in value attributable to interest rate movement. In October 2002, we sold our five Interest Rate Swap Agreements back to the counter party for \$13.8 million and will amortize the gain over the fixed-rate debt's remaining life through 2009 to 2010.

The following table summarizes the notional values and fair values of our derivative financial instruments. The notional value at September 30, 2002 provides an indication of the extent of our involvement in these instruments at that time, but does not represent exposure to credit, interest rate, or market risk. The fixed rates shown below include spreads of 3.08% for the swaps maturing in 2009 and 3.77% for the swap maturing in 2010.

**At September 30, 2002**

| <b>Hedge Type</b> | <b>Current Notional Value (\$000's)</b> | <b>Fixed Rate</b> | <b>Maturity</b> | <b>Fair Value (\$000's)</b> |
|-------------------|-----------------------------------------|-------------------|-----------------|-----------------------------|
| Swap Fair Value   | \$ 66,383                               | 8.180%            | 2/1/2009        | \$ 5,973                    |
| Swap Fair Value   | 32,203                                  | 9.000%            | 1/4/2010        | 3,116                       |
| Swap Fair Value   | 28,856                                  | 8.180%            | 2/1/2009        | 2,597                       |
| Swap Fair Value   | 23,247                                  | 8.180%            | 2/1/2009        | 2,092                       |
| Swap Fair Value   | 10,142                                  | 8.180%            | 2/1/2009        | 938                         |
| Cap Cash Flow     | 120,000                                 | 7.000%            | 2/1/2009        | 1,825                       |
| Cap Cash Flow     | 32,000                                  | 7.000%            | 1/1/2010        | 671                         |

On September 30, 2002, the derivative instruments were reported at their fair value of \$17.2 million in Other Assets.

Hedges that are designated as fair value hedges mitigate risk on changes in the fair value of fixed-rate debt. The unrealized gains/losses in the fair value of these hedges are reported in earnings with an offsetting adjustment through earnings to the carrying value of the hedged debt. Adjustments to the carrying value of the hedged debt are amortized to earnings beginning no later than when the hedged debt ceases to be adjusted for changes in its fair value attributable to the interest rate risk being hedged.

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Cash Flow hedges hedge the future cash outflows of current or forecasted debt. Interest rate caps protect against variability in interest cash outflows above the cap strike rate. The changes in the fair value of these hedges are reported on the balance sheet with a corresponding adjustment to either Accumulated Other Comprehensive Income or in earnings depending on the hedging relationship. Unrealized gains and losses held in Accumulated Other Comprehensive Income will be reclassified to earnings in the same period or periods that the hedged cash flows affect earnings. As of September 30, 2002, the balance in Accumulated Other Comprehensive Loss relating to derivatives was \$0.9 million. Within the next twelve months, we do not expect to reclassify any of this balance to earnings as the caps are forward starting and take effect July 1, 2004.

We hedge our exposure to the variability in future cash flows for forecasted transactions other than interest-related cash flows over a maximum period of 12 months. During the forecasted period, unrealized gains and losses in the hedging instrument will be reported in Accumulated Other Comprehensive Income. Once the hedged transaction takes place, the hedge gains and losses will be reported in earnings during the same period in which the hedged item is recognized in earnings. We

20

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are not currently hedging exposure to variability in future cash flows for forecasted transactions other than interest-related cash flows on future anticipated debt.

### **Note 11 Related Party Transactions**

In connection with the Merger, we acquired \$9.4 million in notes receivable from certain officers and affiliates of Excel Legacy, which are due March 2003. The notes are collateralized by approximately 2.9 million shares of our common stock. In the third quarter of 2002, the market value of these shares was less than the amounts due on the notes. The Sarbanes-Oxley Act of 2002, issued in the third quarter, prohibits any material changes to notes receivable from officers. As a result of these events and discussions related to the eventual disposition of the notes, we have applied Emerging Issues Task Force (EITF) 00-23, "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44" issued in 2002. EITF 00-23 requires accounting as if the shares had been repurchased and treated as treasury shares, with a corresponding issuance of a new stock option. The impact of EITF 00-23 on our third quarter financial statements was as follows:

we retired the notes receivable from officers and the 2.9 million shares securing the notes at the current market value in the third quarter of 2002. The shares collateralizing the notes are now treated as treasury stock and

we recorded a one-time non-cash charge of \$2.8 million in compensation expense to record the difference between the note's book value and the value of the shares

The above only impacts our accounting records. Legally, the notes and shares remain outstanding until the notes are repaid or otherwise settled. The 2.9 million shares are treated similar to stock options and are accounted for under variable option plan accounting in accordance with APB No. 25. This valuation had no impact on our financial statements for the third quarter of 2002.

Prior to the Merger, Excel Legacy was responsible for the daily management of PEI, including property management, finance and administration. We reimbursed Excel Legacy for these services based on our historical costs for similar expenses. We expensed \$0.7 million for these services during the third quarter of 2001 and \$2.4 million for the nine month year-to-date period of 2001.

Prior to the Merger, we executed a note receivable with Excel Legacy allowing them to borrow up to \$40.0 million. During the third quarter of 2001 we recorded \$0.9 million in interest income on this note, and \$2.9 million for the nine month year-to-date period of 2001. As a result of the Merger, interest income is no longer recorded on this note.

In connection with the San Diego/Rancho Bernardo, CA office building purchased from Excel Legacy, we leased the building back to Excel Legacy under a 10-year lease agreement. We recorded \$0.3 million of rental revenue from Excel Legacy in connection with this lease during the third quarter of 2001, and \$1.1 million for the nine months year-to-date period of 2001. Due to the Merger, rental revenue is no longer recorded on this lease.

In connection with the purchase of the Anaheim land in the first quarter of 2001, we executed a ground lease agreement with Excel Legacy. The lease has a term of 50 years and requires payments of \$2.8 million per year in rent. During the third quarter of 2001, we recorded \$0.6 million in rental revenue from Excel Legacy related to this lease, and \$1.8 million for the nine month year-to-date period of 2001. Due to the Merger, rental revenue is no longer recorded on this lease.

We discuss other related party transactions in Note 2.

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

### *Introduction*

This report on Form 10-Q contains certain "forward-looking" statements within the meaning of the Private Securities Litigation Reform Act of 1995 which provides a "safe harbor" for these types of statements. You can identify these forward-looking statements by forward-looking words such as "believe," "may," "could," "will," "estimate," "continue," "anticipate," "intend," "seek," "plan," "expect," "should," "would" and similar expressions in this report on Form 10-Q. These forward-looking statements are subject to a number of risks, uncertainties and assumptions about Price Legacy, including, among other things:

the effect of economic, credit and capital market conditions in general and on real estate companies in particular, including changes in interest rates

our ability to compete effectively

developments in the retail industry

the financial stability of our tenants, including our reliance on major tenants

our ability to successfully complete real estate acquisitions, developments and dispositions

our ability to achieve the expected benefits of our merger with Excel Legacy Corporation

government approvals, actions and initiatives, including the need for compliance with environmental requirements

our ability to continue to qualify as a real estate investment trust, or REIT

The factors identified above are believed to be some, but not all, of the important factors that could cause actual events and results to be significantly different from those that may be expressed or implied in any forward-looking statements. Any forward-looking statements should also be considered in light of the information provided in "Factors That May Affect Future Performance" located in our Form 10-K filing for the 2001 fiscal year. We assume no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. You are advised, however, to consult any further disclosures we make on related subjects in our reports on Forms 10-K, 10-Q and 8-K filed with the SEC. Our Form 10-K filing for the 2001 fiscal year listed various important factors that could cause actual results to differ materially from expected and historic results.

In Management's Discussion and Analysis we explain our general financial condition and results of operations including:

why revenues, costs and earnings changed from the prior period

funds from operations (FFO)

how we used cash for capital projects and dividends and how we expect to use cash in the remainder of 2002 and in 2003

where we plan on obtaining cash for future dividend payments and future capital expenditures

## Critical Accounting Policies and Estimates

### *General*

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). Preparation of our financial statements in accordance with GAAP requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and the related notes. We believe that the following accounting policies are critical because they affect the more significant judgments and estimates used in the preparation of our consolidated financial statements. Actual results may differ from these estimates under different assumptions or conditions. For a detailed discussion on the application of these and other accounting policies, see Note 1 in the Notes to the Consolidated Financial Statements in Item 8 of our Annual Report on Form 10-K for the 2001 fiscal year.

### *Consolidation*

We combine our financial statements with those of our wholly-owned subsidiaries as well as all affiliates in which we have control and present them on a consolidated basis. The consolidated financial statements do not include the results of transactions between us and our subsidiaries or among our subsidiaries.

### *Revenue Recognition*

Recognition of revenue is dependent upon the quality and ability of our tenants to pay their rent in a timely manner. Rental revenues include: (1) minimum annual rentals, adjusted for the straight-line method for recognition of fixed future increases; (2) additional rentals, including recovery of property operating expenses, and certain other expenses which we accrue in the period in which the related expense occurs; and (3) percentage rents based on the level of sales achieved by the lessee, which we recognize when earned.

Gain or loss on sale of real estate is recognized when the sales contract is executed, title has passed, payment is received, and we no longer have continuing involvement in the asset.

### *Real Estate Assets and Depreciation*

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

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

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

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

We review long-lived assets for impairment when events or changes in business conditions indicate that their full carrying value may not be recovered. We consider assets to be impaired and write them

down to fair value if their expected associated future undiscounted cash flows are less than their carrying amounts.

We capitalize interest incurred during the construction period of certain assets and this interest is depreciated over the lives of those assets.

Pre-development costs that are directly related to specific construction projects are capitalized as incurred. We expense these costs to the extent they are unrecoverable or it is determined that the related project will not be pursued.

### ***Derivative Instruments and Hedging Activities***

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

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

### ***Asset Disposal***

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 addresses financial accounting for the impairment or disposal of long-lived assets and is effective in fiscal years beginning after December 15, 2001. We have adopted this statement and report discontinued operations for the quarter and nine month period ended September 30, 2002.

### ***Rental Revenues***

|                   | <u>Amount</u> | <u>Change</u> | <u>Percent<br/>Change</u> |
|-------------------|---------------|---------------|---------------------------|
| 3rd Quarter 2002  | \$ 30,170     | \$ 12,039     | 66%                       |
| 3rd Quarter 2001  | 18,131        |               |                           |
| Year-to-Date 2002 | 88,705        | 37,389        | 72%                       |
| Year-to-Date 2001 | 51,316        |               |                           |

Revenues increased \$12.0 million to \$30.2 million in the third quarter of 2002 compared to the same period in 2001 primarily because:

properties we acquired during 2001 and 2002 generated \$12.2 million of additional revenues

properties we owned both years generated \$0.5 million of additional revenues

partially offsetting these increases were revenues from properties we sold, which contributed \$0.7 million of revenues in 2001

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Revenues increased \$37.4 million to \$88.7 million in the nine month year-to-date period of 2002 compared to the same period in 2001 primarily because:

properties we acquired during 2001 and 2002 generated \$36.4 million of additional revenues

properties we owned both years generated \$3.4 million of additional revenues, including a \$2.3 million termination fee received in the second quarter of 2002

partially offsetting these increases were revenues from properties we sold, which contributed \$2.4 million of revenues in 2001

### Expenses

|                   | Amount    | Change    | Percent Change |
|-------------------|-----------|-----------|----------------|
| 3rd Quarter 2002  | \$ 18,342 | \$ 10,635 | 138%           |
| 3rd Quarter 2001  | 7,707     |           |                |
| Year-to-Date 2002 | 50,035    | 28,346    | 131%           |
| Year-to-Date 2001 | 21,689    |           |                |

Expenses increased \$10.6 million to \$18.3 million in the third quarter of 2002 compared to 2001 primarily because:

properties we acquired in 2001 and 2002 generated \$7.1 million of additional expenses

general and administrative expense increased \$3.7 million, primarily due to additional non-cash compensation expense of \$2.8 million to record the difference between the officers' notes book value and the market value of the related shares in the third quarter of 2002

these increases to expenses were partially offset by expenses from properties we sold, which contributed \$0.2 million to expenses in the third quarter of 2001

Expenses increased \$28.3 million to \$50.0 million for the year-to-date period ended September 2002 compared to 2001 primarily because:

properties we acquired in 2002 and 2001 generated \$20.1 million of additional expenses

general and administrative expense increased \$6.4 million, primarily due to additional compensation expense of \$2.8 million to record the difference between the officers' notes book value and the value of the related shares. General and administrative expense also increased due to legal fees and other costs of \$1.5 million related to our investment in Destination Villages, LLC.

we recognized an impairment loss of \$2.5 million on one of our properties in the second quarter of 2002. The loss was based on the assessed fair value of the property

expenses from properties we owned in both years increased by \$0.3 million

these increases to expenses were partially offset by expenses from properties we sold, which contributed \$1.0 million to expenses in the prior year

**Operating Income**

|                   | <b>Amount</b> | <b>Change</b> | <b>Percent Change</b> |
|-------------------|---------------|---------------|-----------------------|
| 3rd Quarter 2002  | \$ 11,828     | \$ 1,404      | 13%                   |
| 3rd Quarter 2001  | 10,424        |               |                       |
| Year-to-Date 2002 | 38,670        | 9,043         | 31%                   |
| Year-to-Date 2001 | 29,627        |               |                       |

Operating income increased for the third quarter and year-to-date periods of 2002 compared to the same periods in the prior year primarily because of the changes in Rental Revenues and Expenses discussed above.

**Interest Expense**

|                   | <b>Amount</b> | <b>Change</b> | <b>Percent Change</b> |
|-------------------|---------------|---------------|-----------------------|
| 3rd Quarter 2002  | \$ 6,157      | \$ 2,341      | 61%                   |
| 3rd Quarter 2001  | 3,816         |               |                       |
| Year-to-Date 2002 | 18,045        | 7,693         | 74%                   |
| Year-to-Date 2001 | 10,352        |               |                       |

Interest expense increased \$2.3 million in the third quarter of 2002 because we had an average of \$524.1 million debt outstanding compared to \$270.8 million in the third quarter of 2001. Interest expense increased \$7.7 million for the year-to-date period compared to 2001 because during the third quarter of 2002 we had an average of \$503.3 for the nine month year-to-date period of 2002 compared to \$226.6 for the same period in 2001. The increase in interest expense due to the amount of debt outstanding was partially offset by a decrease in interest rates on our variable rate debt and by the use of interest rate swap agreements which exchange rates on some of our fixed rate debt for lower variable rates.

The weighted average interest rate on our variable rate debt decreased to 3.5% on September 30, 2002 from 5.2% on September 30, 2001. We discuss our outstanding debt further in "Liquidity and Capital Resources" located elsewhere in this Form 10-Q.

**Interest Income**

|                   | <b>Amount</b> | <b>Change</b> | <b>Percent Change</b> |
|-------------------|---------------|---------------|-----------------------|
| 3rd Quarter 2002  | \$ 1,219      | \$ (206)      | -14%                  |
| 3rd Quarter 2001  | 1,425         |               |                       |
| Year-to-Date 2002 | 3,607         | (1,461)       | -29%                  |
| Year-to-Date 2001 | 5,068         |               |                       |

Interest income decreased \$0.2 million in the third quarter of 2002 compared to 2001 primarily because:

during the third quarter of 2001, we recorded \$0.9 million in interest income on our note with Excel Legacy. As a result of the Merger, interest income is no longer recorded on this note

partially offsetting this decrease was an increase in interest income of \$0.7 million from other developers' notes receivable

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Interest income decreased \$1.5 million in the nine month year-to-date period ended September 2002 compared to the same period in 2001 primarily because:

during the nine months ended September 2001 we recorded \$2.9 million in interest income on our note with Excel Legacy. As a result of the Merger, interest income is no longer recorded on this note

partially offsetting this decrease was an increase in interest income of \$1.4 million from other developers' notes receivable

### *Gain/Loss on Sale of Real Estate*

During the first nine months of 2002, we sold the following non-depreciable properties for a net gain of \$0.3 million:

| Location                    | Description              | Date Sold | Sales Price (000's) |
|-----------------------------|--------------------------|-----------|---------------------|
| Hollywood, FL               | Land                     | 1/31/02   | \$1,410             |
| Tucson/Marana, AZ           | Land                     | 1/31/02   | 684                 |
| Hollywood, FL               | Land                     | 4/19/02   | 1,028               |
| San Diego/Pacific Beach, CA | Self Storage Development | 6/1/02    | 11,632              |
| Walnut Creek, CA            | Self Storage Development | 6/1/02    | 7,708               |
| San Juan Capistrano, CA     | Self Storage Development | 6/1/02    | 6,918               |

Also during the first nine months of 2002, we sold the following operating properties and recorded a net gain of \$9.1 million. This gain is recorded as discontinued operations in the Consolidated Statements of Operations in accordance with SFAS No.144.

| Location                    | Description     | Date Sold | Sales Price (000's) |
|-----------------------------|-----------------|-----------|---------------------|
| Glen Burnie, MD             | Shopping Center | 6/21/02   | \$15,200            |
| San Diego/Murphy Canyon, CA | Self Storage    | 8/29/02   | 29,688              |
| Solana Beach, CA            | Self Storage    | 8/29/02   | 16,282              |
| Azusa, CA                   | Self Storage    | 9/30/02   | 6,537               |

During the first nine months of 2001, we sold the following properties for a net gain of \$1.3 million:

| Location                | Description     | Date Sold | Sales Price (000's) |
|-------------------------|-----------------|-----------|---------------------|
| Aurora, CO              | Retail Building | 1/15/01   | \$1,592             |
| Sacramento, CA          | Office Building | 6/1/01    | 5,125               |
| San Diego/Southeast, CA | Retail Building | 9/5/01    | 1,680               |

27

### *Funds From Operations*

|                                                          | Three Months<br>Ended September 30 |          | Nine Months<br>Ended September 30 |           |
|----------------------------------------------------------|------------------------------------|----------|-----------------------------------|-----------|
|                                                          | 2002                               | 2001     | 2002                              | 2001      |
| Net income                                               | \$ 17,756                          | \$ 9,766 | \$ 37,062                         | \$ 29,467 |
| Depreciation and amortization                            | 4,503                              | 2,282    | 12,620                            | 6,194     |
| Depreciation and amortization of discontinued operations | 164                                | 312      | 796                               | 936       |
| Price Legacy's share of joint venture depreciation       | 171                                | 154      | 477                               | 458       |
| Depreciation of non-real estate assets                   | (36)                               | (10)     | (120)                             | (36)      |
| Asset impairment                                         |                                    |          | 2,528                             |           |
| Gain on sale of depreciable real estate                  |                                    | (161)    |                                   | (1,321)   |

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|                                         | Three Months<br>Ended September 30 |          | Nine Months<br>Ended September 30 |           |
|-----------------------------------------|------------------------------------|----------|-----------------------------------|-----------|
| Gain on sale of discontinued operations | (9,991)                            |          | (9,148)                           |           |
| FFO before preferred dividends          | 12,567                             | 12,343   | 44,215                            | 35,698    |
| Preferred dividends                     | (12,241)                           | (8,761)  | (36,549)                          | (25,505)  |
| FFO                                     | \$ 326                             | \$ 3,582 | \$ 7,666                          | \$ 10,193 |

|                                 | Three Months Ended<br>September 30 |           | Nine Months Ended<br>September 30 |           |
|---------------------------------|------------------------------------|-----------|-----------------------------------|-----------|
|                                 | 2002                               | 2001      | 2002                              | 2001      |
| Net cash provided by (used in): |                                    |           |                                   |           |
| Operating activities            | \$ 11,772                          | \$ 11,132 | \$ 35,560                         | \$ 29,425 |
| Investing activities            | (32,755)                           | (7,614)   | (86,279)                          | (72,624)  |
| Financing activities            | 38,960                             | 8,931     | 57,112                            | 16,325    |
| Significant non-cash items:     |                                    |           |                                   |           |
| Deferred rents                  | \$ 828                             | \$ 891    | \$ 3,403                          | \$ 2,279  |
| Series B Preferred dividends    | 2,639                              | 296       | 7,743                             | 296       |
| Compensation expense            | 2,836                              |           | 2,836                             |           |

Our Company, as well as real estate industry analysts, generally consider FFO as another measurement of economic profitability for real estate-oriented companies. The Board of Governors of the National Association for Real Estate Investment Trusts (NAREIT), defines FFO as net income in accordance with GAAP, excluding depreciation and amortization expense and gains (losses) from depreciable operating real estate. We calculate FFO in accordance with the NAREIT definition and also exclude provisions for asset impairments and gains (losses) from the sale of investments when we calculate FFO. FFO does not represent the cash flows from operations defined by GAAP, may not be comparable to similarly titled measures of other companies and should not be considered as an alternative to net income as an indicator of our operating performance or to cash flows as a measure of liquidity. Excluded from FFO are significant components in understanding our financial performance.

FFO before preferred dividends during the third quarter of 2002 increased \$0.2 million or 1.8% to \$12.6 million compared to the third quarter of 2001 primarily because:

properties we acquired during 2001 and 2002 contributed an additional \$7.3 million to FFO

properties we owned in both years increased FFO by \$0.4 million

28

partially offsetting this increase are decreases to FFO for the following as discussed above:

increased general and administrative expense of \$3.7 million, including a one-time non cash charge to compensation expense to record the difference between the officers' notes book value and the value of the related shares as previously discussed

increased interest expense of \$2.3 million

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properties sold, which contributed \$1.3 million to FFO in the previous year

decreased interest income of \$0.2 million

FFO before preferred dividends during the nine month year-to-date period of 2002 increased \$8.5 million or 23.9% to \$44.2 million compared to the third quarter of 2001 primarily because:

properties we acquired during 2001 and 2002 contributed an additional \$22.6 million to FFO

properties we owned in both years contributed an additional \$3.2 million to FFO, primarily due to a non-recurring lease termination fee of \$2.3 million received in the second quarter of 2002

gain on non-depreciable land sold during the year contributed \$0.3 million to FFO

partially offsetting these increases are decreases to FFO for the following as discussed above:

increased interest expense of \$7.7 million

increased general and administrative expense of \$6.4 million

properties sold, which contributed \$2.2 million to FFO in the previous year

decreased interest income of \$1.5 million

### Liquidity and Capital Resources

Liquidity refers to our ability to generate sufficient cash flows to meet the short and long-term cash requirements of our business operations. Capital resources represent those funds used or available to be used to support our business operations and consist of stockholders' equity and debt.

Cash flow from operations has been the principal source of capital to fund our ongoing operations and dividend payments, while use of our credit facilities and mortgage financing have been the principal sources of capital required to fund our growth. While we are positioned to finance our business activities through a variety of sources, we expect to satisfy short-term liquidity requirements through net cash provided by operations and through borrowings.

In September 2001, we obtained a \$100.0 million unsecured credit facility with Fleet Bank as agent. The facility has a three-year term and has a current interest rate of LIBOR plus 188 basis points. The rate may vary between 150 and 188 basis points based on our leverage and other financial ratios. At September 30, 2002, we had \$61.0 million outstanding on the facility at a 3.7% weighted average interest rate.

In February 2002, we filed a \$500 million shelf-registration statement pursuant to which we may issue debt securities, preferred stock, depositary shares, common stock, warrants or rights. We have not issued any instruments from this shelf-registration.

In April 2002, we entered into five Interest Rate Swap Agreements with Fleet Bank that are accounted for under SFAS No. 133. The combined notional amount is approximately \$161 million and the maturities range from 2009 to 2010. We paid monthly interest of LIBOR plus 3.08% to 3.77%

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(4.26% to 4.95% based upon LIBOR rates at September 30, 2002) and Fleet Bank assumed our fixed rates of 8.18% to 9.00%. These swaps hedge the fair value of fixed-rate debt and as the swaps change in fair value, both the swaps and the hedged debt will be adjusted on the Consolidated Balance Sheets. In October 2002, we sold the five swaps back to the counter party for \$13.8 million and will amortize the gain over the fixed-rate debt's remaining life through 2009 to 2010.

In July 2002, we entered into four Interest Rate Cap Agreements with Wells Fargo Bank and Fleet Bank that are also accounted for under SFAS No. 133. The combined notional amount is \$152.0 million and the maturities range from 2009 to 2010. The agreements cap our variable rate risk on one month LIBOR interest at 7%.

In October 2001, our Board of Directors approved the repurchase of up to \$10.0 million of our outstanding common stock. In September 2002, we repurchased 546,900 shares of our common stock on the open market for approximately \$1.6 million.

We have \$64.5 million in notes receivable at September 30, 2002. These notes are primarily due from developers and are collateralized by the related projects or other real estate. Of these notes, \$47.2 million involve entities controlled by one individual. Approximately \$52.1 million of these notes do not require cash payments on the interest until specified future dates, typically when the projects are completed or sold. Also included are notes receivable of \$12.3 million we obtained from the buyers of our recently completed self storage development properties. These notes are payable on May 31, 2003 or earlier, depending on stabilization of the properties.

We continue to evaluate various properties for acquisition or development and continue to evaluate other investment opportunities. We anticipate borrowing available amounts on our credit facility or mortgages to fund these acquisition and development opportunities. We also anticipate obtaining construction loans to fund our development activities. During the nine months ended September 30, 2002 we purchased six properties for a total of \$131.4 million. We used proceeds from tax-deferred exchange transactions on properties sold in 2001 and 2002, mortgage financing, borrowings on our unsecured line of credit, and assumed loans to fund these acquisitions.

From time to time we will consider selling properties to better align our portfolio with our geographic and tenant composition strategies. We may also participate in additional tax-deferred exchange transactions, which allow us to dispose of properties and reinvest the proceeds in a tax efficient manner. During the nine months ended September 30, 2002 we sold three parcels of land for \$3.1 million, three self storage development properties for \$26.3 million, three self storage operating properties for \$52.5 million and one operating retail property for \$15.2 million. When we sell an operating property, we anticipate a temporary reduction in operating income due to the time lag between selling a property and reinvesting the proceeds.

We are contemplating purchasing various properties and selling certain other properties. As we sell properties, our cash flows from operations may decrease until the proceeds are reinvested into new properties.

We have a significant retail project in Newport, KY. The majority of the construction was completed in October 2001, with all of the primary buildings completed except for one out parcel yet to be leased. The project opened in October 2001. At present the project is approximately 67% occupied and 77% leased, excluding ground leases.

30

We also have two significant retail development projects in which construction will continue through 2002 and 2003. The Temecula, CA project is an open-air retail shopping center with Wal-Mart, Kohl's and other tenants. We estimate \$16.0 million remaining to complete construction. We expect to fund the remaining cost through a construction loan. The Anaheim Garden Walk project in Anaheim, CA, located at the corner of Harbor Blvd. and Disney Way will consist of an open-air retail center and three hotels. Total cost of the retail portion's first phase of this project is approximately \$110 million. Additional phases may be developed over the next eight years based on the success of the first phase. We expect to fund construction costs through a construction loan, sales of adjacent land parcels for hotels or potential joint venture investors.

The following table summarizes all of our long-term contractual obligations, excluding interest, to pay third parties as of September 30, 2002:

| Contractual Cash Obligations |      |      |      |      |            |       |
|------------------------------|------|------|------|------|------------|-------|
| 2002                         | 2003 | 2004 | 2005 | 2006 | Thereafter | Total |

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## Contractual Cash Obligations

|                             |                  |                  |                   |                  |                 |                   |                   |
|-----------------------------|------------------|------------------|-------------------|------------------|-----------------|-------------------|-------------------|
| Mortgages and notes payable | \$ 44,872        | \$ 39,790        | \$ 205,845        | \$ 23,259        | \$ 5,142        | \$ 236,355        | \$ 555,263        |
| Capital lease obligations   | 199              | 796              | 796               | 796              | 796             | 16,252            | 19,635            |
| <b>Total</b>                | <b>\$ 45,071</b> | <b>\$ 40,586</b> | <b>\$ 206,641</b> | <b>\$ 24,055</b> | <b>\$ 5,938</b> | <b>\$ 252,607</b> | <b>\$ 574,898</b> |

In 2002 and 2003, we plan to use cash flow from operations to fund our principal payments due on mortgages and we plan to refinance or borrow on our unsecured line of credit to repay debt maturing in 2002 and 2003.

## Off-Balance Sheet Financing Matters

Also related to our Newport, KY project discussed previously, the City of Newport, KY in 1999 issued two series of public improvement bonds related to the Newport development project. The Series 2000a tax exempt bonds total \$44.2 million and are broken down as follows: (a) \$18.7 million maturing 2018 with interest at 8.375%; (b) \$20.5 million maturing 2027 with interest at 8.5%; and (c) \$5.0 million maturing 2027 with interest at 8.375%. The Series 2000b bonds are taxable and have a par amount of \$11.6 million with interest at 11% due 2009. The bonds are guaranteed by the Newport project, the Company, and the project's third party developers. As of September 30, 2002, Newport had drawn on \$43.7 million of the bonds for construction incurred prior to that date.

Summarized debt information for our unconsolidated joint ventures and the amount guaranteed by us at September 30, 2002 is as follows:

| Joint Venture                | September 30<br>2002 | Debt<br>Guaranteed |
|------------------------------|----------------------|--------------------|
| Orlando Business Park, LLC   | \$ 10,937            | \$ 10,937          |
| Old Mill District Shops, LLC | 17,939               | 14,401             |
| Blackstone Ventures I        | 8,797                | 8,797              |
| 3017977 Nova Scotia Company  | 5,123                | 5,123              |
|                              | <b>\$ 42,796</b>     | <b>\$ 39,258</b>   |

We also have guaranteed a \$12.8 million note payable related to a development project in Scottsdale, AZ and have a \$22.8 million note receivable with a participating interest.

In connection with the sale of three self storage development properties in June 2002, we agreed to guarantee \$14.2 million of debt associated with the properties that was assumed by the buyer in the transaction. We guarantee this debt until it matures in April 2003.

## Transactions with Related and Certain Other Parties

In connection with the Merger, we acquired \$9.4 million in notes receivable from certain officers and affiliates of Excel Legacy, which are due March 2003. The notes are collateralized by approximately 2.9 million shares of our common stock. In the third quarter of 2002, the market value of these shares was less than the amounts due on the notes. The Sarbanes-Oxley Act of 2002, issued in the third quarter, prohibits any material changes to notes receivable from officers. As a result of these events and discussions related to the eventual disposition of the notes, we have applied Emerging Issues Task Force (EITF) 00-23, "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44" issued in 2002. EITF 00-23 requires accounting as if the shares had been repurchased and treated as treasury shares, with a corresponding issuance of a new stock option. The impact of EITF 00-23 on our third quarter financial statements was as follows:

we retired the notes receivable from officers and the 2.9 million shares securing the notes at the current market value in the third quarter of 2002. The shares collateralizing the notes are now treated as treasury stock and

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we recorded a one-time non-cash charge of \$2.8 million in compensation expense to record the difference between the note's book value and the value of the shares

The above only impacts our accounting records. Legally, the notes and shares remain outstanding until the notes are repaid or otherwise settled. The 2.9 million shares are treated similar to stock options and are accounted for under variable option plan accounting in accordance with APB No. 25. This valuation had no impact on our financial statements for the third quarter of 2002.

Prior to the Merger, Excel Legacy was responsible for the daily management of PEI, including property management, finance and administration. We reimbursed Excel Legacy for these services based on historical costs for similar expenses. We expensed \$0.7 million for these services during the third quarter of 2001, and \$2.4 million for the nine month year-to-date period of 2001.

Prior to the Merger, we executed a note receivable with Excel Legacy allowing them to borrow up to \$40.0 million. During the third quarter of 2001, we recorded \$0.9 million in interest income from Excel Legacy on this note and \$2.9 million for the nine month year-to-date period of 2001. As a result of the Merger, interest income is no longer recorded on this note.

In connection with the San Diego/Rancho Bernardo, CA office building purchased from Excel Legacy, we leased the building back to Excel Legacy under a 10-year lease agreement. We recorded \$0.3 million of rental revenue from Excel Legacy in connection with this lease during the third quarter of 2001, and \$1.1 million for the nine month year-to-date period of 2001. Due to the Merger, rental revenue is no longer recorded on this lease.

In connection with the purchase of the Anaheim land in the first quarter of 2001, we executed a ground lease agreement with Excel Legacy. The lease has a term of 50 years and requires payments of \$2.8 million per year in rent. During the third quarter of 2001 we recorded \$0.6 million in rental revenue from Excel Legacy related to this lease and \$1.8 million for the nine month year-to-date period of 2001. Due to the Merger, rental revenue is no longer recorded on this lease.

### **Inflation**

Because a substantial number of our leases contain provisions for rent increases based on changes in various consumer price indices, based on fixed rate increases, or based on percentage rent if tenant sales exceed certain base amounts, we do not expect inflation to have a material impact on future net income or cash flow from developed and operating properties. In addition, substantially all retail leases are triple net, which means specific operating expenses and property taxes are passed through to the tenant.

### **ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risks relating to our operations result primarily from changes in short-term LIBOR interest rates. We do not have any significant foreign exchange or other material market risk.

Our exposure to market risk for changes in interest rates relates primarily to our variable interest rate debt. We enter into variable rate debt obligations to support general corporate purposes, including acquisitions, capital expenditures and working capital needs. We continuously evaluate our level of variable rate debt with respect to total debt and other factors, including our assessment of the current and future economic environment.

We had \$280.3 million in variable rate debt outstanding at September 30, 2002. Based upon these year-end debt levels, a hypothetical increase in interest rates by 100 basis points would increase interest expense by approximately \$2.8 million on an annual basis, and likewise decrease our earnings and cash flows. We cannot predict market fluctuations in interest rates and their impact on our variable rate debt, nor can there be any assurance that fixed rate long-term debt will be available to us at favorable rates, if at all. Consequently, future results may differ materially from the estimated adverse changes discussed above.

Also, as previously discussed, we entered into five fair-value interest rate swap agreements for \$161 million in April 2002. These swap agreements effectively convert \$161 million of fixed rate loans with interest rates ranging from 8.18% to 9% to variable interest rates. The fair value of these interest rate swap agreements represents the estimated amount we would receive if we terminated the agreements. In October 2002, we sold the five swaps for \$13.8 million and will amortize the gain over the fixed-rate debt's remaining life.

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In July 2002, in order to mitigate our variable interest rate exposure, we acquired four interest rate caps, which hedge our exposure on \$152 million of variable rate debt. The hedges limit our exposure to the one-month LIBOR index associated with certain of our outstanding debt at 7%. To the extent the one-month LIBOR index exceeds 7%, the counter parties on the hedges will pay us the difference between the actual index and 7%.

The following table presents the scheduled principal payments on notes receivable and the scheduled principal payments on mortgages payable over the next five years and thereafter. The table also includes the average interest rates of the financial instruments during each respective year and the fair value of the notes receivable and mortgages payable. We determine the fair value of financial instruments through the use of discounted cash flows analysis using current interest rates for notes receivable with terms and credit characteristics similar to our existing portfolio and borrowings under terms similar to our existing mortgages payable. Accordingly, we have determined that the carrying value of our financial instruments at September 30, 2002 approximated fair value.

| Expected Maturity Date<br>(dollar amounts in thousands) |           |           |            |           |          |            |            |
|---------------------------------------------------------|-----------|-----------|------------|-----------|----------|------------|------------|
|                                                         | 2002      | 2003      | 2004       | 2005      | 2006     | Thereafter | Fair Value |
| Notes receivable, including notes from affiliates       | \$ 19,228 | \$ 39,434 | \$ 4,375   |           |          | \$ 1,435   | \$ 64,472  |
| Average interest rate                                   | 13%       | 12%       | 12%        |           |          | 11%        | 12%        |
| Mortgages and notes payable                             | \$ 44,872 | \$ 39,790 | \$ 205,845 | \$ 23,259 | \$ 5,142 | \$ 236,355 | \$ 555,263 |
| Average interest rate                                   | 4%        | 5%        | 3%         | 8%        | 7%       | 7%         | 5%         |

### ITEM 4 CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission,

33

and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Within 90 days prior to the date of this quarterly report, under the supervision and with the participation of certain management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that the company's disclosure controls and procedures were effective.

There have been no significant changes in our internal controls or in other factors that could significantly affect the internal controls subsequent to the date we completed our evaluation.

34

## PART II OTHER INFORMATION

### ITEM 1 LEGAL PROCEEDINGS

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On or about February 13, 2001, Lewis P. Geyser filed a lawsuit against Excel Legacy in Santa Barbara County Superior Court, Anacapa Division, Case No. 01038577. The suit arose out of an Operating Agreement for Destination Villages, LLC, an entity which is owned jointly by Excel Legacy and Mr. Geyser, under which Destination Villages, LLC would develop certain eco-tourism resorts. The complaint included causes of action for breach of contract, breach of fiduciary duty, fraud and negligent misrepresentation. The lawsuit included a prayer for compensatory and punitive damages. Excel Legacy had also filed a cross-complaint against Mr. Geyser for breach of contract, fraud, breach of fiduciary duty and other related claims.

The trial of this matter concluded on March 19, 2002. The trial judge dismissed both the complaint and cross-complaint, and granted nothing to Mr. Geyser under any of his allegations. On June 5, 2002, Mr. Geyser filed an appeal and Excel Legacy subsequently filed a cross-appeal against Mr. Geyser.

On June 13, 2002 the Bank of NT Butterfield & Sons Limited filed a lawsuit against Price Legacy and Excel Legacy in Bermuda for \$6.1 million plus other costs related to a guarantee agreement for a promissory note on the Destination Villages Daniel's Head project in Bermuda. The bank claims that Excel Legacy did not provide sufficient capital for the project to be completed which was required in the guarantee agreement. The bank has currently appointed a receiver who is actively marketing the project for sale to third parties. We believe we were in full compliance with the guarantee and intend to vigorously defend the lawsuit.

We are not party to any other legal proceedings other than various claims and lawsuits arising in the ordinary course of business that, in the opinion of our management, are not individually or in the aggregate material to our business.

### ITEM 6 EXHIBITS AND REPORTS ON FORM 8-K

(a)

The following exhibits are included herein or incorporated by reference:  
None

(b)

Reports on Form 8-K

We filed a report on Form 8-K on August 29, 2002 relating to the sale of two self storage properties for \$45.9 million and the acquisition of a retail property for \$76.2 million.

35

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### 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.

PRICE LEGACY CORPORATION

*Registrant*

Date: November 12, 2002

/s/ GARY B. SABIN

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Gary B. Sabin  
*Chief Executive Officer*

Date: November 12, 2002

/s/ JAMES NAKAGAWA

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James Y. Nakagawa  
*Chief Financial Officer*

36

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**CERTIFICATIONS**

I, Gary B. Sabin, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Price Legacy Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

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Date: November 12, 2002

/s/ GARY B. SABIN

Gary B. Sabin  
Chief Executive Officer

37

I, James Y. Nakagawa, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Price Legacy Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation,

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including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 12, 2002

/s/ JAMES NAKAGAWA

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James Y. Nakagawa  
Chief Financial Officer

38

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### QuickLinks

[PRICE LEGACY CORPORATION INDEX TO FORM 10-Q](#)

[PART I FINANCIAL INFORMATION](#)

[ITEM 1 FINANCIAL STATEMENTS](#)

[PRICE LEGACY CORPORATION CONSOLIDATED BALANCE SHEETS \(in thousands, except share data\)](#)

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

[PRICE LEGACY CORPORATION CONSOLIDATED STATEMENTS OF CASH FLOWS \(unaudited amounts in thousands\)](#)

[PRICE LEGACY CORPORATION CONSOLIDATED STATEMENTS OF CASH FLOWS \(continued\) \(unaudited amounts in thousands\)](#)

[PRICE LEGACY CORPORATION NOTES TO CONSOLIDATED FINANCIAL STATEMENTS \(UNAUDITED\) September 30, 2002](#)

[ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS](#)

[ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK](#)

[ITEM 4 CONTROLS AND PROCEDURES](#)

[PART II OTHER INFORMATION](#)

[ITEM 1 LEGAL PROCEEDINGS](#)

[ITEM 6 EXHIBITS AND REPORTS ON FORM 8-K](#)

[SIGNATURES](#)

[CERTIFICATIONS](#)