Cogdell Spencer Inc.
Form 10-Q
November 10, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 10-Q

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

For the quarterly period ended September 30, 2008

OR

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

For the transition period from __________ to __________

Commission file number 001-32649

COGDELL SPENCER INC.

(Exact name of registrant as specified in its charter)

Maryland	**20-3126457**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4401 Barclay Downs Drive, Suite 300 Charlotte, North Carolina	**28209**
(Address of principal executive offices)	(Zip code)

(704) 940-2900

(Registrant s telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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

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

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

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock as of the latest practicable date: 17,562,322 shares of common stock, par value $.01 per share, outstanding as of November 6, 2008.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

COGDELL SPENCER INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share amounts)
(unaudited)

	September 30, 2008	December 31, 2007
Assets		
Real estate properties:		
Land	$ 30,673	$ 30,673
Buildings and improvements	498,822	455,606
Less: Accumulated depreciation	(63,154)	(44,596)
Net operating real estate properties	466,341	441,683
Construction in progress	10,672	13,380
Net real estate properties	477,013	455,063
Cash and cash equivalents	10,637	3,555
Restricted cash	18,388	1,803
Tenant and accounts receivable, net of allowance of $154 in 2008 and $19 in 2007	42,924	2,249
Goodwill and intangible assets, net of accumulated amortization of $32,776 in 2008 and $18,728 in 2007	308,423	31,589
Other assets	27,689	11,978
Total assets	$ 885,074	$ 506,237
Liabilities and stockholders equity		
Mortgage notes payable	$ 234,497	$ 237,504
Revolving credit facility	90,000	79,200
Term loan	100,000	
Accounts payable	23,185	5,817
Billings in excess of costs and estimated earnings on uncompleted contracts	27,616	
Deferred income taxes	40,302	217
Payable to Erdman shareholders	24,003	
Other liabilities	47,751	21,243
Total liabilities	587,354	343,981
Commitments and contingencies		
Minority interests in real estate partnerships	6,205	2,434
Minority interests in operating partnership	89,885	44,787
Stockholders equity:		
Preferred stock, $0.01 par value; 50,000 shares authorized, none issued or outstanding		
	176	119

Common Stock; $0.01 par value; 200,000 shares authorized, 17,563 and 11,948 shares issued and outstanding in 2008 and 2007, respectively				
Additional paid-in capital		273,635		166,901
Accumulated other comprehensive income (loss)		235		(1,234)
Accumulated deficit		(72,416)		(50,751)
Total stockholders equity		201,630		115,035
Total liabilities and stockholders equity	$	885,074	$	506,237

See notes to condensed consolidated financial statements.

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COGDELL SPENCER INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)
(unaudited)

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2008	September 30, 2007	September 30, 2008	September 30, 2007
Revenues:				
Rental revenue	$ 19,631	$ 16,399	$ 57,622	$ 45,344
Design-Build contract revenue and other sales	72,914		174,870	
Property management and other fees	852	874	2,524	2,644
Development management and other income	622	25	751	276
Total revenues	94,019	17,298	235,767	48,264
Expenses:				
Property operating and management	8,370	6,797	23,403	18,766
Costs related to design-build contract revenue and other sales	59,578		146,907	
Selling, general, and administrative	7,599	1,532	20,396	5,296
Depreciation and amortization	11,871	7,273	33,275	20,664
Total expenses	87,418	15,602	223,981	44,726
Income from operations before other income (expense), income tax expense (benefit), minority interests in real estate partnerships, and minority interests in operating partnership	6,601	1,696	11,786	3,538
Other income (expense):				
Interest and other income, net	210	183	682	763
Interest expense	(6,743)	(4,101)	(18,695)	(11,324)
Equity in earnings (loss) of unconsolidated real estate partnerships	10	2	18	(2)
Total other income (expense)	(6,523)	(3,916)	(17,995)	(10,563)
Income (loss) from operations before income tax expense (benefit), minority interests in real estate partnerships, and minority interests in operating partnership	78	(2,220)	(6,209)	(7,025)
Income tax (expense) benefit	(883)	19	(143)	(151)
	(805)	(2,201)	(6,352)	(7,176)

Loss from operations before minority interests in real estate partnerships, and minority interests in operating partnership								
Minority interests in real estate partnerships		(920)		(16)		(859)		(55)
Minority interests in operating partnership		639		615		2,480		2,226
Net loss	$	(1,086)	$	(1,602)	$	(4,731)	$	(5,005)
Net loss per share basic and diluted	$	(0.07)	$	(0.13)	$	(0.31)	$	(0.47)
Weighted average common shares basic and diluted		15,747		11,934		15,170		10,755

See notes to condensed consolidated financial statements.

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COGDELL SPENCER INC.
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY
(In thousands)
(unaudited)

	Number of Common Shares	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total
Balance at December 31, 2007	11,948	$ 119	$ 166,901	$ (1,234)	$ (50,751)	$ 115,035
Comprehensive loss:						
Net loss					(4,731)	(4,731)
Unrealized gain on interest rate swaps				1,469		1,469
Comprehensive loss						(3,262)
Issuance of common stock, net of costs	5,609	57	91,288			91,345
Restricted stock grants	6		94			94
Amortization of restricted stock grants			47			47
Dividends to common stockholders					(16,934)	(16,934)
Adjustment to record change of interest in the operating partnership due to the issuance of operating partnership units in excess of book value			15,305			15,305
Balance at September 30, 2008	17,563	$ 176	$ 273,635	$ 235	$ (72,416)	$ 201,630

See notes to condensed consolidated financial statements.

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COGDELL SPENCER INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(unaudited)

	For the Nine Months Ended September 30, 2008	For the Nine Months Ended September 30, 2007
Operating activities:		
Net loss	$ (4,731)	$ (5,005)
Adjustments to reconcile net loss to cash provided by operating activities:		
Minority interests	(1,621)	(2,171)
Depreciation and amortization	33,275	20,664
Amortization of acquired above market leases and acquired below market leases, net	(533)	(529)
Straight line rental revenue	(422)	(237)
Amortization of deferred financing costs and debt premium	878	186
Deferred income taxes	(468)	
Equity-based compensation	1,110	158
Equity in loss (earnings) of unconsolidated real estate partnerships	(18)	2
Changes in operating assets and liabilities:		
Tenant and accounts receivable and other assets	13,650	(852)
Accounts payable and other liabilities	(7,042)	5,330
Billings in excess of costs and estimated earnings on uncompleted contracts	(9,518)	
Net cash provided by operating activities	24,560	17,546
Investing activities:		
Business acquisition, net of cash acquired	(130,264)	
Investment in real estate properties, net of cash assumed	(38,633)	(91,868)
Purchase of minority interests in operating partnership	(754)	(3,807)
Proceeds from sales-type capital lease	230	229
Purchase of corporate equipment	(1,068)	(502)
Distributions received from unconsolidated real estate partnerships	5	4
Increase in restricted cash	(16,585)	(329)
Net cash used in investing activities	(187,069)	(96,273)
Financing activities:		
Proceeds from mortgage notes payable	8,087	65,941
Repayments of mortgage notes payable	(13,733)	(16,714)
Proceeds from revolving credit facility	110,500	49,300
Repayments to revolving credit facility	(99,700)	(80,687)
Proceeds from term loan	100,000	
Net proceeds from sale of common stock	91,344	78,443
Dividends and distributions	(22,831)	(15,919)
Equity contributions by partners in consolidated real estate partnerships	517	1,304
Distributions to minority interests in real estate partnership	(963)	(117)
Payment of deferred financing costs	(3,630)	(669)

Net cash provided by financing activities		169,591		80,882
Increase in cash and cash equivalents		7,082		2,155
Balance at beginning of period		3,555		1,029
Balance at end of period	$	10,637	$	3,184
Supplemental disclosure of cash flow information:				
Cash paid for interest, net of capitalized interest	$	17,596	$	11,792
Cash paid for income taxes	$	3,039	$	307
Noncash investing and financing activities:				
Operating Partnership Units issued or to be issued in connection with the acquisition of a business or real estate property		81,673		3,583
Debt assumed with purchase of property		2,733		
Minority interest assumed with purchase of property		3,359		
Investment in real estate costs contributed by partner in a consolidated real estate partnership				460
Accrued dividends and distributions		9,379		5,779

See notes to condensed consolidated financial statements.

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COGDELL SPENCER INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Business Description

Cogdell Spencer Inc. (the Company), incorporated in Maryland in 2005, is a fully-integrated, self-administered, and self-managed real estate investment trust (REIT) that invests in specialty office buildings for the medical profession, including medical offices and ambulatory surgery and diagnostic centers. The Company focuses on the ownership, development, redevelopment, acquisition, and management of strategically located medical office buildings and other healthcare related facilities in the United States of America. The Company has been built around understanding and addressing the specialized real estate needs of the healthcare industry.

On March 10, 2008, the Company and its operating partnership, Cogdell Spencer LP (the Operating Partnership), completed a merger transaction through which they acquired MEA Holdings, Inc. (MEA) which wholly owns Marshall Erdman & Associates, Inc. (now, Erdman, A Cogdell Spencer Company) (Erdman). Erdman is a market-leading provider of advance planning and design-build services for healthcare facilities throughout the United States of America. Erdman s service offerings include advance planning, architecture, engineering, and construction. Combined, the Company is a fully integrated healthcare facilities solutions company providing services from conceptual planning to long-term ownership and property management.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) and represent the assets and liabilities and operating results of the Company. The consolidated financial statements include the Company s accounts, its wholly-owned subsidiaries, as well as the Operating Partnership and its subsidiaries. The consolidated financial statements also include any partnerships for which the Company or its subsidiaries is the general partner or the managing member and the rights of the limited partners do not overcome the presumption of control by the general partner or managing member. All significant intercompany balances and transactions have been eliminated in consolidation.

The Company reviews its interests in entities to determine if the entity s assets, liabilities, noncontrolling interests and results of activities should be included in the consolidated financial statements in accordance with Financial Accounting Standards Board (FASB) Interpretation No. 46R, Consolidation of Variable Interest Entities , Emerging Issues Task Force (EITF) 04-5 Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights and Accounting Research Bulletin No. 51, Consolidated Financial Statements.

Interim Financial Information

The financial information for the three and nine months ended September 30, 2008 and 2007 is unaudited, but includes all adjustments, consisting of normal recurring adjustments that, in the opinion of management, are necessary for a fair presentation of the Company s financial position, results of operations, and cash flows for such periods. Operating results for the three and nine months ended September 30, 2008 and 2007 are not necessarily indicative of results that may be expected for any other interim period or for the full fiscal years of 2008 or 2007 or any other future period. These condensed consolidated financial statements do not include all disclosures required by GAAP for annual consolidated financial statements. The Company s audited consolidated financial statements are contained in the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

Use of Estimates in Financial Statements

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Significant estimates and assumptions are used by management in determining the percentage of completion revenue, useful lives of real estate properties and improvements, and the initial valuations and underlying allocations of purchase price in connection with business and real estate property acquisitions. Actual results may differ from those estimates.

Revenue Recognition

Rental Revenue and Property Management. Rental income related to non-cancelable operating leases is recognized as earned over the term, which is the period from the date the lessee has access and control over the leased space to the lease termination date, of the lease agreements on a straight-line basis. Rental income recognized on a straight-line basis for certain lease agreements results in recognized revenue greater than or less than amounts contractually due from tenants. In addition, the leases generally contain provisions under which the tenants reimburse the Company for a portion of property operating expenses and real estate taxes. At times the Company will receive cash payments at the inception of the lease for tenant improvements and these amounts are amortized into rental revenue over the life of the lease. These amounts are included in Other liabilities in the consolidated balance sheets. The Company monitors the creditworthiness of its tenants on a regular basis and maintains an allowance for doubtful accounts.

The Company receives fees for property management and related services provided to third parties which are reflected as management fee revenue. Management fees are generally based on a percentage of revenues for the month as defined in the related property management agreements. The Company pays certain payroll and related costs related to the operations of third party properties that are managed by the Company. Under terms of the related management agreements, these costs are reimbursed by the third party property owners. The amounts billed to the third party owners are recognized as revenue in accordance with EITF 01-14, Income Statement Characterization of Reimbursements Received for Out of Pocket Expenses Incurred.

Design-Build Contract Revenues and Development Management. Design-Build contract revenue is recognized under the percentage-of-completion method of accounting in accordance with American Institute of Certified Public Accountants Statement of Position (SOP) 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. Revenues are determined by measuring the percentage of costs incurred to date to estimated total costs for each design-build contract based on current estimates of costs to complete. Contract costs include all labor and benefits, materials, subcontracts, and an allocation of indirect costs related to contract performance such as architectural, engineering, and construction management. Indirect costs are allocated to projects based upon labor hours charged. As long-term design-build projects extend over one or more years, revisions in cost and estimate earnings during the course of the work are reflected in the accounting period in which the facts which require the revision become known. At the time a loss on a design-build project becomes known, the entire amount of the estimated ultimate loss is recognized in the consolidated financial statements. Change orders are recognized when they are approved by the client.

Costs and estimated earnings in excess of billings on uncompleted design-build projects (underbillings) are included in Other assets in the consolidated balance sheets. Billings in excess of costs and estimated earnings on uncompleted design-build projects (overbillings) are included in liabilities in the consolidated balance sheets. Customers are billed on a monthly basis at the end of each month. As a result, typically the Company generates billings in excess of costs and estimated earnings on design-build projects.

Revenue from project analysis and design agreements is accounted for on the completed contract method. Costs in excess of billings and billings in excess of costs on project analysis and design agreements are included with design-build projects over and underbillings in the consolidated balance sheets. Revenue from development agreements is recognized as earned per the agreements and costs are expensed as incurred.

Gains on Disposition of Real Estate. The Company recognizes sales of real estate properties upon closing and meeting the criteria for a sale under Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS) No. 66, Accounting for Sales of Real Estate (SFAS 66). Payments received from purchasers prior to closing are recorded as deposits. Profit on real estate sold is recognized using the full accrual method upon closing when the collectibility of the sales price is reasonably assured and the Company is not obligated to perform significant activities after the sale. This includes the buyer s initial and continuing investments being adequate to demonstrate a commitment to pay for the property and the Company not having substantial

continuing involvement whereby the usual risks and rewards of ownership would not be transferred to the buyer. Profit may be deferred in whole or part until the sales meet the requirements of profit recognition on sales of real estate under SFAS 66.

Other income. Other income on the Company s statement of operations generally includes income incidental to the operations of the Company and is recognized when earned. Interest and other income includes the amortization of unearned income related to a sales-type capital lease.

Income Taxes

The Company elected to be taxed as a REIT under sections 856 through 860 of the Internal Revenue Code of 1986, as amended. REITs are subject to a number of organizational and operational requirements, including a requirement that 90% of ordinary taxable income be distributed. As a REIT, the Company will generally not be subject to U.S. federal income tax to the extent that it meets the organization and operational requirements and distributions equal or exceed taxable income. For all periods subsequent to the REIT election, the Company has met the organization and operational requirements and distributions exceeded net taxable income. Accordingly, no provision has been made for federal and state income taxes, except as follows.

The Company, together with Cogdell Spencer Advisors, LLC (CSA, LLC), wholly-owned by the Operating Partnership, have jointly elected for CSA, LLC to be treated as a taxable REIT subsidiary (a TRS). Consera Healthcare Real Estate, LLC has been reorganized and is now a wholly-owned subsidiary of CSA, LLC. The Company, together with MEA, wholly-owned by the Operating Partnership and the parent company of Erdman, have also jointly elected for MEA to be treated as a TRS (Erdman TRS). As TRSs, the operations of CSA, LLC and MEA are generally subject to corporate income taxes.

The Company s TRSs account for their income taxes based on the requirements of SFAS No. 109, Accounting for Income Taxes (SFAS 109), which includes an estimate of the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in the Company s financial statements or tax returns. The calculation of the TRSs tax provision may require interpreting tax laws and regulations and could result in the use of judgments or estimates which could cause their recorded tax liability to differ from the actual amount due. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The TRSs periodically assess the realizability of deferred tax assets and the adequacy of deferred tax liabilities, including the results of local, state, or federal statutory tax audits or estimates and judgments used.

Effective January 1, 2007, the Company and the TRSs began applying the provisions of the FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 for measuring and recognizing tax benefits associated with uncertain tax positions. Penalties and interest, if incurred, would be recorded as a component of income tax expense. There were no penalties or interest recorded during the three and nine months ended September 30, 2008 and 2007. The Company and the TRSs have no unrecognized tax benefits. For 2004 (Erdman), 2005, 2006, and 2007, U.S. federal and state tax returns are open for examination.

Warranties

Erdman provides standard industry warranties, which generally are for one year after completion of a project. Buildings are guaranteed against defects in workmanship for one year after completion. The typical warranty requires that Erdman replace or repair the defective item. Erdman records an estimate for future warranty related costs based on actual historical warranty claims. This estimated liability is included in Other liabilities in the consolidated balance sheets. Based on analysis of warranty costs, the warranty provisions are adjusted as necessary. While warranty costs have historically been within its calculated expectations, it is possible that future warranty costs could exceed expectations.

The changes in the carrying amounts of the total warranty liabilities for the three and nine months ended September 30, 2008 and 2007 are as follows (in thousands):

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2008	September 30, 2007	September 30, 2008	September 30, 2007
Balance at the beginning of period	$ 2,000	$	$	$
Erdman acquisition			2,000	
Accruals	1,666		2,330	
Settlements	(1,666)		(2,330)	
Balance at the end of period	$ 2,000	$	$ 2,000	$

Deferred Financing Costs

Deferred financing costs include fees and costs incurred in conjunction with long-term financings and are amortized over the terms of the related debt using the straight-line method, which approximates the effective interest method. Upon repayment of or in conjunction with a material change in the terms of the underlying debt agreement, any unamortized costs are charged to earnings. Deferred financing costs were $4.3 million, net of accumulated amortization of $1.6 million as of September 30, 2008 and $1.6 million, net of accumulated amortization of $0.7 million, as of December 31, 2007.

Per Share Data

Basic and diluted earnings per share are computed based upon the weighted average number of shares outstanding during the respective period. There were 7,372 and 13,275 shares of unvested restricted stock outstanding at September 30, 2008 and 2007, respectively, that were not included in the computation of diluted earnings per share because the effects of their inclusion would be anti-dilutive.

Concentrations and Credit Risk

The Company maintains its cash in commercial banks. Balances on deposit are insured by the Federal Deposit Insurance Corporation (FDIC) up to specific limits. Balances on deposit in excess of FDIC limits are uninsured.

One customer accounted for over 10% of accounts receivable at September 30, 2008. No customers or tenants accounted for more than 10% of revenue for the three and nine months ended September 30, 2008 and 2007.

Reclassifications

As a result of the merger with Erdman, management has revised certain presentations in the condensed consolidated balance sheets and the condensed consolidated statements of operations to reflect the appropriate line items for the operations of the integrated business. These revisions include new line items for design-build operations, combining presentation of management fees and other reimbursements, and separately presenting income tax provision in the condensed consolidated statements of operations as well as separating out tenant and accounts receivable from other assets, accounts payable from accounts payable and other liabilities, and the combination of some immaterial line items into new lines for other assets and other liabilities in the condensed consolidated balance sheets. The reclassifications did not affect previously reported stockholders equity or net loss.

Recent Accounting Pronouncements

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 (SFAS 161). SFAS 161 is intended to provide users of financial statements with an enhanced understanding of derivative instruments and hedging activities by having the Company disclose: (1) how and why the Company uses derivative instruments; (2) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations; and (3) how derivative instruments and related hedged items affect the Company s financial position, financial performance and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after

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November 15, 2008, with early application encouraged. SFAS 161 encourages, but does not require, comparative disclosures for earlier periods at initial adoption. The Company has not adopted SFAS 161 and is in the process of evaluating the impact SFAS 161 may have on its consolidated financial statements.

In April 2008, the FASB issued Financial Statement Position (FSP) No. EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities (FSP No. EITF 03-6-1). FSP No. EITF 03-6-1 states that all outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends participate in undistributed earnings with common shareholders and should be included in basic and diluted earnings per share calculations. FSP No. EITF 03-6-1 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2008. The Company is evaluating the impact FSP No. EITF 03-6-1 may have on its consolidated financial statements.

In April 2008, the FASB issued FSP No. FAS 142-3, Determination of the Useful Life of Intangible Assets (FSP No. FAS 142-3). FSP No. FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets (SFAS 142). The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141(R) and other GAAP. FSP FAS 142-3 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2008. The Company is evaluating the impact FSP No. FAS 142-3 may have on its consolidated financial statements.

