PS BUSINESS PARKS INC/CA
Form 10-Q
November 07, 2007

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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, 2007

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 1-10709
PS BUSINESS PARKS, INC.
(Exact name of registrant as specified in its charter)

California	**95-4300881**
(State or Other Jurisdiction of Incorporation)	(I.R.S. Employer Identification Number)

701 Western Avenue, Glendale, California 91201-2397
(Address of principal executive offices) (Zip Code)
Registrant s telephone number, including area code: **(818) 244-8080**

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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer þ **Accelerated Filer** o **Non-accelerated Filer** o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o **No** þ

As of October 31, 2007, the number of shares of the registrant s common stock, $0.01 par value per share, outstanding was 21,348,963.

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PS BUSINESS PARKS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

	September 30, 2007 (Unaudited)	December 31, 2006
ASSETS		
Cash and cash equivalents	$ 56,725	$ 66,282
Real estate facilities, at cost:		
Land	494,849	439,777
Buildings and equipment	1,471,564	1,353,442
	1,966,413	1,793,219
Accumulated depreciation	(513,177)	(441,336)
	1,453,236	1,351,883
Land held for development	7,869	9,011
	1,461,105	1,360,894
Rent receivable	2,049	2,080
Deferred rent receivable	21,943	21,454
Other assets	8,129	12,154
Total assets	$ 1,549,951	$ 1,462,864
LIABILITIES AND SHAREHOLDERS EQUITY		
Accrued and other liabilities	$ 46,688	$ 42,394
Preferred stock called for redemption		50,000
Mortgage notes payable	61,064	67,048
Total liabilities	107,752	159,442
Minority interests:		
Preferred units	94,750	82,750
Common units	160,924	165,469
Commitments and contingencies		
Shareholders equity:		
Preferred stock, $0.01 par value, 50,000,000 shares authorized, 28,650 and 22,900 shares issued and outstanding at September 30, 2007 and December 31, 2006, respectively	716,250	572,500
Common stock, $0.01 par value, 100,000,000 shares authorized, 21,348,771 and 21,311,005 shares issued and outstanding at September 30, 2007 and December 31, 2006, respectively	213	213
Paid-in capital	396,613	398,048
Cumulative net income	535,555	483,403
Cumulative distributions	(462,106)	(398,961)

Total shareholders equity	1,186,525	1,055,203
Total liabilities and shareholders equity	$ 1,549,951	$ 1,462,864

See accompanying notes.

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PS BUSINESS PARKS, INC.
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited, in thousands, except per share data)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2007	2006	2007	2006
Revenues:				
Rental income	$ 68,530	$ 61,695	$ 200,929	$ 179,608
Facility management fees	177	147	542	442
Total operating revenues	68,707	61,842	201,471	180,050
Expenses:				
Cost of operations	21,204	19,213	62,665	55,354
Depreciation and amortization	25,285	22,184	71,841	63,720
General and administrative	2,124	1,742	5,938	5,264
Total operating expenses	48,613	43,139	140,444	124,338
Other income and expenses:				
Interest and other income	1,151	1,884	4,141	5,457
Interest expense	(1,009)	(628)	(3,128)	(1,658)
Total other income and expenses	142	1,256	1,013	3,799
Income from continuing operations before minority interests	20,236	19,959	62,040	59,511
Minority interests in continuing operations:				
Minority interest in income preferred units				
Distributions to preferred unit holders	(1,752)	(2,672)	(5,103)	(8,234)
Redemption of preferred operating partnership units		(1,366)		(1,366)
Minority interest in income common units	(1,461)	(1,185)	(4,785)	(3,850)
Total minority interests in continuing operations	(3,213)	(5,223)	(9,888)	(13,450)
Income from continuing operations	17,023	14,736	52,152	46,061
Discontinued operations:				
Loss from discontinued operations				(125)
Gain on disposition of real estate				2,328
Minority interest in income attributable to discontinued operations common units				(560)
Income from discontinued operations				1,643
Net income	17,023	14,736	52,152	47,704

Net income allocable to preferred shareholders:				
Preferred stock distributions	12,756	11,258	38,181	33,111
Redemption of preferred stock				1,658
Total preferred stock distributions	12,756	11,258	38,181	34,769
Net income allocable to common shareholders	$ 4,267	$ 3,478	$ 13,971	$ 12,935
Net income per common share basic:				
Continuing operations	$ 0.20	$ 0.16	$ 0.65	$ 0.53
Discontinued operations	$	$	$	$ 0.08
Net income	$ 0.20	$ 0.16	$ 0.65	$ 0.61
Net income per common share diluted:				
Continuing operations	$ 0.20	$ 0.16	$ 0.64	$ 0.52
Discontinued operations	$	$	$	$ 0.08
Net income	$ 0.20	$ 0.16	$ 0.64	$ 0.60
Weighted average common shares outstanding:				
Basic	21,345	21,290	21,332	21,345
Diluted	21,616	21,599	21,670	21,630

See accompanying notes.

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PS BUSINESS PARKS, INC.
CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2007
(Unaudited, in thousands, except share data)

	Preferred Stock		Common Stock		Paid-in	Cumulative Net	Cumulative	Total Shareholders
	Shares	Amount	Shares	Amount	Capital	Income	Distributions	Equity
Balances at December 31, 2006	22,900	$ 572,500	21,311,005	$ 213	$ 398,048	$ 483,403	$ (398,961)	$ 1,055,203
Issuance of preferred stock, net of costs	5,750	143,750			(4,183)			139,567
Exercise of stock options			14,600		479			479
Stock compensation			23,166		1,911			1,911
Shelf registration					(88)			(88)
Net income						52,152		52,152
Distributions:								
Preferred stock							(38,181)	(38,181)
Common stock							(24,964)	(24,964)
Adjustment to minority interests underlying ownership					446			446
Balances at September 30, 2007	28,650	$ 716,250	21,348,771	$ 213	$ 396,613	$ 535,555	$ (462,106)	$ 1,186,525

See accompanying notes.

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PS BUSINESS PARKS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited, in thousands)

	For the Nine Months Ended September 30, 2007	2006
Cash flows from operating activities:		
Net income	$ 52,152	$ 47,704
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	71,841	63,747
In-place lease adjustment	(53)	172
Lease incentives net of tenant improvement reimbursements	96	387
Amortization of mortgage premium	(184)	
Minority interest in income	9,888	14,010
Gain on disposition of real estate		(2,328)
Stock compensation expense	2,746	2,007
Decrease (increase) in receivables and other assets	3,057	(3,370)
Increase in accrued and other liabilities	926	4,123
Total adjustments	88,317	78,748
Net cash provided by operating activities	140,469	126,452
Cash flows from investing activities:		
Capital improvements to real estate facilities	(30,118)	(25,459)
Acquisition of real estate facilities	(138,936)	(108,237)
Proceeds from disposition of real estate facilities		7,714
Insurance proceeds from casualty loss		500
Net cash used in investing activities	(169,054)	(125,482)
Cash flows from financing activities:		
Principal payments on mortgage notes payable	(850)	(565)
Repayment of mortgage note payable	(4,950)	
Net proceeds from the issuance of preferred units	11,665	
Net proceeds from the issuance of preferred stock	139,567	92,557
Exercise of stock options	479	843
Shelf registration costs	(88)	
Repurchase of common stock		(16,117)
Redemption of preferred units		(53,000)
Redemption of preferred stock	(50,000)	(65,850)
Distributions paid to preferred shareholders	(38,181)	(33,357)
Distributions paid to minority interests preferred units	(5,103)	(8,234)
Distributions paid to common shareholders	(24,964)	(18,538)
Distributions paid to minority interests common units	(8,547)	(6,356)
Net cash provided by (used in) financing activities	19,028	(108,617)

Net decrease in cash and cash equivalents	(9,557)	(107,647)
Cash and cash equivalents at the beginning of the period	66,282	200,447
Cash and cash equivalents at the end of the period	$ 56,725	$ 92,800

See accompanying notes.

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PS BUSINESS PARKS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited, in thousands)

Supplemental schedule of non cash investing and financing activities:		
Adjustment to minority interest to underlying ownership:		
Minority interest common units	$ (781)	$ (1,812)
Paid-in capital	$ 781	$ 1,812
Effect of EITF Topic D-42:		
Cumulative distributions	$	$ (1,658)
Minority interest common units	$	$ (1,366)
Paid-in capital	$	$ 3,024
Mortgage note payable assumed in property acquisition:		
Real estate facilities	$	$ (17,939)
Mortgage notes payable	$	$ 17,939

See accompanying notes.

PS BUSINESS PARKS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2007

1. Organization and description of business

PS Business Parks, Inc. (PSB) was incorporated in the state of California in 1990. As of September 30, 2007, PSB owned approximately 74.5% of the common partnership units of PS Business Parks, L.P. (the Operating Partnership). The remaining common partnership units are owned by Public Storage (PS) and its affiliates. PSB, as the sole general partner of the Operating Partnership, has full, exclusive and complete responsibility and discretion in managing and controlling the Operating Partnership. PSB and the Operating Partnership are collectively referred to as the Company.

The Company is a fully-integrated, self-advised and self-managed real estate investment trust (REIT) that acquires, develops, owns and operates commercial properties containing commercial and industrial rental space. As of September 30, 2007, the Company owned and operated approximately 19.6 million rentable square feet of commercial space located in eight states. The Company also manages approximately 1.4 million rentable square feet on behalf of PS and its affiliated entities.

2. Summary of significant accounting policies

Basis of presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from these estimates. In the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ended December 31, 2007. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

The accompanying consolidated financial statements include the accounts of PSB and the Operating Partnership. All significant inter-company balances and transactions have been eliminated in the consolidated financial statements.

Use of estimates

The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from these estimates.

Allowance for doubtful accounts

We monitor the collectibility of our receivable balances, including the deferred rent receivable, on an on-going basis. Based on these reviews, we maintain an allowance for doubtful accounts for estimated losses resulting from the possible inability of our tenants to make required rent payments to us. A provision for doubtful accounts is recorded during each period. The allowance for doubtful accounts, which represents the cumulative allowances less write-offs of uncollectible rent, is netted against tenant and other receivables on our consolidated balance sheets. Tenant receivables are net of an allowance for uncollectible accounts totaling $300,000 at September 30, 2007 and December 31, 2006.

Financial instruments

The methods and assumptions used to estimate the fair value of financial instruments are described below. The Company has estimated the fair value of financial instruments using available market information and appropriate valuation methodologies. Considerable judgment is required in interpreting market data to develop estimates of market value. Accordingly, estimated fair values are not necessarily indicative of the amounts that could be realized in current market exchanges.

The Company considers all highly liquid investments with a remaining maturity of three months or less at the date of purchase to be cash equivalents. Due to the short period to maturity of the Company s cash and cash equivalents, accounts receivable, other assets and accrued and other liabilities, the carrying values as presented on the consolidated balance sheets are reasonable estimates of fair value. Based on borrowing rates currently available to the Company, the carrying amount of debt approximates fair value.

Financial assets that are exposed to credit risk consist primarily of cash and cash equivalents and receivables. Cash and cash equivalents, which consist primarily of short-term investments, including commercial paper, are only invested in entities with an investment grade rating. Receivables are comprised of balances due from a large number of tenants. Balances that the Company expects to become uncollectable are reserved for or written off.

Real estate facilities

Real estate facilities are recorded at cost. Costs related to the renovation or improvement of the properties are capitalized. Expenditures for repairs and maintenance are expensed as incurred. Expenditures that are expected to benefit a period greater than 24 months and exceed $2,000 are capitalized and depreciated over the estimated useful life. Buildings and equipment are depreciated using the straight-line method over the estimated useful lives, which are generally 30 and 5 years, respectively. Leasing costs in excess of $1,000 for leases with terms greater than two years are capitalized and depreciated/amortized over their estimated useful lives. Leasing costs for leases of less than two years or less than $1,000 are expensed as incurred. Interest cost and property taxes incurred during the period of construction of real estate facilities are capitalized.

Properties held for disposition

The Company accounts for properties held for disposition in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets . An asset is classified as an asset held for disposition when it meets the requirements of SFAS No. 144, which include, among other criteria, the approval of the sale of the asset, the asset has been marketed for sale and the Company expects that the sale will likely occur within the next twelve months. Upon classification of an asset as held for disposition, the net book value of the asset, net of any impairment provision and estimated costs of disposition, is included on the consolidated balance sheet as properties held for disposition and the operating results of the asset are included in discontinued operations.

Intangible assets/liabilities

Intangible assets and liabilities include above-market and below-market in-place lease values of acquired properties based on the present value (using an interest rate which reflects the risks associated with the leases acquired) of the difference between (i) the contractual amounts to be paid pursuant to the in-place leases and (ii) management s estimate of fair market lease rates for the corresponding in-place leases, measured over a period equal to the remaining non-cancelable term of the lease. The capitalized above and below-market lease values (included in other assets and accrued liabilities in the accompanying consolidated balance sheet) are amortized, net, to rental income over the remaining non-cancelable terms of the respective leases. The Company amortized $44,000 and $60,000 of intangible assets and liabilities resulting from the above and below market lease values during the three months ended September 30, 2007 and 2006, respectively. Amortization was $53,000 and $172,000 for each of the nine months ended September 30, 2007 and 2006, respectively. As of September 30,

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2007, the value of in-place leases resulted in a net intangible asset of $479,000, net of $713,000 of accumulated amortization, and a net intangible liability of $1.1 million, net of $232,000 of accumulated amortization. As of December 31, 2006 the value of in-place leases resulted in a net intangible asset of $656,000, net of $535,000 of accumulated amortization.

Evaluation of asset impairment

The Company evaluates its assets used in operations by identifying indicators of impairment and by comparing the sum of the estimated undiscounted future cash flows for each asset to the asset s carrying amount. When indicators of impairment are present and the sum of the undiscounted future cash flows is less than the carrying value of such asset, an impairment loss is recorded equal to the difference between the asset s current carrying value and its value based on discounting its estimated future cash flows. In addition, the Company evaluates its assets held for disposition. Assets held for disposition are reported at the lower of their carrying amount or fair value, less cost of disposition. At September 30, 2007, the Company did not consider any assets to be impaired.

Stock-based compensation

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), Share-Based Payment, which is a revision of SFAS No. 123, Accounting for Stock-Based Compensation. SFAS No. 123(R) supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and amends SFAS No. 95, Statement of Cash Flows. Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Effective January 1, 2006, the Company adopted SFAS No. 123(R) using the modified prospective method, which did not have a material impact on the results of operations or the financial position of the Company. See Note 11.

Revenue and expense recognition

Revenue is recognized in accordance with Staff Accounting Bulletin No. 104 of the Securities and Exchange Commission, Revenue Recognition in Financial Statements (SAB 104), as amended. SAB 104 requires that four basic criteria must be met before revenue can be recognized: persuasive evidence of an arrangement exists; the delivery has occurred or services rendered; the fee is fixed or determinable; and collectibility is reasonably assured. All leases are classified as operating leases. Rental income is recognized on a straight-line basis over the terms of the leases. Straight-line rent is recognized for all tenants with contractual increases in rent that are not included on the Company s credit watch list. Deferred rent receivables represent rental revenue recognized on a straight-line basis in excess of billed rents. Reimbursements from tenants for real estate taxes and other recoverable operating expenses are recognized as rental income in the period the applicable costs are incurred. Property management fees are recognized in the period earned.

Costs incurred in connection with leasing (primarily tenant improvements and leasing commissions) are capitalized and amortized over the lease period.

Gains from sales of real estate

The Company recognizes gains from sales of real estate at the time of sale using the full accrual method, provided that various criteria related to the terms of the transactions and any subsequent involvement by the Company with the properties sold are met. If the criteria are not met, the Company defers the gains and recognizes them when the criteria are met or using the installment or cost recovery methods as appropriate under the circumstances.

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General and administrative expense

General and administrative expense includes executive and other compensation, office expense, professional fees, state income taxes, dues, listing fees and other administrative items.

Income taxes

The Company qualified and intends to continue to qualify as a REIT, as defined in Section 856 of the Internal Revenue Code. As a REIT, the Company is not subject to federal income tax to the extent that it distributes its taxable income to its shareholders. A REIT must distribute at least 90% of its taxable income each year. In addition, REITs are subject to a number of organizational and operating requirements. If the Company fails to qualify as a REIT in any taxable year, the Company will be subject to federal income tax (including any applicable alternative minimum tax) based on its taxable income using corporate income tax rates. Even if the Company qualifies for taxation as a REIT, the Company may be subject to certain state and local taxes on its income and property and to federal income and excise taxes on its undistributed taxable income. The Company believes it met all organizational and operating requirements to maintain its REIT status during 2006 and intends to continue to meet such requirements for 2007. Accordingly, no provision for income taxes has been made in the accompanying consolidated financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 is an interpretation of FASB Statement No. 109, Accounting for Income Taxes, and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, FIN 48 provides guidance on derecognition, classification, interest and penalties, and accounting in interim periods and requires expanded disclosure with respect to the uncertainty in income taxes. The cumulative effect, if any, of applying FIN 48 is to be reported as an adjustment to the opening balance of retained earnings in the year of adoption. The adoption of FIN 48 effective January 1, 2007 did not have a material effect on the Company.

Accounting for preferred equity issuance costs

In accordance with Emerging Issues Task Force (EITF) Topic D-42, the Company records its issuance costs as a reduction to paid-in capital on its balance sheet at the time the preferred securities are issued and reflects the carrying value of the preferred stock at the stated value. The Company reduces the carrying value of preferred stock by the issuance costs, with a corresponding reduction to income allocable to common shareholders, at the time it notifies the holders of preferred stock or units of its intent to redeem such shares or units.

Net income per common share

Per share amounts are computed using the number of weighted average common shares outstanding. Diluted weighted average common shares outstanding include the dilutive effect of stock options and restricted stock units under the treasury stock method. Basic weighted average common shares outstanding exclude such effect. Earnings per share have been calculated as follows (in thousands, except per share amounts):

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The Company is a leading manufacturer and global distributor of educational, health, medical technology and agricultural products, primarily offered through catalogs.

The following is a summary of key events for the first quarter of 2005:

- increase in net sales of 7.0% in the first quarter of 2005, as compared to the same period in 2004;
- increase in gross profit of 5.8% in the first quarter of 2005, as compared to the same period in 2004;
- 4.8% increase in earnings before income taxes in the

first quarter of 2005, as compared to the same period in 2004;

- increase in cash retained in the Company to $1.6 million in the first quarter of 2005, from $1.5 million in the comparable quarter in 2004, primarily as a result of the increased current utilization of Federal net operating tax loss carryforwards;

- EBITDA(1) amounted to $5.9 million for the first quarter of 2005, an increase of 2.3% from the same period in 2004;

- decrease in cash flows from operating activities to a $2.1 million use of cash in the first quarter of 2005, from a $.3 million generation of cash in the comparable quarter in 2004, primarily as a result of additional working capital requirements related to accounts receivable, inventories and accrued expenses and other liabilities of $1.1 million, $.9 million and $.9 million, respectively, offset by a $.6 million decrease in working capital used by prepaid expenses and other; the increase in inventories is primarily attributable to

management decisions to accelerate certain purchases thereof for the seasonal peak 2005 summer season.

- purchase of land for $.6 million in the first quarter of 2005 for the construction of an 80,000 square foot office and warehouse facility for the Company's Simulaids operations;

- the Company had investments of $4.1 million at March 31, 2005, as compared to none at March 31, 2004;

- increase in net principal proceeds from debt of $5.6 million in the first quarter of 2005, as compared to the same period in 2004, primarily as a result of the increase in the amounts outstanding on the Company's primary credit facility due to seasonal working capital requirements; and

- semi-annual dividend payments (March 31 and September 30) totaling $4.3 million on the Company's Series I Preferred Stock and Series J Preferred Stock in the first quarter of 2005, of which, $2.2 million was accreted during the first quarter of 2005.

A key strength of the Company's business is its ability to generate cash consistently. The Board of Directors and management use cash generated as a measure of the Company's performance. The Company uses the cash generated from operations to strengthen the balance sheet, including making investments and reducing liabilities such as pension and debt, paying dividends on its preferred stock and completing prudent acquisition opportunities. The Company's management believes that examining the ability to generate cash provides investors with additional insight into the Company's performance.

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The following table sets forth selected financial data (i) as a percentage of net sales for the three months ended March 31, 2005 and 2004 and (ii) the percentage change in dollars in those reported items from the comparable period in 2004:

	% of Net Sales				Balance	
	2005		2004		% Change	
Net sales	100.0	%	100.0	%	7.0	%
Cost of sales	61.5		61.1		7.8	

Gross profit	38.5	38.9	5.8
Selling and administrative expense	25.5	25.3	7.7
Earnings from operations	13.0	13.6	2.2
Other expense (income):			
Interest expense	.7	.8	(7.0)
Other, net	(.2)	.1	(333.3)
	.5	.9	(35.6)
Earnings before income taxes	12.5	12.7	4.8
Income taxes			
Current	1.1	1.2	2.0
Deferred	3.7	3.8	5.9
	4.8	5.0	5.0
Net earnings	7.7 %	7.7 %	4.7

1. "EBITDA," which is considered a non-GAAP financial measure, is defined as earnings before income taxes, interest expense, other income and expense, depreciation and amortization. A non-GAAP financial measure is a numerical measure of a company's historical or future financial performance, financial position or cash flows that either excludes or includes amounts that are normally included or excluded in a comparable measure calculated and presented under GAAP. EBITDA is not presented as an alternative measure of operating results (such as earnings from operations or net earnings) or cash flow from operations, as determined in accordance with GAAP, but is presented because the Company's management believes it is a widely accepted indicator of the Company's current financial performance and ability to incur and service debt. EBITDA does not give effect to cash used for debt service requirements and thus does not reflect funds available for dividends, reinvestment or other discretionary uses. In addition, EBITDA as presented herein may not be comparable to similarly titled measures reported by other companies. The following table provides a reconciliation of net earnings to EBITDA for the three months ended March 31 (in thousands):

	2005	2004

Net earnings		$ 3,188	3,045
Add:			
	Income taxes	2,021	1,925
	Interest expense	291	313
	Other expense (income)	(70)	30
	Depreciation and amortization	429	416
EBITDA		$ 5,859	5,729

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FLUCTUATIONS IN QUARTERLY RESULTS OF OPERATIONS

The Company is subject to seasonal influences with peak levels occurring in the second and third quarters of the fiscal year primarily due to increased educational shipments coinciding with the start of new school years in the Fall. As a result, the Company recognizes approximately 75% of its annual net earnings in the second and third quarters of its fiscal year. Inventory levels increase in March through June in anticipation of the peak shipping season. The majority of shipments are made between June and August and the majority of cash receipts are collected from August through October.

Quarterly results may also be materially affected by the timing of acquisitions, the timing and magnitude of costs related to such acquisitions, variations in costs of products sold, the mix of products sold and general economic conditions. Results for any quarter are not indicative of the results for any subsequent fiscal quarter or for a full fiscal year.

RESULTS OF OPERATIONS - THREE MONTHS ENDED MARCH 31, 2005 AS COMPARED TO THREE MONTHS ENDED MARCH 31, 2004

Net Sales

Net sales for the first quarter of 2005 increased 7.0% to $41.7 million from $39.0 million for the comparable period in 2004. The growth in net sales for the first quarter of 2005 is primarily attributable to organic growth of approximately 3.6% and the inclusion of an additional $1.3 million of net sales from the CPR Prompt and Ginsberg acquisitions. Net sales in the educational segment, totaling $33.9 million, increased 9.2% in the first quarter of 2005 from $31.1 million in the comparable period in 2004. Excluding the net sales from CPR Prompt and Ginsberg, educational net sales increased 4.9% from the first quarter of 2004. The commercial segment recorded net sales of $7.8 million in the first quarter of 2005 as compared to $7.9 million in the first quarter of 2004.

Gross Profit

Gross profit for the first quarter of 2005 increased 5.8% to $16.1 million from $15.2 million for the comparable period in 2004. The increase in gross profit for the first quarter of 2005 is primarily attributable to the 7.0% increase in net sales including the additional gross profit of $.6 million contributed by CPR Prompt and Ginsberg. The gross profit margin of 38.5% in the first quarter of 2005 decreased slightly from the 38.9% gross profit margin in the comparable period in 2004. The educational segment gross profit for the first quarter of 2005 increased 6.9% to $14.1 million from $13.2 million for the comparable period in 2004. The educational segment gross profit margin decreased to 41.5% in the first quarter of 2005 from 42.4% for the comparable period in 2004. The decrease in the educational segment gross profit margin in the first quarter of 2005 is primarily due to an increase in higher volume, lower margin quote sales to the school supply market and increased fuel costs supporting product distribution. The commercial segment gross profit for the first quarters of 2005 and 2004 amounted to $2.9 million. The commercial segment yielded a gross profit margin of 37.2% in the first quarter of 2005, as compared to 36.0% in the comparable period in 2004. The increase in the commercial segment gross profit margin is primarily due to a shift in sales mix, offset by increased fuel costs supporting product distribution.

Selling and Administrative Expenses

Selling and administrative expenses for the first quarter of 2005 increased 7.7% to $10.6 million from $9.9 million in the comparable period in 2004. As a percent of net sales, selling and administrative expenses amounted to 25.5% for the first quarter of 2005, as compared to 25.3% in the first quarter of 2004. Expenses included in this total include advertising and catalog costs, warehouse and shipping activities, customer service and general administrative functions. Selling and administrative expenses for the first quarter of 2005 were impacted by the following: (i) increase in salaries and wages of $.3 million, or 5.2%, as a result of the increases in annual employee compensation and the number of employees; and (ii) an increase in group health care costs by 39.7% to $1.0 million in the first quarter of 2005.

The Company recorded $.1 million in compensation expense for the first quarters of 2005 and 2004 related to grants of stock options to certain employees and directors.

The Company incurred expenses of $.2 million to Geneve for certain administrative services for the first quarters of 2005 and 2004.

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Interest Expense

Interest expense decreased 7.0% to $.3 million for the first quarter of 2005. The decrease in interest expense is primarily due to the decrease in the weighted average debt outstanding during the first quarter of 2005, net of increases in the interest rates on debt outstanding, compared to the same period in 2004. The decrease in the weighted average debt outstanding during the first quarter of 2005 is the result of the following: (i) decrease in the weighted average amounts outstanding on the Company's primary credit facility; (ii) payment in full of the $.5 million note payable to a related party during the second quarter of 2004; and (iii) payment of $3.4 million during the third quarter of 2004 in full settlement of the mortgage related to the properties held by NHI, LLC

. The weighted average interest rate on the Company's debt increased to 4.2% in the first quarter of 2005 compared to 3.7% in the comparable period in 2004.

The Company's credit agreements assessed interest at a weighted average rate of 4.5%, 4.1% and 3.5% at March 31, 2005, December 31, 2004 and March 31, 2004, respectively.

Income Tax Provision

Aristotle and its qualifying domestic subsidiaries are included in the Federal income tax return and certain state income tax returns of Geneve. The provision for income taxes for the Company is determined on a separate return basis in accordance with the terms of a tax sharing agreement with Geneve, and payments for current Federal and certain state income taxes are made to Geneve.

The income tax provision for the first quarter of 2005 was $2.0 million compared to $1.9 million for the comparable period in 2004. These tax provisions reflect effective tax rates of 38.8% and 38.7% for the first quarters of 2005 and 2004, respectively. For the first quarters of 2005 and 2004, the difference between the Federal statutory income tax rate of 35% and the effective income tax rate results principally from foreign and state income taxes. Approximately $1.6 million of the income tax provision for the first quarter of 2005 relates to the current utilization of the Company's Federal net operating tax loss carryforwards, compared to approximately $1.5 million in the first quarter of 2004. Although the reported earnings for the first quarters of 2005 and 2004 are shown after-tax, approximately $1.6 million and $1.5 million, respectively, of cash from operations was retained in the Company primarily as a result of the current utilization of these Federal net operating tax loss carryforwards. Except for Federal alternative minimum tax obligations arising from limitations on the utilization of Federal net operating tax loss carryforwards in 2005 and future years, the Company anticipates that the utilization of the available Federal net operating tax loss carryforwards to offset future Federal taxable income will result in the Company not having to use its cash resources to pay Federal income taxes for approximately the next two years.

At March 31, 2005, the Condensed Consolidated Balance Sheet contains a net deferred tax asset of $18.9 million, net of a valuation allowance of $7.7 million. Substantially all of the net deferred tax asset relates to Federal net operating tax loss carryforwards, which were recognized in applying purchase accounting to the merger with Nasco International, Inc. on June 17, 2002. The valuation allowance has been established primarily to reflect the estimate of Federal net operating tax loss carryforwards that are expected to expire unutilized. There were no changes to the valuation allowance during the first quarters of 2005 and 2004.

LIQUIDITY AND CAPITAL RESOURCES

At March 31, 2005, the Company had working capital of $61.6 million, increasing from $53.4 million at December 31, 2004. At March 31, 2004, the Company had working capital of $47.8 million. Cash and cash equivalents decreased $1.3 million in the first quarter of 2005, ending the period at $.8 million. Cash and cash equivalents decreased $3.8 million in first quarter of 2004, ending the period at $1.8 million. This decrease in the use of cash and cash equivalents during the first quarter of 2005 as compared to the same period in 2004 is primarily due to the following activities:

- The Company used cash of $2.1 million for operations during the first quarter of 2005 compared to cash generated from operations of $.3 million in the first quarter of 2004. In the first quarter of 2005, the increase in cash used for operations compared to the first quarter of 2004 was principally the result of additional working capital requirements primarily related to accounts receivable, inventories and accrued expenses and other liabilities of $1.1 million, $.9 million and $.9 million, respectively, offset by a $.6 million decrease in working capital used by prepaid expenses and other. The increase in inventories is primarily attributable to

management decisions to accelerate certain purchases thereof for the seasonal peak 2005 summer season.

These changes in current assets and liabilities are typical for the first quarter of the fiscal year as the Company is preparing for its peak business cycle, which occurs during the second and third quarters of the fiscal year. For more information on the seasonality of the Company's business, please refer to the "Fluctuations in Quarterly Results of Operations" section above.

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- The Company used cash of $.9 million for investing activities in the first quarter of 2005, compared to $.3 million in the first quarter of 2004. In the first quarter of 2005, the Company used cash of $.6 million to purchase land for the construction of an approximately 80,000 square foot office and warehouse facility for the Company's Simulaids operations. It is estimated that the construction cost of the facility will be approximately $4.8 million. The Company anticipates completing construction of the facility by the first quarter of 2006. The Company initially is funding the construction of the facility through a

one year, $4.3 million construction loan, with interest payable monthly at the bank's prime rate. Subsequent to the completion of the facility, the Company intends to convert the construction loan to a long-term debt arrangement secured by a mortgage on the new facility. The Company intends to sell the current Simulaids facility following commencement of operations at the new facility. Capital expenditures to replace and upgrade existing capital equipment and install new equipment and fixtures to provide additional operating efficiencies totaled $.3 million in the first quarters of 2005 and 2004.

The Company invests in an investment limited partnership, the general partner of which is an affiliate of the Company. The assets of the limited partnership are managed exclusively by a non-affiliate of the Company (see Note 7 of the Notes Condensed Consolidated Financial Statements included in Item 1 of this Form 10-Q). The Company had investments of $4.1 million at March 31, 2005, as compared to none at March 31, 2004.

- Financing activities provided cash of $1.7 million in the first quarter of 2005, compared to a use of cash of $3.8 million in the first quarter of 2004. In the first quarter of 2005, the net principal proceeds from debt of $5.9 million were primarily due to the increase in the amounts outstanding on the Company's primary credit facility due to seasonal working capital requirements and the $.6 million purchase of land for the Simulaids facility

. In the first quarter of 2004, the net principal proceeds from debt of $.3 million were primarily due to the following: (i) increase of $1.5 million in the amounts outstanding on the Company's primary credit facility due to seasonal working capital requirements; and (ii) payment of $1.1 million for the settlement of capital lease obligations related to the office and warehouse facility for the Company's Haan Crafts operations.

The Company paid dividends of $4.3 million in the first quarters of 2005 and 2004 on its Series I Preferred Stock and Series J Preferred Stock.

On October 15, 2003, the Company entered into a five-year, non-amortizing, $45.0 million Revolving Credit Facility. The Revolving Credit Facility provides the Company with seasonal working capital, letters of credit and funds for appropriate acquisitions of businesses similar in nature to the Company's current business segments. This debt carries a variable rate of interest that is based on Prime or LIBOR rates plus applicable margins. At March 31, 2005, the weighted average interest rate on this debt was 4.3%. The Revolving Credit Facility currently has a committed weighted average rate of interest (including applicable margins) of approximately 4.3%. Such rate commitments expire on various dates through June 8, 2005. The Company's Revolving Credit Facility is collateralized by certain accounts receivable, inventories and property, plant and equipment, and shares of a certain subsidiary's capital stock outstanding and ownership interests of certain of the Company's limited liability subsidiaries. The Revolving Credit Facility contains various financial and operating covenants, including, among other things, requirements to maintain certain financial ratios and restrictions on additional indebtedness, common stock dividend payments, capital disposals and intercompany management fees. The Company was in compliance with all financial covenants as of March 31, 2005.

In 2005, capital expenditures to replace and upgrade existing equipment and install new equipment and fixtures to provide additional operating efficiencies are expected to approximate $1.7 million.

Capital resources in the future are expected to be used for the development of catalogs and product lines, to acquire additional businesses and for other investing activities. The Company anticipates that there will be sufficient financial resources to meet projected working capital and other cash requirements for at least the next twelve months. Management of the Company believes it has sufficient capacity to maintain current operations and support a sustained level of future growth.

INFLATION

Inflation has had and is expected to have only a minor effect on the Company's operating results and its sources of liquidity.

SIGNIFICANT ACCOUNTING POLICIES

The preparation of the Condensed Consolidated Financial Statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the Condensed Consolidated Financial Statements and notes thereto. Actual results could differ from those estimates. The Company believes the following accounting policies affect the more significant judgments and estimates used in the preparation of the Condensed Consolidated Financial Statements:

<u>Prepaid Catalog Costs and Amortization</u>

- The Company accumulates all direct costs, less vendor rebates, incurred in the development, production and circulation of catalogs on the Condensed Consolidated Balance Sheets until the related catalog is mailed, at which time such catalog costs are amortized into selling and administrative expense over the estimated sales realization cycle of one year, using the straight-line method.

<u>Deferred Income Taxes</u>

- At March 31, 2005, the Condensed Consolidated Balance Sheet contains a net deferred tax asset of approximately $18.9 million, net of a valuation allowance of approximately $7.7 million, related primarily to Federal net operating tax loss carryforwards. The realizability of this asset is dependent upon the Company's generation of sufficient levels of future taxable income and the ability to retain its Federal net operating tax loss carryforward position. Events may limit the use of all or a portion of these Federal net operating tax loss carryforwards, thus potentially resulting in a higher tax liability for the Company in the future. The net deferred tax asset, including the valuation allowance, at March 31, 2005 is subject to future adjustment based upon changes in management's evaluation of the realizability of the deferred tax asset.

<u>Goodwill</u>

- The Company evaluates goodwill for impairment at least annually or more frequently if events or circumstances indicate that the assets may be impaired, by applying a fair value based test and, if impairment occurs, the amount of impaired goodwill is written off immediately. The Company evaluates goodwill for impairment based on the expected future cash flows or earnings projections. Goodwill is deemed impaired if the estimated discounted cash flows or earnings projections do not substantiate the carrying value. The estimation of such amounts requires significant management judgment with respect to revenue and expense growth rates, changes in working capital and selection of an appropriate discount rate, as applicable. The use of different assumptions would increase or decrease discounted future operating cash flows or earnings projections and could, therefore, change the impairment determination. The Company evaluated its goodwill at December 31, 2004, and determined that there was no impairment of goodwill.

Defined Benefit Plans

- The Company accounts for the benefits under its defined benefit pension plan using actuarial models required by SFAS No. 87, *"Employers' Accounting for Pensions."* These models use an attribution approach that generally spreads individual events over the service lives of the employees in the plan. Examples of "events" are plan amendments and changes in actuarial assumptions such as discount rate, expected return on plan assets and rate of compensation increases. The principle underlying the required attribution approach is that employees render service over their service lives on a relatively consistent basis and, therefore, the statement of earnings effects of pension benefits are earned in, and should be expensed in, the same pattern.

In calculating net periodic benefit cost and the related benefit obligation, the Company is required to select certain actuarial assumptions. These assumptions include discount rate, expected return on plan assets and rate of compensation increase. The discount rate assumptions reflect the prevailing market rates for long-term, high-quality, fixed-income debt instruments that, if the obligation was settled at the measurement date, would provide the necessary future cash flows to pay the benefit obligation when due. The Company uses long-term historical actual return experience with consideration of the expected investment mix of the plan's assets, as well as future estimates of long-term investment returns, to develop its assumptions of the expected return on plan assets. The rate of compensation increase is based on historical experience and the Company's long-term plans for such increases.

Revenues

- Customarily applying FOB-shipping point terms, the Company recognizes revenue upon shipment of products to its customers, which corresponds to the time when risk of ownership transfers. The point of shipment is typically from one of the Company's distribution centers or, on occasion, a vendor's location as a drop shipment. All drop shipment sales are recorded at gross selling price.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company's financial instruments include cash and cash equivalents, investments, accounts receivable, accounts payable, accrued liabilities and debt. As described below, credit risk and interest rate risk are the primary sources of market risk in the Company's accounts receivable and debt.

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QUALITATIVE

Credit Risk: The Company provides credit in the normal course of business to its customers, which are primarily educational institutions or distributors. No single customer accounted for more than 10% of the Company's sales in the first quarters of 2005 and 2004. The Company performs ongoing credit evaluations of its customers, maintains allowances for potential credit losses and generally does not require collateral to support its accounts receivable balances.

Interest Rate Risk: Changes in interest rates can potentially impact the Company's profitability and its ability to realize assets and satisfy liabilities. Interest rate risk is resident primarily in debt, which typically has variable interest rates based on Prime or LIBOR rates. Assuming no other change in financial structure, an increase of 1% in the Company's variable interest rate for debt would decrease pre-tax earnings for 2005 by approximately $.3 million. This amount is determined by considering the impact of a 1% increase in interest on the average debt estimated to be outstanding in 2005.

QUANTITATIVE

The Company's debt as of March 31, 2005 is as follows (in millions, except percentage data):

	MATURITY LESS THAN ONE YEAR	MATURITY GREATER THAN ONE YEAR
Amount	$ .1	$ 30.9
Weighted average interest rate	5.3%	4.5%
Fair market value	$ .1	$ 30.9

The fair market value of debt equals the face amount of debt outstanding because the underlying rate of interest on substantially all of the Company's debt is variable based upon Prime or LIBOR rates.

ITEM 4. CONTROLS AND PROCEDURES

The President and Chief Financial Officer of the Company (its principal executive officer and principal financial officer, respectively) have concluded, based on their evaluation as of the end of the period covered by this Report, that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in the reports filed or submitted by it under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms, and include controls and procedures designed to ensure that information required to be disclosed by the Company in such reports is accumulated and communicated to the Company's management, including the President and Chief Financial Officer, as appropriate, and allow timely decisions regarding required disclosure.

There have not been any changes in the Company's internal control over financial reporting during the fiscal quarter ended March 31, 2005 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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FORWARD-LOOKING STATEMENTS

The Company believes that this Quarterly Report on Form 10-Q may contain forward-looking statements within the meaning of the "safe-harbor" provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on management's current expectations and are subject to a number of uncertainties and risks that could cause actual results to differ materially from those projected or suggested in such forward-looking statements. The Company cautions investors that there can be no assurance that actual results or business conditions will not differ materially from those projected or suggested in such forward-looking statements as a result of various factors including, but not limited to, the following: (i) the ability of the Company to obtain financing and additional capital to fund its business strategy on acceptable terms, if at all; (ii) the ability of the Company on a timely basis to find, prudently negotiate and consummate additional acquisitions; (iii) the ability of the Company to manage any to-be acquired businesses; (iv) the ability of the Company to retain and utilize its Federal net operating tax loss carryforward position; and (v) other factors identified in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, "Forward-Looking Statements," contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2004. As a result, the Company's future development efforts involve a high degree of risk. For further information, please see the Company's filings with the SEC, including its Forms 10-K, 10-Q and 8-K.

PART II

ITEM 6. EXHIBITS

The following exhibits are filed as part of this report:

EXHIBIT NUMBER	DESCRIPTION
31.1	Rule 13a-14(a)/15d-14(a) Certifications.
31.2	Rule 13a-14(a)/15d-14(a) Certifications.

32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: May 12, 2005

/s/ Steven B. Lapin

Steven B. Lapin

President and Chief Operating Officer

(Principal Executive Officer)

Date: May 12, 2005

/s/ Dean T. Johnson

Dean T. Johnson

Vice President and Chief Financial Officer

(Principal Financial and Accounting Officer)

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