PNC FINANCIAL SERVICES GROUP INC
Form 10-Q
November 09, 2006
**Table of Contents**

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, DC 20549**

# FORM 10-Q

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

**For the quarterly period ended September 30, 2006**

**or**

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

**For the transition period from _______ to _______**

**Commission file number 001-09718**

# The PNC Financial Services Group, Inc.

**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Pennsylvania** | **25-1435979** |
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |

**One PNC Plaza, 249 Fifth Avenue, Pittsburgh, Pennsylvania 15222-2707**

**(Address of principal executive offices)**

**(Zip Code)**

**(412) 762-2000**

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

**(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 x No ¨

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

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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

Yes ¨ No x

As of October 31, 2006, there were 293,812,255 shares of the registrant s common stock ($5 par value) outstanding.

**Table of Contents**

**The PNC Financial Services Group, Inc.**

**Cross-Reference Index to 2006 Third Quarter Form 10-Q**


| | Pages |
|---|---|
| PART I FINANCIAL INFORMATION | |
| Item 1. Financial Statements (Unaudited). | 37-62 |
| Consolidated Income Statement | 37 |
| Consolidated Balance Sheet | 38 |
| Consolidated Statement Of Cash Flows | 39 |
| Notes To Consolidated Financial Statements (Unaudited) | |
| Note 1 Accounting Policies | 40 |
| Note 2 Acquisitions | 47 |
| Note 3 Securities | 48 |
| Note 4 Asset Quality | 49 |
| Note 5 Mortgage Loan Portfolio Repositioning | 50 |
| Note 6 Goodwill And Other Intangible Assets | 50 |
| Note 7 Variable Interest Entities | 51 |
| Note 8 Capital Securities Of Subsidiary Trusts | 51 |
| Note 9 Certain Employee Benefit And Stock-Based Compensation Plans | 52 |
| Note 10 Financial Derivatives | 53 |
| Note 11 Earnings Per Share | 55 |
| Note 12 Shareholders Equity And Other Comprehensive Income | 56 |
| Note 13 Legal Proceedings | 57 |
| Note 14 Segment Reporting | 58 |
| Note 15 Commitments And Guarantees | 61 |
| Note 16 Subsequent Event | 62 |
| Statistical Information (Unaudited) | |
| Average Consolidated Balance Sheet And Net Interest Analysis | 63-64 |
| Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations. | 1-36, 63-64 |
| Consolidated Financial Highlights | 1-2 |
| Financial Review | |
| Executive Summary | 3 |
| Consolidated Income Statement Review | 7 |
| Consolidated Balance Sheet Review | 10 |
| Off-Balance Sheet Arrangements And Variable Interest Entities | 14 |
| Business Segments Review | 15 |
| Critical Accounting Policies And Judgments | 23 |
| Status Of Qualified Defined Benefit Pension Plan | 23 |
| Risk Management | 24 |
| Internal Controls And Disclosure Controls And Procedures | 33 |
| Glossary Of Terms | 33 |
| Cautionary Statement Regarding Forward-Looking Information | 35 |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk. | 24-30 |
| Item 4. Controls and Procedures. | 33 |
| PART II OTHER INFORMATION | |
| Item 1. Legal Proceedings. | 65 |
| Item 1A. Risk Factors. | 65 |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds. | 65 |

| | |
|---|---|
| Item 6. Exhibits. | 65 |
| Exhibit Index. | 65 |
| Signature | 65 |
| Corporate Information | 66 |

Table of Contents

## *CONSOLIDATED FINANCIAL HIGHLIGHTS*

THE PNC FINANCIAL SERVICES GROUP, INC.

| Dollars in millions, except per share data | Three months ended September 30 | | Nine months ended September 30 | |
|---|---|---|---|---|
| Unaudited | **2006** | 2005 | **2006** | 2005 |
| **FINANCIAL PERFORMANCE** | | | | |
| Revenue | | | | |
| Net interest income, taxable-equivalent basis (a) | **$574** | $566 | **$1,699** | $1,619 |
| Noninterest income (b) | **2,943** | 1,116 | **5,358** | 3,019 |
| Total revenue (b) | **$3,517** | $1,682 | **$7,057** | $4,638 |
| Net income (c) | **$1,484** | $334 | **$2,219** | $970 |
| Per common share | | | | |
| Diluted earnings (c) | **$5.01** | $1.14 | **$7.46** | $3.35 |
| Cash dividends declared | **$.55** | $.50 | **$1.60** | $1.50 |
| **SELECTED RATIOS** | | | | |
| Net interest margin | **2.89%** | 2.96% | **2.92%** | 2.99% |
| Noninterest income to total revenue (d) | **84** | 67 | **76** | 65 |
| Efficiency (e) | **34** | 69 | **50** | 69 |
| Return on | | | | |
| Average common shareholders equity | **65.94%** | 16.13% | **33.87%** | 16.49% |
| Average assets | **6.17** | 1.45 | **3.17** | 1.48 |

See page 33 for a glossary of certain terms used in this Report.

Certain prior period amounts included in these Consolidated Financial Highlights have been reclassified to conform with the current period presentation.

(a) The interest income earned on certain earning assets is completely or partially exempt from federal income tax. As such, these tax-exempt instruments typically yield lower returns than a taxable asset. To provide more meaningful comparisons of yields and margins for all earning assets, we also provide revenue on a taxable-equivalent basis by increasing the interest income earned on tax-exempt assets to make it fully equivalent to interest income on other taxable assets. This adjustment is not permitted under GAAP in the Consolidated Income Statement.

The following is a reconciliation of net interest income as reported in the Consolidated Income Statement to net interest income on a taxable-equivalent basis (in millions):

| | Three months ended September 30 | | Nine months ended September 30 | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| Net interest income, GAAP basis | **$567** | $559 | **$1,679** | $1,599 |
| Taxable-equivalent adjustment | **7** | 7 | **20** | 20 |
| Net interest income, taxable-equivalent basis | **$574** | $566 | **$1,699** | $1,619 |

(b) Noninterest income for the three months and nine months ended September 30, 2006 included the pre-tax impact of the net gain on the BlackRock/MLIM transaction of $2.1 billion. This category also included the impact of pre-tax charges from third quarter 2006 balance sheet repositioning activities totaling $244 million. Further information is included in the Executive Summary portion of the Financial Review section of this Report.

(c) Net income and earnings per share for the three months and nine months ended September 30, 2006 included the after-tax impact of the items referred to in note (b) above, in addition to the after-tax impact of integration costs related to the BlackRock/MLIM transaction. These integration costs totaled $72 million and $91 million on a pre-tax basis for the three months and nine months ended September 30, 2006, respectively, or $31 million and $39 million on an after-tax basis, net of related minority interest.

(d) Calculated as noninterest income divided by the sum of net interest income (GAAP basis) and noninterest income. See note (b) above regarding certain items impacting noninterest income for both 2006 periods.

(e) Calculated as noninterest expense divided by the sum of net interest income (GAAP basis) and noninterest income. See notes (b) and (c) above regarding certain items impacting noninterest income and expense for both 2006 periods.

**Table of Contents**

| Unaudited | **September 30 2006** | December 31 2005 | September 30 2005 |
|---|---|---|---|
| **BALANCE SHEET DATA** (dollars in millions, except per share data) | | | |
| Assets | **$98,436** | $91,954 | $93,241 |
| Loans, net of unearned income | **48,900** | 49,101 | 50,510 |
| Allowance for loan and lease losses | **566** | 596 | 634 |
| Securities | **19,512** | 20,710 | 20,658 |
| Loans held for sale | **4,317** | 2,449 | 2,377 |
| Investment in BlackRock (a) | **3,836** | | |
| Deposits | **64,572** | 60,275 | 60,214 |
| Borrowed funds | **14,695** | 16,897 | 18,374 |
| Shareholders equity | **10,758** | 8,563 | 8,317 |
| Common shareholders equity | **10,751** | 8,555 | 8,309 |
| Book value per common share | **36.60** | 29.21 | 28.54 |
| Common shares outstanding (millions) | **294** | 293 | 291 |
| Loans to deposits | **76%** | 81% | 84% |
| **ASSETS ADMINISTERED** (billions) | | | |
| Managed (b) | **$52** | $494 | $469 |
| Nondiscretionary | **89** | 84 | 85 |
| **FUND ASSETS SERVICED** (billions) | | | |
| Accounting/administration net assets | **$774** | $835 | $793 |
| Custody assets | **399** | 476 | 475 |
| **CAPITAL RATIOS** | | | |
| Tier 1 risk-based (c)(d) | **10.4%** | 8.3% | 8.4% |
| Total risk-based (c)(d) | **13.6** | 12.1 | 12.5 |
| Leverage (c)(d) | **9.4** | 7.2 | 7.1 |
| Tangible common equity | **7.5** | 5.0 | 4.9 |
| Common shareholders equity to assets | **10.9** | 9.3 | 8.9 |
| **ASSET QUALITY RATIOS** | | | |
| Nonperforming assets to loans, loans held for sale and foreclosed assets | **.36%** | .42% | .29% |
| Nonperforming loans to loans | **.34** | .39 | .25 |
| Net charge-offs to average loans (for the three months ended) | **.37** | .33 | .12 |
| Allowance for loan and lease losses to loans | **1.16** | 1.21 | 1.26 |
| Allowance for loan and lease losses to nonperforming loans | **339** | 314 | 499 |

(a) See BlackRock/MLIM Transaction in the Executive Summary portion of the Financial Review section of this Report for additional information.

(b) Assets under management at September 30, 2006 do not include BlackRock s assets under management as we deconsolidated BlackRock effective September 29, 2006. Excluding the impact of BlackRock, our assets under management (consisting of Retail Banking assets under management) totaled $49 billion at December 31, 2005 and $50 billion at September 30, 2005.

(c) The regulatory minimums are 4.0% for Tier 1, 8.0% for Total, and 3.0% for Leverage ratios. The well-capitalized levels are 6.0% for Tier 1, 10.0% for Total, and 5.0% for Leverage ratios.

(d) The ratios for September 30, 2006 reflect the impact of the deconsolidation of BlackRock effective September 29, 2006.

**Table of Contents**

# *Financial Review*

The PNC Financial Services Group, Inc.

This Financial Review should be read together with our unaudited Consolidated Financial Statements and unaudited Statistical Information included elsewhere in this Report and with Items 6, 7, 8 and 9A of our 2005 Annual Report on Form 10-K ( 2005 Form 10-K ). We have reclassified certain prior period amounts to conform with the current period presentation. For information regarding certain business and regulatory risks, see the Risk Factors and Risk Management sections in this Financial Review and Items 1A and 7 of our 2005 Form 10-K. Also, see the Cautionary Statement Regarding Forward-Looking Information and Critical Accounting Policies And Judgments sections in this Financial Review for certain other factors that could cause actual results or future events to differ, perhaps materially, from those anticipated in the forward-looking statements included in this Report or from historical performance. See Note 14 Segment Reporting in the Notes To Consolidated Financial Statements included in Part I, Item 1 of this Report for a reconciliation of total business segment earnings to total PNC consolidated net income as reported on a generally accepted accounting principles ( GAAP ) basis.

# *Executive Summary*

## *The PNC Financial Services Group, Inc.*

PNC is one of the largest diversified financial services companies in the United States based on assets, operating businesses engaged in retail banking, corporate and institutional banking, asset management and global fund processing services. We provide many of our products and services nationally and others in our primary geographic markets located in Pennsylvania; New Jersey; the greater Washington, DC area, including Maryland and Virginia; Ohio; Kentucky; and Delaware. We also provide certain global fund processing services internationally.

### *Key Strategic Goals*

Our strategy to enhance shareholder value centers on achieving revenue growth in our various businesses underpinned by prudent management of risk, capital and expenses. In each of our business segments, the primary drivers of growth are the acquisition, expansion and retention of customer relationships. We strive to achieve such growth in our customer base by providing convenient banking options, leading technological systems and a broad range of asset management products and services. We also intend to grow through appropriate and targeted acquisitions and, in certain businesses, by expanding into new geographical markets.

In recent years, we have managed our interest rate risk to achieve a moderate risk profile with limited exposure to earnings volatility resulting from interest rate fluctuations. Our actions have created a balance sheet characterized by strong asset quality and significant flexibility to take advantage, where appropriate, of changing interest rates and to adjust to changing market conditions.

### *BlackRock/MLIM Transaction*

As previously reported, in February 2006, BlackRock, Inc. ( BlackRock ), then a majority-owned subsidiary of PNC, and Merrill Lynch entered into a definitive agreement pursuant to which Merrill Lynch agreed to contribute its investment management business ( MLIM ) to BlackRock in exchange for 65 million shares of newly issued BlackRock common and preferred stock. This transaction closed on September 29, 2006. BlackRock accounted for the MLIM transaction under the purchase method of accounting. The value of the 65 million shares issued to Merrill Lynch was allocated among the MLIM assets acquired, including intangibles, and the MLIM liabilities assumed to the extent of their fair market value, with any excess purchase price being allocated to goodwill. Immediately following the closing, PNC continued to own approximately 44 million shares of BlackRock common stock, representing an ownership interest of approximately 34% of the combined company after the closing (as compared with 69% immediately prior to the closing). Although PNC s share ownership percentage

declined, BlackRock s equity increased due to the increase in total net assets recorded by BlackRock as a result of the MLIM transaction.

Upon the closing of the BlackRock/MLIM transaction, the carrying value of our investment in BlackRock increased by approximately $3.1 billion to $3.8 billion, primarily reflecting PNC s portion of the increase in BlackRock s equity resulting from the value of shares issued in that transaction. Based on BlackRock s closing market price of $149 per common share on September 29, 2006, the market value of PNC s investment in BlackRock was approximately $6.6 billion at that date. As such, an additional $2.8 billion of value is not recognized in PNC s investment account.

We also recorded a liability at September 30, 2006 for deferred taxes of approximately $.9 billion, related to the excess of the book value over the tax basis of our investment in BlackRock, and a liability of approximately $.6 billion related to our obligation to provide shares of BlackRock common stock to help fund BlackRock long-term incentive plan ( LTIP ) programs. The LTIP liability will be adjusted quarterly based on changes in BlackRock s common stock price and the number of remaining committed shares.

The overall balance sheet impact was an increase to our shareholders equity of approximately $1.6 billion. The increase to equity was comprised of an after-tax gain of approximately $1.3 billion, net of the expense associated with the LTIP liability and the deferred taxes, and an after-tax increase to capital surplus of approximately $.3 billion. The recognition of the gain is consistent with our existing accounting policy for the sale or issuance by subsidiaries of their stock to third parties. The gain represents the difference between our basis in BlackRock stock prior to the BlackRock/MLIM transaction and the new book value per share and resulting increase in value of our investment realized from the transaction. The direct increase to capital surplus rather than inclusion in the gain resulted from the accounting treatment required due to existing BlackRock repurchase commitments or programs.

For the three months and nine months ended September 30, 2006, our Consolidated Income Statement included our former 69% ownership interest in BlackRock s net income through the closing date. However, our Consolidated Balance Sheet as of September 30, 2006 reflects the deconsolidation of BlackRock s balance sheet amounts and recognizes our 34% ownership interest in BlackRock as an investment to be accounted for under the equity method. On a prospective basis, this accounting will result in a reduction in certain revenue and noninterest expense categories on PNC s Consolidated Income Statement as the net pretax earnings impact of our net investment in BlackRock will be reported on a separate line item within noninterest income.

Additional information on the BlackRock/MLIM transaction is included in Current Reports on Form 8-K ( Form 8-K ) dated February 15, 2006 and September 29, 2006 filed by PNC and BlackRock.

**Table of Contents**

### *Mercantile Bankshares Acquisition*

As previously reported, on October 8, 2006 we entered into a definitive agreement with Mercantile Bankshares Corporation ( Mercantile ) for PNC to acquire Mercantile for 52.5 million shares of PNC common stock and $2.13 billion in cash. Based on PNC s common stock price on October 6, 2006, the consideration represents $6.0 billion in stock and cash or $47.24 per Mercantile share.

Mercantile is a $17 billion asset banking company that provides banking and investment and wealth management services through 240 offices in Maryland, Virginia, the District of Columbia, Delaware and Southeastern Pennsylvania. This transaction will enable us to significantly expand our presence in the mid-Atlantic region, particularly within the attractive Baltimore and Washington, DC markets.

The transaction is subject to customary closing conditions, including regulatory approval and the approval of Mercantile s shareholders, and is expected to close during the first quarter of 2007. We refer you to our Form 8-K dated October 8, 2006 for additional information on this transaction.

### *The One PNC Initiative*

As further described in our 2005 Form 10-K, the One PNC initiative began in January 2005 and is an ongoing, company-wide initiative with goals of moving closer to the customer, improving our overall efficiency and targeting resources to more value-added activities. PNC expects to realize $400 million of total annual pretax earnings benefit by mid-2007 from this initiative.

PNC plans to achieve approximately $300 million of cost savings through a combination of workforce reduction and other efficiencies. Of the approximately 3,000 positions to be eliminated, approximately 2,700 had been eliminated as of September 30, 2006. We estimate that these changes will result in employee severance and other implementation costs of approximately $74 million, including $54 million recognized during full year 2005 and $9 million recognized during the first nine months of 2006. We expect that the remaining charges of approximately $11 million will be incurred in the remainder of 2006 and early 2007. In addition, PNC intends to achieve at least $100 million in net revenue growth through the implementation of various pricing and business growth enhancements driven by the One PNC initiative. The initiative is progressing according to plan.

We realized a net pretax financial benefit from the One PNC program of approximately $185 million in the first nine months of 2006, including $65 million in the third quarter. We achieved an annualized run rate benefit of $260 million in the third quarter of 2006.

### *Key Factors Affecting Financial Performance*

Our financial performance is substantially affected by several external factors outside of our control, including:

- General economic conditions,
- Loan demand and utilization of credit commitments,
- Movement of customer deposits from lower to higher rate accounts or to off-balance sheet accounts,
- The level of interest rates, and the shape of the interest rate yield curve,
- The performance of the capital markets, and
- Customer demand for other products and services.

In addition to changes in general economic conditions, including the direction, timing and magnitude of movement in interest rates and the performance of the capital markets, our

success in the remainder of 2006 will depend, among other things, upon:

- Further success in the acquisition, growth and retention of customers,
- Successful execution of the One PNC initiative,
- Revenue growth,
- A sustained focus on expense management and improved efficiency,
- Maintaining strong overall asset quality, and
- Prudent risk and capital management.

### *Summary Financial Results*

| In millions, except per share data | Three months ended Sept. 30 2006 | Sept. 30 2005 | Nine months ended Sept. 30 2006 | Sept. 30 2005 |
|---|---|---|---|---|
| Net income | **$1,484** | $334 | **$2,219** | $970 |
| Diluted earnings per share | **$5.01** | $1.14 | **$7.46** | $3.35 |
| Return on | | | | |
| Average common shareholders equity | **65.94%** | 16.13% | **33.87%** | 16.49% |
| Average assets | **6.17%** | 1.45% | **3.17%** | 1.48% |

Results for the third quarter and first nine months of 2006 included the impact of the following items:

- The gain on the third quarter BlackRock/MLIM transaction totaling $1.3 billion after-tax, or $4.36 per diluted share;
- Securities portfolio rebalancing charges recognized in the third quarter totaling $127 million after-tax, or $.43 per diluted share;
- The third quarter mortgage loan portfolio repositioning loss of $31 million after-tax, or $.10 per diluted share; and
- Our share of the after-tax impact of BlackRock/MLIM integration costs, which totaled $31 million, or $.10 per diluted share, for the third quarter of 2006 and $39 million, or $.13 per diluted share, for the first nine months of 2006.

In addition to the closing of the BlackRock/MLIM transaction and our balance sheet repositioning activities, our third quarter 2006 performance included the following accomplishments:

- Average loans of $50.3 billion for the third quarter of 2006 increased $888 million, or 2 percent, compared with $49.5 billion for the third quarter 2005, primarily as a result of increased commercial, commercial real estate and residential mortgage loans. Average loans increased $3.0 billion, or 6 percent, compared with the prior year third quarter excluding the $2.1 billion of average loans in the prior year period related to Market Street Funding, PNC s commercial paper conduit that was deconsolidated in October 2005.

- Average deposits for the third quarter increased $5.0 billion, or 8 percent, compared with the same quarter in the prior year, primarily as a result of an increase in money market deposits, retail certificates of deposit, Eurodollar deposits and noninterest-bearing deposits.

- Asset quality remained very strong, with the ratio of nonperforming assets to loans, loans held for sale and foreclosed assets declining to .36% from .42% at December 31, 2005.

4

**Table of Contents**

***Balance Sheet Highlights***

Total assets were $98.4 billion at September 30, 2006. Total average assets were $93.7 billion for the first nine months of 2006 compared with $87.4 billion for the first nine months of 2005. This increase was primarily attributable to a $5.5 billion increase in average interest-earning assets. An increase of $2.9 billion in average loans was the primary factor for the increase in average interest-earning assets. In addition, average total securities increased $2.6 billion in the first nine months of 2006 compared with the prior year period.

Our deconsolidation of BlackRock effective September 29, 2006 and recognition of our investment in BlackRock under the equity method of accounting as of September 30, 2006 did not significantly impact average balances in the nine-month comparison.

Average total loans were $49.8 billion for the first nine months of 2006 and $46.9 billion in the first nine months of 2005. This increase was driven by continued improvements in market loan demand and targeted sales efforts across our banking businesses, as well as our expansion into the greater Washington, DC area that began in May 2005. The increase in average total loans reflected growth in residential mortgages of approximately $1.5 billion, commercial loans of approximately $1.1 billion, and commercial real estate loans of approximately $.6 billion. In addition, average loans for the first nine months of 2005 included $2.1 billion related to Market Street Funding ( Market Street ) which was deconsolidated in October 2005. Loans represented 64% of average interest-earning assets for the first nine months of 2006 and 65% for the first nine months of 2005.

Average securities totaled $21.3 billion for the first nine months of 2006 and $18.8 billion for the first nine months of 2005. Of this increase, $3.0 billion was attributable to increases in mortgage-backed, asset-backed, and other debt securities, partially offset by a $.4 billion decline in US Treasury and government agencies securities. Our third quarter 2006 securities portfolio rebalancing actions are further described in the Consolidated Balance Sheet Review section of this Report. The overall higher average securities balances reflected our desire to continue investing through the interest rate cycle and the impact of the May 2005 Riggs acquisition. Securities comprised 28% of average interest-earning assets for the first nine months of 2006 and 26% for the first nine months of 2005.

Average total deposits were $62.7 billion for the first nine months of 2006, an increase of $6.2 billion over the first nine months of 2005. The increase in average total deposits was primarily driven by the impact of higher retail certificates of deposit, money market account and noninterest-bearing deposit balances, and by higher Eurodollar deposits. Growth in deposits from commercial mortgage loan servicing activities also contributed to the increase. Similar to its impact on average loans and securities described above, our expansion into the greater Washington, DC area also contributed to the increase in average total deposits.

Average total deposits represented 67% of average total assets for the first nine months of 2006 and 65% for the first nine months of 2005. Average transaction deposits were $41.7

billion for the first nine months of 2006 compared with $38.7 billion for the first nine months of 2005.

Average borrowed funds were $15.2 billion for the first nine months of 2006 and $16.2 billion for the first nine months of 2005. This decrease reflected a $2.3 billion decline in commercial paper due to the deconsolidation of Market Street in October 2005, partially offset by net increases in federal funds purchased, subordinated debt and bank notes and senior debt.

Shareholders equity totaled $10.8 billion at September 30, 2006, compared with $8.6 billion at December 31, 2005. The increase resulted from the BlackRock/MLIM transaction. See the Consolidated Balance Sheet Review section of this Financial Review for additional information.

***Business Segment Highlights***

| | Three months ended | | Nine months ended | |
|---|---|---|---|---|
| In millions | **Sept.30 2006** | Sept. 30 2005 | **Sept. 30 2006** | Sept. 30 2005 |
| Total segment earnings | **$422** | $383 | **$1,217** | $1,101 |

Total business segment earnings for the first nine months of 2005 included the benefit of a second quarter $53 million loan recovery included in the Corporate & Institutional Banking business segment. A summary of results for both the first nine months and third quarter 2006 comparisons with the prior year periods follows. Further analysis of business segment results for the nine-month periods is found on pages 15 through 24.

We provide a reconciliation of total business segment earnings to total PNC consolidated net income as reported on a GAAP basis in Note 14 Segment Reporting in the Notes To Consolidated Financial Statements in this Report and in the Results of Businesses - Summary table on page 15.

Retail Banking

Retail Banking s earnings were $581 million for the first nine months of 2006 compared with $487 million for the same period in 2005. Compared with the prior year, revenues increased 10% and noninterest expenses increased 4%, resulting in a 19% earnings improvement. The increase in earnings was driven by improved fee income from customers, higher taxable-equivalent net interest income fueled by continued customer and balance sheet growth, and a sustained focus on expense management.

Earnings from Retail Banking totaled $206 million in the third quarter of 2006 compared with $176 million in the third quarter of 2005. Revenue increased 7% compared with the prior year third quarter, while noninterest expense increased only 2%, driving a 17% increase in earnings and creating positive operating leverage.

Corporate & Institutional Banking

Earnings from Corporate & Institutional Banking for the first nine months of 2006 totaled $334 million compared with $372 million for the first nine months of 2005. This decline was primarily attributable to the benefit of a $53 million loan recovery recognized in the second quarter of 2005 compared with a $36 million provision for credit losses in the first nine months of 2006. In addition to the negative impact of the $89 million change in the provision for credit losses, total revenue increased $101 million and noninterest expenses grew by $69 million for the first nine months of 2006 compared with the first nine months of 2005.

Corporate & Institutional Banking earned $113 million in the third quarter of 2006 compared with $118 million in the third quarter of 2005. The decrease compared with the prior year quarter was largely the result of an increase in the provision for credit losses. The increase in noninterest revenue and expense was driven by the acquisition of Harris Williams. Revenue increased $10 million compared with the third quarter of 2005, driven by a $22 million increase in noninterest income, partly offset by a $12 million decrease in taxable-equivalent net interest income.

BlackRock

BlackRock reported net income of $153 million for the first nine months of 2006 and $161 million for the first nine months of 2005. BlackRock s reported net income for the first nine months of 2006 and 2005 included after-tax MLIM and State Street Research and Management ( SSRM ) integration costs of $56 million and $6 million, respectively. The BlackRock business segment earned $209 million in the first nine months of 2006 and $167 million for the first nine months of 2005 excluding the impact of these costs, which we have reported in Other for PNC business segment reporting. Adjusted earnings in 2006 reflected higher investment advisory and administration fees due to an increase in assets under management and increased performance fees. These factors more than offset the increase in expense due to increased compensation and benefits, general and administration expense, and a one-time expense of $34 million incurred in the first quarter of 2006 related to the January 2005 acquisition of SSRM.

BlackRock reported net income of $19 million for the third quarter of 2006, compared with $61 million for the third quarter of 2005. BlackRock s reported net income included after-tax MLIM integration costs of $44 million in the third quarter of 2006. BlackRock earned $63 million in the third quarter of 2006, an increase of $2 million compared with the third quarter of 2005, excluding the impact of MLIM integration costs. The increase compared with the third quarter of 2005 was a result of higher investment and advisory fees due to growth in assets under management, partly offset by lower nonoperating income, due principally to unrealized losses on energy-related investments.

We refer you to the BlackRock/MLIM Transaction section of this Executive Summary for further information related to this transaction that closed on September 29, 2006. Information on this transaction is also included in Note 2 Acquisitions in the Notes To Consolidated Financial Statements included in this Report.

PFPC

PFPC s earnings of $93 million in the first nine months of 2006 increased $18 million, or 24%, compared with the first nine months of 2005. Earnings for the 2006 period included the impact of a $14 million reversal of deferred taxes related to earnings from foreign subsidiaries following management s determination that the earnings would be indefinitely reinvested outside of the United States. In addition, higher earnings in the first nine months of 2006 reflected servicing revenue contributions from several growth areas of the business and the successful implementation of expense control initiatives which improved the company s operating margin. Earnings for the first nine months of 2005 included a $3 million tax benefit identified as part of the One PNC initiative.

PFPC earned $40 million in the third quarter of 2006 compared with $28 million in the third quarter of 2005. The earnings increase from the third quarter of 2005 resulted from the $14 million reversal of deferred taxes referred to above.

Other

Other earnings for the first nine months of 2006 totaled $1.1 billion, while Other for the first nine months of 2005 was a net loss of $80 million. Other earnings for the 2006 period included the $1.3 billion after-tax gain on the BlackRock/MLIM transaction recorded in the third quarter of 2006, partially offset by the impact of charges related to the following, all on an after-tax basis:

- Third quarter 2006 balance sheet repositioning activities amounting to $158 million,
- MLIM integration costs of $39 million, and
- Reversal in the third quarter of 2006 of trust preferred securities hedge accounting of $13 million.

The first nine months of 2005 included the impact of third quarter 2005 implementation costs related to the One PNC initiative totaling $29 million after-tax, net securities losses of $24 million after-tax, and Riggs acquisition integration costs totaling $19 million after-tax. These factors were partially offset by the first quarter 2005 benefit recognized from a $45 million deferred tax liability reversal related to the internal transfer of our investment in BlackRock as described above under Summary Financial Results.

We recorded earnings of $1.1 billion in Other for the third quarter of 2006 primarily due to the reasons outlined above for the nine-month earnings. Other for the third quarter of 2005 was a net loss of $30 million. The net loss for the prior year quarter reflected the One PNC implementation costs referred to above.

Table of Contents

## Consolidated Income Statement Review

### Net Interest Income and Net Interest Margin

| Dollars in millions | Three months ended Sept. 30 2006 | Three months ended Sept. 30 2005 | Nine months ended Sept. 30 2006 | Nine months ended Sept. 30 2005 |
|---|---|---|---|---|
| Taxable-equivalent net interest income | **$574** | $566 | **$1,699** | $1,619 |
| Net interest margin | **2.89%** | 2.96% | **2.92%** | 2.99% |

We provide a reconciliation of net interest income as reported under GAAP to net interest income presented on a taxable-equivalent basis in the Consolidated Financial Highlights section on page 1 of this Report.

Changes in net interest income and margin result from the interaction of the volume and composition of interest-earning assets and related yields, interest-bearing liabilities and related rates paid, and noninterest-bearing sources. See Statistical Information-Average Consolidated Balance Sheet And Net Interest Analysis included on pages 63 and 64 of this Report for additional information.

The increase in taxable-equivalent net interest income for the first nine months of 2006 compared with the first nine months of 2005 reflected the impact of a $5.5 billion increase in average interest-earning assets in 2006, driven by organic growth and our expansion into the greater Washington, DC area. The $2.9 billion increase in average interest-earning assets for the third quarter of 2006 compared with the third quarter of 2005 drove the increase in taxable-equivalent net interest income in the third quarter of 2006.

The following factors contributed to the decline in net interest margin for the first nine months of 2006 compared with the first nine months of 2005:

- An increase in the average rate paid on deposits of 106 basis points for the first nine months of 2006 compared with the 2005 period. The average rate paid on money market accounts, the largest single component of interest-bearing deposits, increased 116 basis points. The average rate paid on Retail Banking money market accounts increased only 98 basis points while the average rate paid on Corporate & Institutional Banking money market accounts increased 152 basis points. The average rate paid on money market accounts reported in Other increased 190 basis points. These accounts are utilized as an alternative source of short-term liquidity and pay interest at rates that closely approximate short-term market rates.
- An increase in the average rate paid on borrowed funds of 156 basis points for the first nine months of 2006 compared with the first nine months of 2005.
- By comparison, the yield on interest-earning assets increased only 83 basis points. Loans, the single largest component, increased 86 basis points.
- These factors were partially offset by the favorable impact on net interest margin in 2006 of an increase of 21 basis points related to noninterest-bearing sources of funding.

During the first nine months of 2006, the average federal funds rate was 4.88% compared with 2.97% for the first nine months of 2005.

The decline in net interest margin for the third quarter of 2006 compared with the third quarter of 2005 reflected the following:

- An increase in the average rate paid on deposits of 110 basis points for the third quarter of 2006 compared with the third quarter of 2005. The average rate paid on money market accounts, the largest single component of interest-bearing deposits, increased 114 basis points. The average rate paid on Retail Banking money market accounts increased only 89 basis points while the average rate paid on Corporate & Institutional Banking money market accounts increased 153 basis points. The average rate paid on money market accounts reported in Other increased 173 basis points.
- An increase in the average rate paid on borrowed funds of 161 basis points for the third quarter of 2006 compared with the prior year period.
- By comparison, the yield on interest-earning assets increased only 86 basis points. Loans, the single largest component, increased 84 basis points.
-

These factors were partially offset by the favorable impact on net interest margin in 2006 of an increase of 22 basis points related to noninterest-bearing sources of funding.

During the third quarter of 2006, the average federal funds rate was 5.25% compared with 3.46% for the third quarter of 2005.

We believe that net interest margins for our industry will continue to be challenged if the yield curve remains flat or inverted, as competition for loans and deposits remains intense and as customers continue to migrate from lower cost to higher cost deposits. However, we believe that our balance sheet repositioning will have a positive impact on taxable-equivalent net interest income and net interest margin.

### *Provision For Credit Losses*

The provision for credit losses increased $85 million, to $82 million, in the first nine months of 2006 compared with the first nine months of 2005. For the third quarter of 2006, the provision for credit losses was unchanged at $16 million compared with the prior year third quarter. The increase in the nine-month comparison reflected the following:

- A $53 million loan recovery in the second quarter of 2005 resulting from a litigation settlement,
- The impact of overall loan growth, as total average loans grew $2.9 billion in the first nine months of 2006 compared with the respective prior year period,
- The effect of a single large overdraft situation that occurred during the second quarter of 2006, and
- Growth in unfunded commitments.

We do not expect to sustain asset quality at its current level. However, based on the assets we currently hold and current business trends and activities, we believe that overall asset quality will remain strong by historical standards for at least the near term. See the Credit Risk Management portion of the Risk Management section of this Financial Review for additional information regarding factors that impact the provision for credit losses.

## *NONINTEREST INCOME*

*Summary*

Noninterest income was $5.358 billion for the first nine months of 2006 compared with $3.019 billion for the first nine months of 2005. Noninterest income for the third quarter of 2006 totaled $2.943 billion and totaled $1.116 billion in the prior year third quarter. Both the first nine months and third quarter of 2006 included the impact of the gain on the BlackRock transaction, which totaled $2.078 billion, partially offset by the effects of our third quarter balance sheet repositioning activities that resulted in charges totaling $244 million.

*Additional Analysis*

Asset management fees totaled $1.271 billion in the first nine months of 2006, an increase of $259 million compared with the first nine months of 2005. The increase in the nine-month comparison reflected the impact of higher performance fees, BlackRock s first quarter 2005 acquisition of SSRM and other growth in assets managed. Asset management fees increased $17 million, to $381 million, for the third quarter of 2006 compared with the third quarter of 2005. An increase in investment advisory base fees at BlackRock, partially offset by lower performance fees, drove the increase in the quarter comparison.

While asset management fees reflected the consolidated impact of BlackRock for all income statement periods presented, assets managed at September 30, 2006 totaled $52 billion compared with $469 billion at September 30, 2005, due to our deconsolidation of BlackRock effective September 29, 2006.

Fund servicing fees of $644 million for the first nine months of 2006 represented a $13 million decline from the prior year period. For the third quarter of 2006, fund servicing fees totaled $213 million, a decline of $5 million from the third quarter of 2005. The decrease in fund servicing fees in both comparisons was primarily due to lower fund accounting and transfer agent fees during 2006 due to loss of clients and price concessions.

PFPC provided fund accounting/administration services for $774 billion of net fund investment assets and provided custody services for $399 billion of fund investment assets at September 30, 2006, compared with $793 billion and $475 billion, respectively, at September 30, 2005. The decreases in domestic accounting/administration net fund assets and custody fund assets at September 30, 2006 resulted primarily from the deconversion of a major client during the first quarter of 2006 which was partially offset by new business, asset inflows from existing customers and equity market appreciation.

Service charges on deposits grew $35 million, to $234 million, in the first nine months of 2006 compared with the prior year nine-month period. Service charges on deposits increased $8 million in the third quarter of 2006, to $81 million, compared with the third quarter of 2005. These increases can be attributed to customer growth, expansion of the branch network, including the expansion into the greater Washington, DC area that began in May 2005, and various pricing actions resulting from the One PNC initiative.

Brokerage fees totaled $183 million in the first nine months of 2006 and $168 million in the first nine months of 2005. Brokerage fees increased $5 million, to $61 million, for the third quarter of 2006 compared with the third quarter of 2005. These increases reflected higher annuity income and mutual fund-related revenues in 2006.

Consumer services fees grew $59 million, to $272 million, for the first nine months of 2006 compared with the first nine months of 2005. Consumer services fees increased $13 million, to $89 million, in the third quarter of 2006 compared with the third quarter of 2005. Higher fees reflected the impact of consolidating our merchant services activities in the fourth quarter of 2005 as a result of our increased ownership interest in the merchant services business. The increases in fees were also due to higher debit card revenues resulting from higher transaction volumes, our expansion into the greater Washington, DC area and pricing actions related to the One PNC initiative. These factors were partially offset by lower ATM surcharge revenue in the 2006 periods compared with the respective prior year periods as a result of changing customer behavior and a strategic decision to reduce the out-of-footprint ATM network.

Corporate services revenue totaling $449 million in the first nine months of 2006 represented a $107 million, or 31%, increase over the comparable prior year period. Corporate services revenue increased $36 million, or 30%, in the third quarter of 2006 compared with the third quarter of 2005. Both 2006 periods benefited from the impact of our October 2005 Harris Williams acquisition that resulted in higher revenues.

Equity management (private equity) net gains on portfolio investments totaled $82 million for the first nine months of 2006 compared with $80 million for the first nine months of 2005. For the third quarter of 2006, net gains on portfolio investments totaled $21 million compared with $36 million in the prior year quarter. Based on the nature of private equity activities, net gains or losses may be volatile from period to period.

Net securities losses amounted to $207 million for the first nine months of 2006 compared with net securities losses of $37 million in the first nine months of 2005. Net securities losses totaled $195 million in the third quarter of 2006 and $2 million in the third quarter of 2005. We refer you to the Securities portion of our Consolidated Balance Sheet Review section of this Report for further information regarding the actions we took during the third quarter of 2006 that resulted in the sale of approximately $6 billion of securities available for sale at an aggregate pretax loss of $196 million during that quarter.

Net securities losses for the first nine months of 2005 reflect actions taken during the second quarter of that year regarding our securities portfolio that resulted in realized net securities and other losses of approximately $31 million.

Noninterest revenue from trading activities, which is primarily customer-related, was $150 million for the first nine months of 2006 compared with $108 million for the first nine months of 2005. For the third quarter of 2006, noninterest revenue from trading activities was $38 million, compared with $47 million in the prior year third quarter. We provide additional information on our trading activities under Market Risk

Management    Trading Risk in the Risk Management section of this Financial Review.

Other noninterest income of $202 million for the first nine months of 2006 represented a $75 million decrease compared with the prior year first nine months. Other noninterest income totaled $19 million in the third quarter of 2006 compared with $127 million in the third quarter of 2005. Other noninterest income for both 2006 periods included the impact of the following:

- A $48 million pretax loss incurred in the third quarter of 2006 in connection with the rebalancing of our residential mortgage portfolio. Further information on these actions is included in the Loans Held For Sale portion of the Consolidated Balance Sheet Review section of this Report;
- A $20 million charge for an accounting adjustment related to our trust preferred securities hedges recognized during the third quarter of 2006; and
- Lower other equity management income.

Other noninterest income for the first nine months of 2006 included gains totaling $39 million, including $13 million recognized in the third quarter, related to our contributions of BlackRock stock to the PNC Foundation. The comparable 2005 amount was $16 million, recognized in the third quarter. These transactions also impacted noninterest expense in each of those periods.

Other noninterest income typically fluctuates from period to period depending on the nature and magnitude of transactions completed.

***Product Revenue***

In addition to credit products to commercial customers, Corporate & Institutional Banking offers treasury management and capital markets-related products and services, commercial loan servicing and equipment leasing products that are marketed by several businesses across PNC.

Treasury management revenue, which includes fees as well as net interest income from customer deposit balances, totaled $316 million for first nine months of 2006 and $305 million for first nine months of 2005. For the third quarter of 2006, revenue totaled $108 million compared with $105 million for the third quarter of 2005. The higher revenue in both comparisons reflected continued expansion and client utilization of commercial payment card services, strong revenue growth in various electronic payment and information services, and a steady increase in business-to-business processing volumes.

Revenue from capital markets products and services, including mergers and acquisitions advisory activities, was $204 million for the first nine months of 2006, compared with $113 million in the first nine months of 2005. The acquisition of Harris Williams in October 2005 together with improved customer and proprietary trading activities drove the increase in capital markets revenue in the nine-month comparison. Consolidated revenue from capital markets products and services for the third quarter of 2006 totaled $64 million compared with $42 million for the third quarter of 2005. The increase in capital markets revenue for the third quarter of 2006 compared with the prior year quarter was primarily due to the acquisition of Harris Williams.

Midland Loan Services offers servicing, real estate advisory and technology solutions for the commercial real estate

finance industry. Midland s revenue, which includes servicing fees and net interest income from servicing portfolio deposit balances, totaled $131 million for first nine months of 2006 and $103 million for first nine months of 2005. Third quarter 2006 revenue totaled $47 million compared with $39 million for the third quarter of 2005. Revenue growth in both comparisons was primarily driven by growth in the commercial mortgage servicing portfolio and related services.

As a component of our advisory services to clients, we provide a select set of insurance products to fulfill specific customer financial needs. Primary insurance offerings include:

- Annuities,
- Life,
- Credit life,
- Health,
- Disability, and
- Commercial lines coverage.

Client segments served by these insurance solutions include those in Retail Banking and Corporate & Institutional Banking. Insurance products are sold by licensed PNC insurance agents and through licensed third-party arrangements. Revenue from these products was $53 million in the first nine months of 2006 and $46 million in first nine months of 2005. Revenue for the third quarter of 2006 totaled $18 million compared with

$15 million for the third quarter of 2005. The increases resulted from higher annuity fee revenue.

PNC, through subsidiary companies Alpine Indemnity Limited and PNC Insurance Corp., participates as a direct writer for its general liability, automobile liability, workers compensation, property and terrorism programs.

In the normal course of business, Alpine Indemnity Limited and PNC Insurance Corp. maintain insurance reserves for reported claims and for claims incurred but not reported based on actuarial assessments. We believe these reserves were adequate at September 30, 2006.

### *NONINTEREST EXPENSE*

*Year-to-date September 30, 2006 and 2005*

Total noninterest expense was $3.498 billion for the first nine months of 2006 and $3.199 billion for the first nine months of 2005.

The Consolidated Financial Highlights section of this Report includes our efficiency ratios for the third quarter and first nine months of both 2006 and 2005, along with notes regarding certain items impacting noninterest income and expense for both 2006 periods.

Noninterest expense for the first nine months of 2006 included the following:

- An increase of $270 million in BlackRock operating expenses (including integration costs related to the MLIM transaction of $91 million), reflecting growth in that business,
- Expenses totaling $65 million related to Harris Williams, which we acquired in October 2005, and
- An increase of $40 million related to the consolidation of our merchant services activities in the fourth quarter of 2005.

Table of Contents

Apart from the impact of these items, noninterest expense for the first nine months of 2006 decreased $76 million over the prior year period as the benefit of the One PNC initiative more than offset the impact of our expansion into the greater Washington, DC area and contributions of BlackRock stock to the PNC Foundation.

*Third quarter 2006 and 2005*

Total noninterest expense was $1.178 billion for the third quarter of 2006 and $1.159 billion for the third quarter of 2005.

Noninterest expense for the third quarter of 2006 reflected a $76 million increase in operating expenses at BlackRock (including MLIM integration costs of $72 million), $22 million of expenses related to Harris Williams and an increase of $11 million related to the fourth quarter 2005 consolidation of our merchant services activities. Apart from the impact of these items, noninterest expense for the third quarter of 2006 decreased $90 million compared with the prior year third quarter.

We expect that the percentage increase in total noninterest expense for full year 2006 compared with 2005, excluding the BlackRock business segment and MLIM transaction integration costs, will be in the low single-digit range, with the increase primarily attributable to the acquisition of Harris Williams and the consolidation of merchant services in the fourth quarter of 2005. However, noninterest expense will continue to be impacted by ongoing investments in our businesses.

Period-end employees totaled 23,539 at September 30, 2006 (comprised of 21,374 full-time and 2,165 part-time) compared with 25,348 at December 31, 2005 (comprised of 23,593 full-time and 1,755 part-time) and 25,369 at September 30, 2005 (comprised of 23,811 full-time and 1,558 part-time). The decline in full-time employees at September 30, 2006 reflects the deconsolidation of BlackRock effective September 29, 2006. The increase in part-time employees reflects Retail Banking initiatives to utilize more customer-facing employees during peak business hours versus full-time employees for the entire day.

### *Effective Tax Rate*

Our effective tax rate for the first nine months of 2006 was 35.1% compared with 29.7% for the first nine months of 2005. The higher effective rate for first nine months of 2006 was primarily due to a $57 million cumulative adjustment to deferred taxes in connection with the BlackRock/MLIM transaction. The lower effective tax rate in 2005 reflected the impact of the first quarter 2005 reversal of deferred tax liabilities in connection with the transfer of our ownership in BlackRock to our intermediate bank holding company. This transaction reduced our first quarter 2005 tax provision by $45 million.

## *Consolidated Balance Sheet Review*

### *Summarized Balance Sheet Data*

| In millions | **September 30 2006** | December 31 2005 |
|---|---|---|
| Assets | | |
| Loans, net of unearned income | **$48,900** | $49,101 |
| Securities available for sale and held to maturity | **19,512** | 20,710 |
| Loans held for sale | **4,317** | 2,449 |
| Investment in BlackRock | **3,836** | |
| Other | **21,871** | 19,694 |
| Total assets | **$98,436** | $91,954 |
| Liabilities | | |
| Funding sources | **$79,267** | $77,172 |
| Other | **8,003** | 5,629 |
| Total liabilities | **87,270** | 82,801 |
| Minority and noncontrolling interests in consolidated entities | **408** | 590 |
| Total shareholders equity | **10,758** | 8,563 |

| | | |
|---|---|---|
| Total liabilities, minority and noncontrolling interests, and shareholders equity | **$98,436** | $91,954 |

Our Consolidated Balance Sheet is presented in Part I, Item 1 on page 38 of this Report.

Various seasonal and other factors impact our period-end balances whereas average balances (discussed under the Balance Sheet Highlights section of this Financial Review above and included in the Statistical Information section of this Report on pages 63 and 64) are more indicative of underlying business trends.

The impact of the deconsolidation of BlackRock s balance sheet amounts and recognition of our approximate 34% ownership interest in BlackRock as an equity investment upon the closing of the BlackRock/MLIM transaction is discussed in the Executive Summary section of this Financial Review and in our Form 8-K dated September 29, 2006.

Table of Contents

An analysis of changes in certain balance sheet categories follows.

## *Loans, Net of Unearned Income*

Loans decreased $201 million, to $48.9 billion, at September 30, 2006 compared with the balance at December 31, 2005. A decline in residential mortgage loans in connection with the third quarter 2006 mortgage loan repositioning more than offset increases in several other loan categories. Targeted sales efforts across our banking businesses drove the increase in commercial lending and consumer loans.

***Details Of Loans***

| In millions | **September 30 2006** | December 31 2005 |
|---|---|---|
| Commercial | | |
| Retail/wholesale | **$5,245** | $4,854 |
| Manufacturing | **4,318** | 4,045 |
| Other service providers | **2,155** | 1,986 |
| Real estate related | **3,000** | 2,577 |
| Financial services | **1,423** | 1,438 |
| Health care | **685** | 616 |
| Other | **3,858** | 3,809 |
| Total commercial | **20,684** | 19,325 |
| Commercial real estate | | |
| Real estate projects | **2,691** | 2,244 |
| Mortgage | **794** | 918 |
| Total commercial real estate | **3,485** | 3,162 |
| Equipment lease financing | **3,609** | 3,628 |
| Total commercial lending | **27,778** | 26,115 |
| Consumer | | |
| Home equity | **13,876** | 13,790 |
| Automobile | **1,061** | 938 |
| Other | **1,419** | 1,445 |
| Total consumer | **16,356** | 16,173 |
| Residential mortgage | **5,234** | 7,307 |
| Other | **347** | 341 |
| Unearned income | **(815)** | (835) |
| Total, net of unearned income | **$48,900** | $49,101 |

As the table above indicates, our total loan portfolio continued to be diversified among types of loan products and numerous industries and businesses. The loans that we hold are also diversified across the geographic areas where we do business.

***Commercial Lending Exposure (a)***

| | **September 30 2006** | December 31 2005 |
|---|---|---|
| Investment grade or equivalent | **49%** | 46% |
| Non-investment grade | | |
| $50 million or greater | **3** | 2 |
| All other non-investment grade | **48** | 52 |
| Total | **100%** | 100% |

(a) Includes total commercial lending in the Retail Banking and Corporate & Institutional Banking business segments.

Commercial loans are the largest category and are the most sensitive to changes in assumptions and judgments underlying the determination of the allowance for loan and lease losses. We have allocated approximately $455 million, or 80%, of the total allowance for loan and lease losses at September 30, 2006 to the commercial loan category. This allocation also considers other relevant factors such as:

- Actual versus estimated losses,
- Regional and national economic conditions,
- Business segment and portfolio concentrations,
- Industry competition and consolidation,
- The impact of government regulations, and
- Risk of potential estimation or judgmental errors, including the accuracy of risk ratings.

***Net Unfunded Credit Commitments***

| In millions | **September 30 2006** | December 31 2005 |
|---|---|---|
| Commercial | **$30,018** | $27,774 |
| Consumer | **10,164** | 9,471 |
| Commercial real estate | **2,998** | 2,337 |
| Other | **624** | 596 |
| Total | **$43,804** | $40,178 |

Commitments to extend credit represent arrangements to lend funds or provide liquidity subject to specified contractual conditions. Commercial commitments are reported net of participations, assignments and syndications, primarily to financial institutions, totaling $6.8 billion at September 30, 2006 and $6.7 billion at December 31, 2005.

Unfunded liquidity facility commitments and standby bond purchase agreements totaled $6.1 billion at September 30, 2006 and $5.1 billion at December 31, 2005 and are included in the preceding table primarily within the Commercial and Consumer categories.

In addition to credit commitments, our net outstanding standby letters of credit totaled $4.4 billion at September 30, 2006 and $4.2 billion at December 31, 2005. Standby letters of credit commit us to make payments on behalf of our customers if specified future events occur.

***Cross-Border Leases and Related Tax and Accounting Matters***

The equipment lease portfolio totaled $3.6 billion at September 30, 2006. Aggregate residual value at risk on the lease portfolio at September 30, 2006 was $1.1 billion. We have taken steps to mitigate $.6 billion of this residual risk, including residual value insurance coverage with third parties, third party guarantees, and other actions. The portfolio included approximately $1.7 billion of cross-border leases at September 30, 2006. Cross-border leases are leveraged leases of equipment located in foreign countries, primarily in western Europe and Australia. We have not entered into cross-border lease transactions since 2003.

Upon completing examination of our 1998-2000 consolidated federal income tax returns, the IRS provided us with an examination report which proposes increases in our tax liability, principally arising from adjustments to several of our cross-border lease transactions.

The IRS has begun an audit of our 2001-2003 consolidated federal income tax returns. We expect them to again make adjustments to the cross-border lease transactions referred to above as well as to new cross-border lease transactions entered into during those years. We believe our reserves for these exposures were adequate at September 30, 2006.

In July 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position No. FAS 13-2, *Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction ( FSP 13-2 ). FSP 13-2 is*

**Table of Contents**

effective January 1, 2007 and will require a recalculation of the timing of income recognition and the reevaluation of lease classification for actual or projected changes in the timing of tax benefits for leveraged leases. Any cumulative adjustment will be recognized through retained earnings upon adoption of FSP 13-2. See Note 1 Accounting Policies in the Notes To Consolidated Financial Statements in this Report for additional information. We estimate that the cumulative adjustment that we will record effective January 1, 2007 from the recalculations required by FSP 13-2 will be in the range of approximately $140 million to $160 million, after-tax. Any immediate or future reductions in earnings from our adoption of FSP 13-2 would be recovered in subsequent years.

In addition to these transactions, three lease-to-service contract transactions that we were party to were structured as partnerships for tax purposes. These partnerships are under audit by the IRS. However, we do not believe that our exposure from these transactions is material to our consolidated results of operations or financial position.

Additional information on cross-border lease transactions is included under Cross-Border Leases and Related Tax and Accounting Matters in the Consolidated Balance Sheet Review section of Item 7 of our 2005 Form 10-K.

## *Securities*

***Details Of Securities (a)***

| In millions | Amortized Cost | Fair Value |
|---|---|---|
| **September 30, 2006** | | |
| *Securities Available for Sale* | | |
| Debt securities | | |
| Mortgage-backed | **$14,799** | **$14,673** |
| US Treasury and government agencies | **556** | **552** |
| Commercial mortgage-backed | **2,342** | **2,334** |
| Asset-backed | **1,527** | **1,519** |
| State and municipal | **141** | **139** |
| Other debt | **89** | **87** |
| Corporate stocks and other | **209** | **208** |
| Total securities available for sale | **$19,663** | **$19,512** |
| December 31, 2005 | | |
| *Securities Available for Sale* | | |
| Debt securities | | |
| Mortgage-backed | $13,794 | $13,544 |
| US Treasury and government agencies | 3,816 | 3,744 |
| Commercial mortgage-backed | 1,955 | 1,919 |
| Asset-backed | 1,073 | 1,063 |
| State and municipal | 159 | 158 |
| Other debt | 87 | 86 |
| Corporate stocks and other | 196 | 196 |
| Total securities available for sale | $21,080 | $20,710 |

(a) Securities held to maturity at September 30, 2006 and December 31, 2005 were less than $.5 million.

Securities represented 20% of total assets at September 30, 2006 and 23% of total assets at December 31, 2005.

We evaluate our portfolio of securities available for sale in light of changing market conditions and other factors and, where appropriate, take steps intended to improve our overall positioning.

At September 30, 2006, securities available for sale included a net unrealized loss of $151 million, which represented the difference between fair value and amortized cost. The comparable amount at December 31, 2005 was a net unrealized loss of $370 million. Net unrealized gains and losses in the securities available for sale portfolio are included in shareholders equity as accumulated other comprehensive income or loss, net of tax.

The fair value of securities available for sale decreases when interest rates increase and vice versa. Consequently, increases in interest rates after September 30, 2006, if sustained, will adversely impact the fair value of securities available for sale compared with the balance at September 30, 2006.

During mid-August through early September 2006, we performed a comprehensive review of our securities available for sale portfolio and, by the end of September 2006, completed the process of executing portfolio rebalancing actions in response to the changing economic landscape, recent statements and actions by the Federal Open Market Committee (in particular, the decision not to raise the Fed funds target rate) and our desire to position the securities portfolio to optimize total return performance over the long term.

As a result, we have repositioned our securities portfolio according to our market views. This included reallocating exposure to certain sectors, selling securities holdings we believed would likely underperform on a relative value basis, retaining certain existing securities and purchasing incremental securities all of which we believe will outperform the market going forward.

As part of the rebalancing, we assessed the entire securities available for sale portfolio of which, for the majority of positions, fair value was less than amortized cost. We executed a strategy to reduce our US government agency and mortgage-backed security sector allocations and increase our interest rate swap sector allocation. We sold substantially all of our US government agency securities to reduce our interest rate spread exposure to that asset class. The US government agency securities that we retained are characterized by relatively short terms to maturity and smaller individual security balances. We also sold specific securities in the mortgage-backed portfolio (e.g. all of our holdings of specific coupon US government agency pass-through securities and collateralized mortgage obligations having specific collateral characteristics), and in the commercial mortgage-backed portfolio (e.g. all of our holdings of specific vintage securities) that we believe, given the underlying collateral, will underperform on a relative value basis. We retained the remaining holdings in our mortgage-backed portfolio including all of our holdings of mortgage-backed securities collateralized by hybrid adjustable rate mortgage loans, our commercial mortgage-backed portfolio and our asset-backed portfolio. Our objective was to reduce the portfolio credit spread and interest rate volatility exposures, to position the portfolio for a steeper yield curve and to optimize the relative value performance of the portfolio. We assessed the securities retained relative to the same portfolio objectives, our market view and outlook, our desired sector allocations, our expectation of performance relative to market benchmarks and, given our assessment, we confirmed our intent to hold these remaining securities until either recovery of fair value or maturity. Accordingly, we do not believe that any in

| Market | Number of Buildings | Square Feet | Purchase Price (in thousands) | Assumed Debt (in thousands) |
| --- | --- | --- | --- | --- |
| Los Angeles | | | $ | $ |
| Miami | 2 | 137,594 | 12,350 | 6,100 |
| Northern New Jersey/New York City | | | | |
| San Francisco Bay Area | | | | |
| Seattle | | | | |
| Washington, D.C./Baltimore | 1 | 65,697 | 6,660 | 3,600 |

| | | | | |
|---|---|---|---|---|
| Total | 3 | 203,291 | $19,010 | $9,700 |

Table of Contents

As of August 7, 2012, the Company has entered into an agreement with a third-party purchaser to sell one property located in the Los Angeles market for a sales price of approximately $17.2 million. There is no assurance that the Company will complete the sale of the property under contract because the proposed sale is subject to the purchaser s completion of satisfactory due diligence and various closing conditions.

**Note 9. Subsequent Events**

On July 3, 2012, the Company acquired three industrial buildings containing 171,707 square feet located in Sunnyvale, CA for a total purchase price of approximately $33.7 million. The property was acquired from an unrelated third party using existing cash on hand and borrowings under the Facility.

On July 19, 2012, the Company completed a public offering of 1,840,000 shares of its 7.75% Series A Cumulative Redeemable Preferred Stock (the Series A Preferred Stock ), including 240,000 shares sold upon the exercise by the underwriters of their option to purchase additional shares, at a price per share of $25.00. The estimated net proceeds of the offering were approximately $44.3 million after deducting the underwriting discount and other estimated offering expenses of approximately $1.7 million. The Company used the net proceeds to reduce outstanding borrowings under the Facility.

On July 23, 2012, the Company acquired one industrial building containing 74,679 square feet located in Doral, FL for a total purchase price of approximately $4.2 million. The property was acquired from an unrelated third party using existing cash on hand and borrowings under the Facility.

On July 31, 2012, the Company acquired one industrial building containing 103,200 square feet located in Redondo Beach, CA for a total purchase price of approximately $14.2 million. The property was acquired from an unrelated third party using existing cash on hand and borrowings under the Facility.

On August 2, 2012, the Company acquired one industrial building containing 24,277 square feet located in South San Francisco, CA for a total purchase price of approximately $3.6 million. The property was acquired from an unrelated third party using existing cash on hand and borrowings under the Facility.

On August 3, 2012, the Company s board of directors declared a cash dividend in the amount of $0.12 per share of the Company s common stock payable on October 26, 2012 to the stockholders of record as of the close of business on October 5, 2012.

On August 3, 2012, the Company s board of directors declared a dividend in the amount of $0.3875 per share of its Series A Preferred Stock for the period from July 19, 2012 through September 30, 2012 payable on October 1, 2012 to the preferred stockholders of record as of the close of business on September 10, 2012.

**Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.**

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended (the Securities Act ) and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act ). We caution investors that forward-looking statements are based on management s beliefs and on assumptions made by, and information currently available to, management. When used, the words anticipate , believe , estimate , expect , intend , may , might project , result , should , will , seek , target , see , likely , position , opportunity and similar expressions which do not relate solely t are intended to identify forward-looking statements. These statements are subject to risks, uncertainties, and assumptions and are not guarantees of future performance, which may be affected by known and unknown risks, trends, uncertainties, and factors that are beyond our control. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated, or projected. We expressly disclaim any responsibility to update our forward-looking statements, whether as a result of new information, future events, or otherwise. Accordingly, investors should use caution in relying on past forward-looking statements, which are based on results and trends at the time they are made, to anticipate future results or trends.

Table of Contents

Some of the risks and uncertainties that may cause our actual results, performance, or achievements to differ materially from those expressed or implied by forward-looking statements include, among others, the following:

- the factors included under the headings Risk Factors and Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2011, which was filed with the Securities and Exchange Commission on February 22, 2012 and in our other public filings;
- our ability to identify and acquire industrial properties on terms favorable to us;
- general volatility of the capital markets and the market price of our common stock;
- adverse economic or real estate conditions or developments in the industrial real estate sector and/or in the markets in which we acquire properties;
- our dependence on key personnel and our reliance on third parties to property manage the majority of our industrial properties;
- our dependence upon tenants;
- our inability to comply with the laws, rules and regulations applicable to companies, and in particular, public companies;
- our ability to manage our growth effectively;
- tenant bankruptcies and defaults on or non-renewal of leases by tenants;
- decreased rental rates or increased vacancy rates;
- increased interest rates and operating costs;
- declining real estate valuations and impairment charges;
- our expected leverage, our failure to obtain necessary outside financing, and future debt service obligations;
- our ability to make distributions to our stockholders;
- our failure to successfully hedge against interest rate increases;

our failure to successfully operate acquired properties;

our failure to qualify or maintain our status as a real estate investment trust, or REIT, and possible adverse changes to tax laws;

uninsured or underinsured losses relating to our properties;

environmental uncertainties and risks related to natural disasters;

financial market fluctuations; and

changes in real estate and zoning laws and increases in real property tax rates.

**Overview**

Terreno Realty Corporation ( Terreno , and together with its subsidiaries, we , us , our , our Company , or the Company ) acquires, owns and operates industrial real estate located in six major coastal U.S. markets: Los Angeles; Northern New Jersey/New York City; San Francisco Bay Area; Seattle; Miami; and Washington, D.C./Baltimore. We invest in several types of industrial real estate, including warehouse/distribution, flex (including light industrial and research and development, or R&D) and trans-shipment. We target functional buildings in infill locations that may be shared by multiple

**Table of Contents**

tenants and that cater to customer demand within the various submarkets in which we operate. Infill locations are geographic locations surrounded by high concentrations of already developed land and existing buildings. As of June 30, 2012, we owned a total of 54 buildings aggregating approximately 4.2 million square feet, which we purchased for an aggregate purchase price of approximately $327.6 million, including the assumption of mortgage loans payable of approximately $39.5 million, which includes mortgage premiums of approximately $0.8 million. As of June 30, 2012, our properties were approximately 91.3% leased to 85 tenants, the largest of which accounted for approximately 10.0% of our total annualized based rent. We are an internally managed Maryland corporation and elected to be taxed as a REIT under Sections 856 through 860 of the Internal Revenue Code of 1986, as amended, or the Code, commencing with our taxable year ending December 31, 2010.

The following table summarizes by market our investments in real estate as of June 30, 2012:

| Market | Number of Buildings | Rentable Square Feet | % of Total | Occupancy % as of June 30, 2012 | Annualized Base Rent (000 s)[1] | % of Total | Annualized Base Rent Per Occupied Square Foot | Weighted Average Remaining Lease Term (Years)[2] | Gross Book Value (000 s) |
|---|---|---|---|---|---|---|---|---|---|
| Los Angeles | 10 | 928,773 | 22.2% | 86.0% | $ 6,027 | 23.8% | $ 7.54 | 3.4 | $ 97,550 |
| Northern New Jersey/New York City | 23 | 1,591,250 | 38.0% | 93.9% | 9,808 | 38.7% | 6.56 | 3.8 | 121,618 |
| San Francisco Bay Area | 9 | 431,866 | 10.3% | 85.5% | 3,233 | 12.8% | 8.75 | 4.3 | 41,378 |
| Seattle | 3 | 306,662 | 7.3% | 100.0% | 1,617 | 6.4% | 5.27 | 6.8 | 24,748 |
| Miami | 6 | 630,212 | 15.0% | 97.7% | 3,134 | 12.4% | 5.09 | 8.6 | 39,654 |
| Washington, D.C./Baltimore | 3 | 302,734 | 7.2% | 80.2% | 1,488 | 5.9% | 6.13 | 6.5 | 20,072 |
| Total/Weighted Average | 54 | 4,191,497 | 100.0% | 91.3% | $ 25,307 | 100.0% | $ 6.61 | 5.0 | $ 345,020 |

1 Annualized base rent is calculated as monthly base rent per the leases, excluding any partial or full rent abatements, as of June 30, 2012, multiplied by 12.

2 Weighted average remaining lease term is calculated by summing the remaining lease term of each lease as of June 30, 2012, weighted by the respective square footage.

The following table summarizes our capital expenditures incurred during the three and six months ended June 30, 2012 (dollars in thousands):

| | *For the Three Months Ended June 30, 2012* | *For the Six Months Ended June 30, 2012* |
|---|---|---|
| Building improvements | $ 2,156 | $ 4,620 |
| Tenant improvements | 529 | 1,031 |
| Leasing commissions | 207 | 543 |
| Total capital expenditures (1) | $ 2,892 | $ 6,194 |

1 Includes approximately $1.4 million and $3.8 million, respectively, related to leasing acquired vacancy and renovation projects at three properties.

Table of Contents

Our top ten tenants as of June 30, 2012 are as follows:

| | Tenant | Leases | Rentable Square Feet | % of Total Rentable Square Feet | Annualized Base Rent (000 s)[1] | % of Total Annualized Base Rent |
|---|---|---|---|---|---|---|
| 1 | YRC Worldwide | 3 | 182,803 | 4.4% | $ 2,518 | 10.0% |
| 2 | H.D. Smith Wholesale Drug Company | 1 | 211,418 | 5.0% | 2,008 | 7.9% |
| 3 | Home Depot | 1 | 413,092 | 9.9% | 1,905 | 7.5% |
| 4 | Precision Custom Coatings | 1 | 208,000 | 5.0% | 1,637 | 6.5% |
| 5 | Miami International Freight Solutions | 1 | 181,340 | 4.3% | 1,043 | 4.1% |
| 6 | Sohnen Enterprises | 1 | 161,610 | 3.9% | 994 | 3.9% |
| 7 | Banah International Group | 1 | 301,983 | 7.2% | 906 | 3.6% |
| 8 | FedEx Corporation | 1 | 72,808 | 1.7% | 852 | 3.4% |
| 9 | JAM N Logistics | 1 | 110,336 | 2.6% | 653 | 2.6% |
| 10 | Maines Paper & Food Service | 1 | 98,745 | 2.3% | 636 | 2.5% |
| | Total | 12 | 1,942,135 | 46.3% | $ 13,152 | 52.0% |

1 Annualized base rent is calculated as monthly base rent per the leases, excluding any partial or full rent abatements, as of June 30 2012, multiplied by 12.

The following table summarizes the anticipated lease expirations for leases in place at June 30, 2012, without giving effect to the exercise of renewal options or termination rights, if any, at or prior to the scheduled expirations:

| Year | Rentable Square Feet[1] | % of Total Rentable Square Feet | Annualized Base Rent (000 s)[1, 2] | % of Total Annualized Base Rent[1] |
|---|---|---|---|---|
| 2012 (6 months) | 87,107 | 2.1% | $ 782 | 2.8% |
| 2013 | 804,959 | 19.2% | 4,570 | 16.2% |
| 2014 | 502,715 | 12.0% | 3,279 | 11.7% |
| 2015 | 439,693 | 10.5% | 3,017 | 10.7% |
| 2016 | 193,124 | 4.5% | 1,329 | 4.7% |
| 2017+ | 1,801,102 | 43.0% | 15,159 | 53.9% |
| Total | 3,828,700 | 91.3% | $ 28,136 | 100.0% |

1 Includes leases that expire on or after June 30, 2012.

2 Annualized base rent is calculated as monthly base rent per the leases at expiration, excluding any partial or full rent abatements, as of June 30, 2012, multiplied by 12.

**Recent Developments**

***Acquisition Activity***

During the three months ended June 30, 2012, we acquired six industrial buildings containing 706,909 square feet for a total purchase price of approximately $68.5 million. The properties were acquired from unrelated third parties using existing cash on hand and borrowings under our credit facility. The following table sets forth the wholly-owned industrial properties we acquired during the three months ended June 30, 2012:

| Property Name | Location | Acquisition Date | Number of Buildings | Square Feet | Purchase Price (in thousands) |
|---|---|---|---|---|---|
| Garfield | Commerce, CA | May 30, 2012 | 5 | 545,299 | 52,400 |
| Whittier | Whittier, CA | June 12, 2012 | 1 | 161,610 | 16,100 |
| Total | | | 6 | 706,909 | $ 68,500 |

Subsequent to June 30, 2012, we acquired six industrial buildings containing 373,863 square feet for a total purchase price of approximately $55.7 million. The properties were acquired from unrelated third parties using existing cash on hand and borrowings under our credit facility. The following table sets forth the wholly-owned industrial properties we acquired subsequent to June 30, 2012:

Table of Contents

| Property Name | Location | Acquisition Date | Number of Buildings | Square Feet | Purchase Price (in thousands) |
|---|---|---|---|---|---|
| Caribbean | Sunnyvale, CA | July 3, 2012 | 3 | 171,707 | $ 33,718 |
| 78th Avenue | Doral, FL | July 23, 2012 | 1 | 74,679 | 4,200 |
| Manhattan Beach | Redondo Beach, CA | July 31, 2012 | 1 | 103,200 | 14,150 |
| Carlton Court | South San Francisco, CA | August 2, 2012 | 1 | 24,277 | 3,600 |
| Total | | | 6 | 373,863 | $ 55,668 |

***Preferred Stock Offering***

On July 19, 2012, we completed a public offering of 1,840,000 shares of our 7.75% Series A Cumulative Redeemable Preferred Stock (the Series A Preferred Stock ), including 240,000 shares sold upon the exercise by the underwriters of their option to purchase additional shares, at a price per share of $25.00. The estimated net proceeds of the offering were approximately $44.3 million after deducting the underwriting discount and other estimated offering expenses of approximately $1.7 million. We used the net proceeds to reduce outstanding borrowings under our credit facility.

***Amendment to Our Senior Revolving Credit Facility***

On June 15, 2012, we entered into a Third Amendment to our Amended and Restated Senior Revolving Credit Agreement (the Facility) with KeyBank National Association, as administrative agent and as a lender, and PNC Bank, National Association, and Union Bank, N.A., as lenders, to increase our Facility from $80.0 million to $100.0 million by exercising the accordion feature under the Facility. Outstanding borrowings under the Facility are limited to the lesser of $100.0 million or 60.0% of the value of the borrowing base properties. The amount available under the Facility may be increased up to $150.0 million, subject to the approval of the administrative agent and the identification of lenders willing to make additional amounts available. The Facility requires payment of an annual unused facility fee in an amount equal to 0.25% or 0.35% depending on the unused portion of the Facility. We guarantee the obligations of the borrower (a wholly-owned subsidiary) under the Facility.

***Secured Financing***

On June 26, 2012 we entered into a $39.8 million non-recourse mortgage loan at a fixed annual interest rate of 3.65% that matures on March 5, 2020. The mortgage loan is secured by three of our properties. The loan proceeds were used to reduce outstanding borrowings under the Facility and for general business purposes.

***Distribution Activity***

The following table sets forth the cash dividends payable per share during the three months ended June 30, 2012:

| For the Three Months Ended | Dividend per Share | Declaration Date | Record Date | Date Paid |
|---|---|---|---|---|
| June 30, 2012 | $ 0.12 | May 4, 2012 | July 9, 2012 | July 23, 2012 |

On August 3, 2012, our board of directors declared a cash dividend in the amount of $0.12 per share of our common stock payable on October 26, 2012 to the stockholders of record as of the close of business on October 5, 2012.

On August 3, 2012, our board of directors declared a dividend in the amount of $0.3875 per share of our Series A Preferred Stock for the period from July 19, 2012 through September 30, 2012 payable on October 1, 2012 to the preferred stockholders of record as of the close of business on September 10, 2012.

***Contractual Commitments***

As of August 7, we had two outstanding contracts with third-party sellers to acquire two industrial properties and one outstanding contract with a third-party purchaser to sell one property as described under the heading Contractual Obligations in this Quarterly Report on Form 10-Q. There is no assurance that we will acquire or sell the properties under contract because the proposed acquisitions and disposition are subject to the completion of satisfactory due diligence, various closing conditions and, with respect to the acquisitions, the consent of the mortgage lender.

Table of Contents

**Financial Condition and Results of Operations**

We derive substantially all of our revenues from rents received from tenants under existing leases on each of our properties. These revenues include fixed base rents and recoveries of certain expenses that we have incurred and that we pass through to the individual tenants.

Our primary cash expenses consist of our property operating expenses, which include: real estate taxes; repairs and maintenance; management expenses; insurance; utilities; general and administrative expenses, which include compensation costs, office expenses, professional fees and other administrative expenses; acquisition costs, which include third-party costs paid to brokers and consultants; and interest expense, primarily on mortgage loans, term loans and the Facility.

Our consolidated results of operations often are not comparable from period to period due to the impact of property acquisitions at various times during the course of such periods. The results of operations of any acquired property are included in our financial statements as of the date of its acquisition.

The analysis of our results below includes the changes attributable to same store properties. The same store pool includes all properties that were owned as of June 30, 2012 and since January 1, 2011. As of June 30, 2012, the same store pool consisted of 12 properties aggregating approximately 2.4 million square feet. As of June 30, 2012, the non-same store properties, which we acquired during the course of 2011 and 2012 consisted of 15 properties aggregating approximately 1.8 million square feet.

Our future financial condition and results of operations, including rental revenues, straight-line rents and amortization of lease intangibles, may be impacted by the acquisitions of additional properties, and expenses may vary materially from historical results.

**Comparison of the Three Months Ended June 30, 2012 to the Three Months Ended 2011:**

| | For the Three Months Ended June 30, | | | |
|---|---|---|---|---|
| | 2012 | 2011 | $ Change | % Change |
| | (Dollars in thousands) | | | |
| Rental revenues | | | | |
| Same store | $ 3,658 | $ 2,835 | $ 823 | 29.0% |
| 2011 and 2012 Acquisitions | 2,393 | 84 | 2,309 | 2748.8% |
| Total rental revenues | 6,051 | 2,919 | 3,132 | 107.3% |
| Tenant expense reimbursements | | | | |
| Same store | 476 | 490 | (14) | (2.9)% |
| 2011 and 2012 Acquisitions | 1,072 | 357 | 715 | 200.3% |
| Total tenant expense reimbursements | 1,548 | 847 | 701 | 82.8% |
| Total revenues | 7,599 | 3,766 | 3,833 | 101.8% |
| Property operating expenses | | | | |
| Same store | 1,279 | 1,357 | (78) | (5.7)% |
| 2011 and 2012 Acquisitions | 821 | 131 | 690 | 526.7% |
| Total property operating expenses | 2,100 | 1,488 | 612 | 41.1% |
| Net operating income [(1)] | | | | |
| Same store | 2,855 | 1,968 | 887 | 45.1% |
| 2011 and 2012 Acquisitions | 2,644 | 310 | 2,334 | 752.9% |
| Total net operating income | $ 5,499 | $ 2,278 | $ 3,221 | 141.4% |

| | | | | |
|---|---|---|---|---|
| Other costs and expenses | | | | |
| Depreciation and amortization | 1,918 | 1,042 | 876 | 84.1% |
| General and administrative | 1,886 | 1,480 | 406 | 27.4% |
| Acquisition costs | 324 | 1,256 | (932) | (74.2)% |
| Total other costs and expenses | 4,128 | 3,778 | 350 | 9.3% |
| Other Income (Expense) | | | | |
| Interest and other income | 2 | 3 | (1) | (33.3)% |
| Interest expense, including amortization | (1,116) | (464) | (652) | 140.5% |
| Total other income and expenses | (1,114) | (461) | (653) | 141.6% |
| Net and comprehensive income (loss) | $ 257 | $ (1,961) | $ 2,218 | n/a |

[1] Includes straight-line rents and amortization of lease intangibles. See Non-GAAP Financial Measures in this Quarterly Report on Form 10-Q for a reconciliation of net operating income and same store net operating income from net and comprehensive income (loss) and a discussion of why we believe net operating income and same store net operating income are useful supplemental measures of our operating performance.

19

**Table of Contents**

*Revenues.* Total revenues increased approximately $3.8 million for the three months ended June 30, 2012 compared to the same period from the prior year. Approximately $0.8 million of this increase is from same store revenues mainly due to increased occupancy, as same store consolidated occupancy at quarter end increased to 92.7% in the second quarter of 2012 as compared to 69.1% from the same period in 2011. The remaining increase in total revenues is due to property acquisitions during 2011 and 2012. For the quarter ended June 30, 2012, approximately $0.8 million was recorded in straight-line rental revenues related to contractual rent abatements given to certain tenants.

*Property operating expenses.* Total property operating expenses increased approximately $0.6 million during the three months ended June 30, 2012 compared to the same period from the prior year. The increase in total property operating expenses was due to an increase of approximately $0.7 million attributable to property acquisitions during 2011 and 2012, which was partially offset by a decrease in same store property operating expenses of approximately $0.1 million.

*Depreciation and amortization.* Depreciation and amortization increased approximately $0.9 million during the three months ended June 30, 2012 compared to the same period from the prior year due to property acquisitions during 2011 and 2012.

*General and administrative expenses.* General and administrative expenses increased approximately $0.4 million for the three months ended June 30, 2012 compared to the same period from the prior year due primarily to an increase in compensation expense.

*Acquisition costs.* Acquisition costs decreased by approximately $0.9 million from the prior year period due to a lower number of property acquisitions during the three months ended June 30, 2012 as compared to the same period in the prior year.

*Interest expense, including amortization.* Interest expense increased approximately $0.7 million for the three months ended June 30, 2012 compared to the same period from the prior year due primarily to the assumption and origination of mortgage loans payable during 2011 and 2012, as well as borrowings under our Facility and term loan payable.

Table of Contents

**Comparison of the Six Months Ended June 30, 2012 to the Six Months Ended 2011:**

| | For the Six Months Ended June 30, 2012 | 2011 | $ Change | % Change |
|---|---|---|---|---|
| | (Dollars in thousands) | | | |
| Rental revenues | | | | |
| Same store | $ 7,053 | $ 5,650 | $ 1,403 | 24.8% |
| 2011 and 2012 Acquisitions | 4,304 | (148) | 4,452 | n/a |
| Total rental revenues | 11,357 | 5,502 | 5,855 | 106.4% |
| Tenant expense reimbursements | | | | |
| Same store | 904 | 1,045 | (141) | (13.5)% |
| 2011 and 2012 Acquisitions | 1,944 | 589 | 1,355 | 230.1% |
| Total tenant expense reimbursements | 2,848 | 1,634 | 1,214 | 74.3% |
| Total revenues | 14,205 | 7,136 | 7,069 | 99.1% |
| Property operating expenses | | | | |
| Same store | 2,593 | 2,805 | (212) | (7.6)% |
| 2011 and 2012 Acquisitions | 1,415 | 146 | 1,269 | 869.2% |
| Total property operating expenses | 4,008 | 2,951 | 1,057 | 35.8% |
| Net operating income [(1)] | | | | |
| Same store | 5,364 | 3,890 | 1,474 | 37.9% |
| 2011 and 2012 Acquisitions | 4,833 | 295 | 4,538 | 1538.3% |
| Total net operating income | $ 10,197 | $ 4,185 | $ 6,012 | 143.7% |
| Other costs and expenses | | | | |
| Depreciation and amortization | 3,743 | 2,001 | 1,742 | 87.1% |
| General and administrative | 3,301 | 3,088 | 213 | 6.9% |
| Acquisition costs | 1,038 | 1,538 | (500) | (32.5)% |
| Total other costs and expenses | 8,082 | 6,627 | 1,455 | 22.0% |
| Other Income (Expense) | | | | |
| Interest and other income | 3 | 7 | (4) | (57.1)% |
| Interest expense, including amortization | (2,128) | (832) | (1,296) | 155.8% |
| Total other income and expenses | (2,125) | (825) | | |