

BERKSHIRE INCOME REALTY INC  
Form 10-Q  
November 15, 2004

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2004

OR

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

For the transition period \_\_\_\_\_ or \_\_\_\_\_

Commission File number 001-31659

Berkshire Income Realty, Inc.

(Exact name of registrant as specified in its charter)

Maryland

32-0024337

(State of other jurisdiction of incorporation or organization)

(IRS employer identification no.)

One Beacon Street, Boston, Massachusetts

02108

(Address of principal executive offices)

(Zip code)

(Registrant's telephone number, including area code)

(617) 523-7722

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes

No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act)

Yes

No

There were 1,283,313 shares of Class B common stock outstanding as of November 12, 2004

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**BERKSHIRE INCOME REALTY, INC.**

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## ITEM NO.

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**PART I. Financial Information**

## Item 1. Financial Statements:

BERKSHIRE INCOME REALTY, INC.(FORMERLY  
BERKSHIRE INCOME REALTY PREDECESSOR GROUP)  
CONSOLIDATED BALANCE SHEETS  
(unaudited)

|   | <b>September 30,<br/>2004</b> | <b>December 31,<br/>2003</b> |
|---|-------------------------------|------------------------------|
| <b>ASSETS</b>   |                               |                              |
| Multifamily apartment communities, net of accumulated depreciation of \$110,520,391 and \$102,609,721, respectively           | \$ 154,399,789                | \$ 145,222,916               |
| Cash and cash equivalents   | 34,904,628                    | 42,145,947                   |
| Available for sale securities, at fair value  | 18,610,841                    | 18,488,414                   |
| Cash restricted for tenant security deposits  | 857,735                       | 856,498                      |
| Replacement reserve escrow  | 478,247                       | 318,708                      |
| Prepaid expenses and other assets   | 7,839,526                     | 5,113,200                    |
| Investment in Mortgage Funds  | 13,027,092                    | 24,046,908                   |
| Investment in Multifamily Joint Venture   | 2,306,847                     | --                           |
| Acquired in place leases and tenant relationships, net of accumulated amortization of \$1,253,003 and \$212,200, respectively | 226,471                       | 1,061,004                    |
| Deferred expenses, net of accumulated amortization of \$540,567 and \$323,067 respectively                                    | 1,529,684                     | 1,621,498                    |
| Total assets  | <u>\$ 234,180,860</u>         | <u>\$ 238,875,093</u>        |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                               |                              |
| Liabilities:  |                               |                              |
| Mortgage notes payable  | \$ 186,092,756                | \$ 184,471,204               |
| Due to affiliates   | 1,221,154                     | 1,318,755                    |
| Dividends and distributions payable   | 1,087,607                     | 1,087,593                    |
| Accrued expenses and other liabilities  | 3,874,790                     | 3,268,859                    |
| Tenant security deposits  | 1,074,738                     | 971,363                      |

|   | <b>September 30,<br/>2004</b> | <b>December 31,<br/>2003</b> |
|---|-------------------------------|------------------------------|
|   | <u>193,351,045</u>            | <u>191,117,774</u>           |
| Total liabilities   |                               |                              |
| Commitments and Contingencies   | --                            | --                           |
| Minority interests  | --                            | --                           |
| Stockholders' equity:   |                               |                              |
| Series A 9% Cumulative Redeemable Preferred Stock, no par value,<br>\$25 stated value, 5,000,000 shares authorized, 2,978,110 shares issued and outstanding at September 30, 2004 and December 31, 2003 | 70,210,830                    | 70,210,830                   |
| Class A common stock, \$.01 par value, 5,000,000 shares authorized; 0 shares issued and outstanding at September 30, 2004 and December 31, 2003   | --                            | --                           |
| Class B common stock, \$.01 par value, 5,000,000 shares authorized; 1,283,313 shares issued and outstanding at September 30, 2004 and December 31, 2003   | 12,833                        | 12,833                       |
| Excess stock, \$.01 par value, 15,000,000 shares authorized, 0 shares issued and outstanding at September 30, 2004 and December 31, 2003  | (29,393,848 )                 | (22,452,115 )                |
| Accumulated deficit   | --                            | (14,229 )                    |
| Accumulated other comprehensive gain (loss)   |                               |                              |
| Total stockholders' equity  | <u>40,829,815</u>             | <u>47,757,319</u>            |
| Total liabilities and stockholders' equity  | <u>\$ 234,180,860</u>         | <u>\$ 238,875,093</u>        |

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

BERKSHIRE INCOME REALTY, INC.  
(FORMERLY BERKSHIRE INCOME REALTY PREDECESSOR GROUP)  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(unaudited)

Three months ended September 30,      Nine months ended September 30,

|   | Three months ended September 30, |              | Nine months ended September 30, |               |
|---|----------------------------------|--------------|---------------------------------|---------------|
|   | 2004                             | 2003         | 2004                            | 2003          |
| Revenue:  |                                  |              |                                 |               |
| Rental  | \$ 9,190,568                     | \$ 6,908,604 | \$ 27,079,335                   | \$ 20,597,848 |
| Interest  | 153,997                          | 11,519       | 640,010                         | 78,235        |
| Utility reimbursement   | 132,474                          | 132,671      | 395,860                         | 339,975       |
| Other   | 463,604                          | 374,448      | 1,159,968                       | 926,784       |
|   | <hr/>                            | <hr/>        | <hr/>                           | <hr/>         |
| Total revenue   | 9,940,643                        | 7,427,242    | 29,275,173                      | 21,942,842    |
|   | <hr/>                            | <hr/>        | <hr/>                           | <hr/>         |
| Expenses:   |                                  |              |                                 |               |
| Operating   | 2,542,538                        | 1,912,239    | 7,304,839                       | 5,187,303     |
| Maintenance   | 782,811                          | 714,588      | 2,102,462                       | 1,783,680     |
| Real estate taxes   | 1,085,799                        | 643,050      | 3,236,604                       | 1,817,100     |
| General and administrative  | 355,951                          | 476,240      | 1,074,150                       | 1,148,700     |
| Management fees   | 647,398                          | 464,696      | 1,922,754                       | 1,572,990     |
| Depreciation  | 2,751,854                        | 1,818,769    | 8,194,823                       | 5,453,969     |
| Loss on extinguishment of debt  | --                               | 86,748       | --                              | 337,832       |
| Organizational costs  | --                               | --           | --                              | 213,428       |
| Interest  | 2,638,987                        | 1,829,877    | 8,093,230                       | 5,580,719     |
| Loss on sale of securities  | --                               | --           | 163,630                         | --            |
| Amortization of acquired in-place leases and Tenant relationships   | 361,251                          | --           | 1,134,188                       | --            |
|   | <hr/>                            | <hr/>        | <hr/>                           | <hr/>         |
| Total expenses  | \$ 11,166,589                    | 7,946,207    | 33,226,680                      | 23,095,721    |
|   | <hr/>                            | <hr/>        | <hr/>                           | <hr/>         |
| Loss before minority interest in properties, equity in loss of Multifamily Joint Venture, equity in income of |                                  |              |                                 |               |

|   | <u>Three months ended September 30,</u> |                 | <u>Nine months ended September 30,</u> |               |
|---|---|-----------------|--|---------------|
| Mortgage Funds,<br>minority<br>common interest in<br>Operating Partnership<br>and<br>gain on transfer of<br>property to<br>Multifamily Joint<br>Venture |   |                 |  |               |
| Multifamily Joint<br>Venture  | \$ (1,225,946 )                         | (518,965 )      | (3,951,507 )                           | (1,152,879 )  |
| Minority interest in<br>properties  | (2,418 )                                | (31,025 )       | (111,228 )                             | (125,228 )    |
| Equity in loss of<br>Multifamily<br>Joint Venture   | (58,105 )                               | --              | (160,778 )                             | --            |
| Equity in income of<br>Mortgage<br>Funds  | 1,559,844                               | 3,153,016       | 2,824,714                              | 4,882,802     |
| Minority common<br>interest in<br>Operating Partnership   | (244,025 )                              | (488,050 )      | (732,075 )                             | (488,050 )    |
| Income (loss) before gain<br>on<br>transfer of property to<br>Multifamily Joint<br>Venture  | 29,350                                  | 2,114,976       | (2,130,874 )                           | 3,116,645     |
| Gain on transfer of<br>property to<br>Multifamily Joint<br>Venture  | --                                      | --              | 232,704                                | --            |
| Net income (loss)   | 29,350                                  | 2,114,976       | (1,898,170 )                           | 3,116,645     |
| Preferred dividend  | (1,675,200 )                            | \$ (1,675,202 ) | (5,025,638 )                           | (3,276,089 )  |
| Net income (loss)<br>available to<br>common shareholders  | \$ (1,645,850 )                         | \$ 439,774      | \$ (6,923,808 )                        | \$ (159,444 ) |

|   | <u>Three months ended September 30,</u> |           | <u>Nine months ended September 30,</u> |            |
|---|---|-----------|--|------------|
| Basic and diluted earnings per share data:                              |   |           |  |            |
| Net income (loss) per common share                                      | \$ (1.28 )                              | \$ 0.34   | \$ (5.40 )                             | \$ (0.19 ) |
| Weighted average number of common shares outstanding, basic and diluted | 1,283,313                               | 1,283,313 | 1,283,313                              | 837,207    |

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

BERKSHIRE INCOME REALTY, INC.  
(FORMERLY BERKSHIRE INCOME REALTY PREDECESSOR GROUP)  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)  
(unaudited)

|  | <u>Three months ended September 30,</u> |              | <u>Nine months ended September 30,</u> |              |
|--|---|--------------|--|--------------|
|  | <u>2004</u>                             | <u>2003</u>  | <u>2004</u>                            | <u>2003</u>  |
| Comprehensive income (loss):                     |   |              |  |              |
| Net income (loss)                                | \$ 29,350                               | \$ 2,114,976 | \$ (1,898,170)                         | \$ 3,116,645 |
| Other comprehensive income (loss):               |   |              |  |              |
| Unrealized gain on available for sale securities | --                                      | --           | 14,229                                 | --           |
| Comprehensive income (loss):                     | \$ 29,350                               | \$ 2,114,976 | \$ (1,883,941)                         | \$ 3,116,645 |

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

BERKSHIRE INCOME REALTY, INC.  
(FORMERLY BERKSHIRE INCOME REALTY PREDECESSOR GROUP)  
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY  
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2004  
(unaudited)

| <u>Series A Preferred Stock</u> |               | <u>Class B Common Stock</u> |               | <u>Other Accumulated Deficit</u> | <u>Total Comprehensive Income</u> | <u>Stockholders' Equity</u> |
|---------------------------------|---------------|-----------------------------|---------------|----------------------------------|-----------------------------------|-----------------------------|
| <u>Shares</u>                   | <u>Amount</u> | <u>Shares</u>               | <u>Amount</u> |                                  |                                   |                             |

|  | Series A Preferred Stock |               | Class B Common Stock |           | Other Accumulated Deficit | Total Comprehensive Income | Stockholders' Equity |
|--|--------------------------|---------------|----------------------|-----------|---------------------------|----------------------------|----------------------|
| Balance at December 31, 2003                         | 2,978,110                | \$ 70,210,830 | 1,283,313            | \$ 12,833 | \$ (22,452,115)           | \$ (14,229)                | \$ 47,757,319        |
| Net loss   | --                       | --            | --                   | --        | (1,898,170)               | --                         | (1,898,170)          |
| Net unrealized gain on available for sale securities | --                       | --            | --                   | --        | --                        | 14,229                     | 14,229               |
| Distributions to common shareholders                 | --                       | --            | --                   | --        | (17,925)                  | --                         | (17,925)             |
| Distributions to preferred shareholders              | --                       | --            | --                   | --        | (5,025,638)               | --                         | (5,025,638)          |
| Balance at September 30, 2004                        | 2,978,110                | \$ 70,210,830 | 1,283,313            | \$ 12,833 | \$ (29,393,848)           | \$ --                      | \$ 40,829,815        |

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

BERKSHIRE INCOME REALTY, INC.  
(FORMERLY BERKSHIRE INCOME REALTY PREDECESSOR GROUP)  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(unaudited)

|  | <b>Nine months ended September 30,</b> |              |
|--|--|--------------|
|  | <b>2004</b>                            | <b>2003</b>  |
| Cash flows from operating activities:  |  |              |
| Net income (loss)  | \$ (1,898,170)                         | \$ 3,116,645 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |  |              |
| Amortization of deferred financing costs   | 221,946                                | 140,621      |
| Amortization of acquired in-place leases and tenant relationships                        | 1,134,188                              | --           |
| Depreciation   | 8,194,823                              | 5,453,969    |
| Loss on the extinguishment of debt   | --                                     | 337,832      |
| Loss on available for sale securities  | 163,630                                | --           |
| Minority interest in properties  | 732,075                                | 488,050      |
| Accretion of Mortgage Funds  | (1,726,193)                            | (1,808,529)  |
| Equity in loss of Multifamily Joint Venture  | 160,778                                | --           |
| Gain on transfer of Multifamily Joint Venture  | (232,704)                              | --           |
| Minority interest in Operating Partnership   | 111,228                                | 125,228      |



**Nine months ended September 30,**

|  |              |              |
|--|--------------|--------------|
| Increase (decrease) in cash attributable to changes in assets and liabilities: |              |              |
| Tenant security deposits, net  | 250,683      | 22,199       |
| Prepaid expenses and other assets  | (610,593)    | 132,476      |
| Due to/from affiliate  | (97,861)     | (1,421,665)  |
| Accrued expenses and other liabilities   | 859,965      | 1,425,898    |
|  | <hr/>        | <hr/>        |
| Net cash provided by operating activities                                      | 7,263,795    | 8,012,724    |
|  | <hr/>        | <hr/>        |
| Cash flows from investing activities:  |              |              |
| Capital improvements   | (7,505,136)  | (3,935,688)  |
| Acquisition of multifamily apartment communities                               | (33,057,228) | (7,071,171)  |
| Earnest money deposits on future acquisitions                                  | (201,622)    | --           |
| Proceeds received from transfer of property to Multifamily Joint Venture       | 3,831,728    | --           |
| Purchase of available for sale securities                                      | (271,827)    | --           |
| Investments in Mortgage Funds  | --           | (212,998)    |
| Deposits to replacement reserve  | (332,592)    | (305,457)    |
| Withdrawals from replacement reserve   | 173,053      | 462,000      |
| Distributions from investment in Multifamily Joint Venture                     | 150,201      | --           |
| Investment in Multifamily Joint Venture  | (529,689)    | --           |
| Distributions from investment of Mortgage Funds                                | 12,746,009   | 36,277,291   |
| Acquisition of in-place leases and tenant relationships                        | (643,450)    | --           |
|  | <hr/>        | <hr/>        |
| Net cash provided by (used in) investing activities                            | (25,640,553) | 25,213,977   |
|  | <hr/>        | <hr/>        |
| Cash flows from financing activities:  |              |              |
| Principal payments on mortgage notes payable                                   | (1,698,448)  | (1,073,312)  |
| Prepayments of mortgages notes payable   | --           | (20,810,471) |
| Borrowings from mortgage notes payable   | 20,720,000   | 31,467,000   |
| Syndication costs  | --           | (4,241,200)  |
| Deposits on mortgages notes payable  | (2,075,275)  | --           |
| Deferred financing costs   | (303,512)    | (452,247)    |
| Cash shortfall distribution from Multifamily Joint Venture                     | 379,527      | --           |
| Distributions to owners  | --           | (104,079)    |
| Contributions from owners  | --           | 1,518,382    |
| Distributions to minority interest in properties                               | (111,228)    | (125,228)    |
| Distributions on common operating partnership units                            | (750,000)    | --           |
| Distributions to preferred shareholders  | (5,025,625)  | (2,438,496)  |
|  | <hr/>        | <hr/>        |
| Net cash provided by financing activities                                      | 11,135,439   | 3,740,349    |
|  | <hr/>        | <hr/>        |

|  | <u>Nine months ended September 30,</u> |                      |
|--|--|----------------------|
| Net increase (decrease) in cash and cash equivalents                                   | (7,241,319)                            | 36,967,050           |
| Cash and cash equivalents at beginning of period                                       | 42,145,947                             | 4,852,257            |
| Cash and cash equivalents at end of period   | <u>\$ 34,904,628</u>                   | <u>\$ 41,819,307</u> |
| Supplemental disclosure:   |  |                      |
| Cash paid for interest   | \$ 8,596,506                           | \$ 6,936,240         |
| Supplemental disclosure of non-cash investing and financing activities:                |  |                      |
| Dividends declared and payable to preferred shareholders                               | \$ 837,607                             | \$ 837,593           |
| Distribution declared and payable to common shareholders                               | \$ 250,000                             | \$ 500,000           |
| Issuance of preferred shares in exchange for interests in Mortgage Funds               | \$ --                                  | \$ 74,452,750        |
| Syndication costs included in due to affiliates  | \$ --                                  | \$ 3,908,345         |
| Transfer of Marina Mile property to Multifamily Joint Venture                          | \$ 23,190,670                          | \$ --                |
| Transfer of Marina Mile mortgage notes payable to Multifamily Joint Venture            | \$ 17,400,000                          | \$ --                |
| Transfer of Marina Mile other assets and liabilities to Multifamily Joint Venture, net | \$ 103,507                             | \$ --                |

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

BERKSHIRE INCOME REALTY, INC.  
(FORMERLY BERKSHIRE INCOME REALTY PREDECESSOR GROUP)  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(unaudited)

## 1. ORGANIZATION AND BASIS OF PRESENTATION

### Organization

Berkshire Income Realty, Inc., (the Company), a Maryland corporation, was organized on July 19, 2002. The Company is engaged primarily in the business of acquiring, owning, operating, and rehabilitating multifamily apartment communities. As of September 30, 2004, the Company owned, or had an interest in, 10 multifamily apartment communities consisting of a total of 4,163 apartment units.

### Discussion of acquisitions for the nine months ended September 30, 2004

On January 28, 2004, our operating partnership, Berkshire Income Realty OP, L.P. (the Operating Partnership), through its newly formed and wholly owned subsidiary Marina Mile L.L.C., purchased Pond Apple Creek Apartments (subsequently renamed The Berkshires at Marina Mile (Marina Mile)), a 306-unit multifamily apartment community located in Fort Lauderdale, Florida, from Pond Apple Creek Associates Limited Partnership. The seller was an unaffiliated third party. The purchase and sale agreement, as amended, was agreed upon through arms length negotiations and provided for the purchase price of \$23,000,000 to be paid in cash. Effective May 1, 2004, the Company consummated a joint venture relationship (the Multifamily Joint Venture) with an unrelated third party (the JV Partner) whereby each of the parties to the agreement will participate, on a pro rata basis, in the economic benefits of Marina Mile. Under the terms of the limited liability company agreement governing the Multifamily Joint Venture, the JV Partner contributed, in cash, 65% of the total Multifamily Joint Venture equity in exchange for a 65% interest in the newly formed entity, JV Marina Mile, L.L.C. (the L.L.C.). The Operating Partnership contributed its interest in Marina Mile, L.L.C., the fee simple owner of the property, in exchange for a 35% interest in the L.L.C. and a cash distribution representing a return of capital, of approximately \$3,594,693 net of \$387,236 of additional capital invested by the Operating Partnership. Both parties will receive proportional distributions of available cash up to an effective 10% internal rate of return on each party's capital (the Preferred Return). After payment of the Preferred Return and the return of each party's capital contribution, the Operating Partnership will be entitled to, in addition to its 35% pro rata share, additional distributions equal to approximately 30% of the distributions otherwise payable to the JV Partner. The Operating Partnership is the managing member of the L.L.C.

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On March 30, 2004, the Operating Partnership, through its newly formed and wholly owned subsidiary BIR Laurel Woods Limited Partnership, purchased Laurel Woods Apartments ( Laurel Woods ), a 150-unit multifamily apartment community located in Austin, Texas, from Berkshire Mortgage Finance Limited Partnership (the Seller ), an affiliate of the Company. The acquisition was approved by the audit committee of the Company's Board of Directors (the Board ), which is composed solely of directors who are independent under applicable rules and regulations of the Securities and Exchange Commission (the SEC ) and the American Stock Exchange. The Seller acquired the property through foreclosure on February 2, 2004. The purchase price of \$5,250,000 was funded with available cash.

On March 31, 2004, the Operating Partnership, through its newly formed and wholly owned subsidiary BIR Bear Creek Limited Partnership, purchased Bear Creek Apartments ( Bear Creek ) from an unaffiliated third party. The purchase price of \$4,900,000 was funded with available cash. Bear Creek apartments is a 152-unit multifamily apartment community located in Dallas, Texas. Prior to the sale, the seller had acquired the property through foreclosure.

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### New Accounting Pronouncements

In January 2003, the FASB issued Financial Interpretation No. 46 Consolidation of Variable Interest Entities (FIN 46), as further revised in December 2003 (FIN 46R), which clarifies the application of Accounting Research Bulletin No. 51, Consolidated Financial Statements, to certain entities in which equity investors do not have a controlling interest or sufficient equity at risk for the entity to finance its activities without additional financial support. FIN 46 requires that if a business entity has a controlling financial interest in a variable interest entity, the financial statements must be included in the consolidated financial statements of the business entity. The adoption of FIN 46 for all interests in variable interest entities created after January 31, 2003 was effective immediately. For variable interest entities created before February 1, 2003, it was effective July 1, 2003. The Company adopted FIN 46R during the first quarter of 2004. The Company evaluated its investments in the six mortgage funds (the Mortgage Funds ), interests for which it previously offered (the Offering ) to exchange shares of its 9% Series A Cumulative Redeemable Preferred Stock (the Preferred Stock ), and its investment in the Multifamily Joint Venture and concluded that the investments did not meet the requirements for consolidation under FIN 46R.

In March 2004, the Emerging Issues Task Force ( EITF ) reached a final consensus regarding Issue 03-6, Participating Securities and the Two-Class Method under FAS 128. Issue 03-6 addresses a number of questions regarding the computation of earnings per share ( EPS ) by companies that have issued securities other than common stock that participate in dividends and earnings of the issuing entity. Such securities are contractually entitled to receive dividends when and if the entity declares dividends on common stock. Issue 03-6 also provides further guidance in applying the two-class method of calculating EPS once it is determined that a security is participating. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. Issue 03-6 is effective for the period ended June 30, 2004, and should be applied by restating prior period earnings per share. The Company has determined that this consensus has no impact on the Company's EPS calculations.

### Reclassifications

Certain prior period balances have been reclassified in order to conform to the current period presentation.

### Unaudited interim financial statements

The accompanying interim financial statements of the Company are unaudited; however, the financial statements have been prepared in accordance with the accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information and in conjunction with the rules and regulations of the SEC. Accordingly, certain disclosures accompanying annual financial statements prepared in accordance with GAAP are omitted. In the opinion of management, all adjustments (consisting solely of normal recurring matters) necessary for a fair presentation of the financial statements for the interim periods have been included. The results of operations for the interim periods are not necessarily indicative of the results to be obtained for other interim periods or for the full fiscal year. The interim financial statements and notes thereto should be read in conjunction with the Company's financial statements and notes thereto included in the Company's Form 10-K for the year ended December 31, 2003 and Forms 8-K/A filed on April 12, 2004 for the significant acquisition of Marina Mile, as well as the Form 8-K filed on April 14, 2004 for the acquisition of Laurel Woods and Bear Creek.

## 2. MULTIFAMILY APARTMENT COMMUNITIES

The Company allocates the acquisition cost of real estate to land, building, tenant relationships and acquired in-place leases based on an assessment of their fair value at the time of purchase. The value of in-place leases and tenant relationships are amortized to expense over the initial terms of the respective leases.

The results of operations of Laurel Woods and Bear Creek, both acquired in 2004, are included in the Company's September 30, 2004 consolidated Statement of Operations for the period subsequent to the purchase date. The purchase prices of Laurel Woods and Bear Creek were

## 2. MULTIFAMILY APARTMENT COMMUNITIES

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\$5,250,000 and \$4,900,260, respectively. The following condensed information provides the amount assigned to each major asset category of the respective properties on the acquisition dates, which are included on the Company's September 30, 2004 consolidated balance sheet:

|                                    | Laurel Woods | Bear Creek   |
|------------------------------------|--------------|--------------|
| Multifamily apartment communities  | \$ 5,151,566 | \$ 4,792,404 |
| Acquired in-place leases           | 75,620       | 61,706       |
| Tenant relationships               | 22,814       | 46,150       |
| Total recorded at acquisition date | \$ 5,250,000 | \$ 4,900,260 |

### 3. AVAILABLE-FOR-SALE SECURITIES

The following summarizes the Company's holdings of available-for-sale securities by major security type as of September 30, 2004 and December 31, 2003:

|                       | September 30, 2004 | December 31, 2003 |
|-----------------------|--------------------|-------------------|
| Cost                  | \$ 18,610,841      | \$ 18,502,643     |
| Total unrealized loss | --                 | (14,229)          |
| Aggregate fair value  | \$ 18,610,841      | \$ 18,488,414     |

### 4. INVESTMENT IN MORTGAGE FUNDS

The Company's investments in the Mortgage Funds consist of the following:

| Mortgage Fund                               | Nominal Ownership |
|---|-------------------|
| Krupp Government Income Trust I ("GIT")     | 30.76%            |
| Krupp Government Income Trust II ("GIT II") | 28.81%            |
| Krupp Income Partnership ("KIP")1           | 29.66%            |
| Krupp Income Partnership III ("KIP III")1   | 28.63%            |

The summarized balance sheets of the individually significant investment in each of the Mortgage Funds and the combined investment in Mortgage Funds as of September 30, 2004 and December 31, 2003 are as follows:

(1) KIP and KIP III liquidated on September 8, and September 29, 2004, respectively, thus the Company's nominal ownership is 0% on September 30, 2004.

|                           | September 30, 2004 |              |               |
|---------------------------|--------------------|--------------|---------------|
|                           | GIT II             | GIT          | Combined      |
| <b>ASSETS</b>             |                    |              |               |
| Mortgage investments      | \$ 43,727,267      | \$ 22,295    | \$ 43,749,562 |
| Cash and cash equivalents | 4,224,568          | 2,840,280    | 7,064,848     |
| Other assets              | 675,246            | 3,689        | 678,935       |
| Total assets              | \$ 48,627,081      | \$ 2,866,264 | \$ 51,493,345 |

### 4. INVESTMENT IN MORTGAGE FUNDS

## September 30, 2004

LIABILITIES AND SHAREHOLDERS'  
EQUITY

|   |               |              |               |
|---|---------------|--------------|---------------|
| Liabilities   | \$ 154,122    | \$ 148,950   | \$ 303,072    |
| Shareholders' equity  | 48,472,959    | 2,717,314    | 51,190,273    |
| Total liabilities and shareholders' equity                      | \$ 48,627,081 | \$ 2,866,264 | \$ 51,493,345 |
| Company's share of equity                                       | 13,965,059    | 835,846      | 14,800,905    |
| Basis differential (1)  | (1,773,813)   | --           | (1,773,813)   |
| Carrying value of the Company's investment<br>in Mortgage Funds | \$ 12,191,246 | \$ 835,846   | \$ 13,027,092 |

## December 31, 2003

|   | GIT II        | Total Other<br>Investments in<br>Mortgage Funds | Combined      |
|---|---------------|---|---------------|
| <b>ASSETS</b>   |               |   |               |
| Mortgage investments  | \$ 45,079,586 | \$ 38,687,776                                   | \$ 83,767,362 |
| Cash and cash equivalents                                       | 5,454,067     | 3,918,598                                       | 9,372,665     |
| Other assets  | 852,987       | 256,513   | 1,109,500     |
| Total assets  | \$ 51,386,640 | \$ 42,862,887                                   | \$ 94,249,527 |
| <b>LIABILITIES AND STOCKHOLDERS'<br/>EQUITY</b>                 |               |   |               |
| Liabilities   | \$ 183,380    | \$ 677,376                                      | \$ 860,756    |
| Shareholders' equity  | 51,203,260    | 42,185,511                                      | 93,388,771    |
| Total liabilities and shareholders' equity                      | \$ 51,386,640 | \$ 42,862,887                                   | \$ 94,249,527 |
| Company's share of equity                                       | \$ 14,751,659 | \$ 12,488,725                                   | \$ 27,240,384 |
| Basis differential (1)  | (2,012,971)   | (1,180,505)                                     | (3,193,476)   |
| Carrying value of the Company's investment<br>in Mortgage Funds | \$ 12,738,688 | \$ 11,308,220                                   | \$ 24,046,908 |

(1) This amount represents the difference between the Company's investment in the Mortgage Funds (fair value) and its underlying equity in the net assets of the Mortgage Funds (book value). Basis differentials occurred upon the acquisition of the Mortgage Fund Interests for which the acquisition price was less than the underlying equity in the net assets of the Mortgage Funds.

The summarized statements of operations of each individually significant investment in the Mortgage Funds and the combined investment in the Mortgage Funds for the three and nine months ended September 30, 2004 are as follows:

**Three months ended September 30, 2004**

|                                    | <b>GIT II</b> | <b>GIT</b> | <b>Total Other<br/>Investments<br/>in Mortgage<br/>Funds</b> | <b>Combined</b> |
|------------------------------------|---------------|------------|--|-----------------|
| Revenues                           | \$ 933,844    | \$ 652,403 | \$ 70,574  | \$ 1,656,821    |
| Expenses                           | 310,547       | 415,048    | 12,096   | 737,691         |
| Net income                         | \$ 623,297    | \$ 237,355 | \$ 58,478  | \$ 919,130      |
| Company's share of net income      | \$ 179,572    | \$ 73,011  | \$ 16,724  | \$ 269,307      |
| Amortization of basis differential | 83,608        | 852,763    | 354,166  | 1,290,537       |
| Equity in income of Mortgage Funds | \$ 263,180    | \$ 925,774 | \$ 370,890   | \$ 1,559,844    |

**Nine months ended September 30, 2004**

|                                    | <b>GIT II</b> | <b>GIT</b>   | <b>Total Other<br/>Investments<br/>in Mortgage<br/>Funds</b> | <b>Combined</b> |
|------------------------------------|---------------|--------------|--|-----------------|
| Revenues                           | \$ 2,597,446  | \$ 1,028,188 | \$ 2,072,485   | \$ 5,698,119    |
| Expenses                           | 958,668       | 266,869      | 724,595  | 1,950,132       |
| Net income                         | \$ 1,638,778  | \$ 761,319   | \$ 1,347,890   | \$ 3,747,987    |
| Company's share of net income      | \$ 472,132    | \$ 234,182   | \$ 392,207   | \$ 1,098,521    |
| Amortization of basis differential | 250,824       | 879,199      | 596,170  | 1,726,193       |
| Equity in income of Mortgage Funds | \$ 722,956    | \$ 1,113,381 | \$ 988,377   | \$ 2,824,714    |

**Three months ended September 30, 2003**

|  | <b>GIT II</b> | <b>GIT</b> | <b>Total Other<br/>Investments<br/>in Mortgage<br/>Funds</b> | <b>Combined</b> |
|--|---------------|------------|--|-----------------|
|--|---------------|------------|--|-----------------|

**Three months ended September 30, 2003**

|                                    |              |            |              |              |
|------------------------------------|--------------|------------|--------------|--------------|
| Revenues                           | \$ 4,396,052 | \$ 374,497 | \$ 2,039,603 | \$ 6,810,152 |
| Expenses                           | 687,128      | 189,849    | 581,969      | 1,458,946    |
| Net income                         | \$ 3,708,924 | \$ 184,648 | \$ 1,457,634 | \$ 5,351,206 |
| Company's share of net income      | \$ 1,068,541 | \$ 56,798  | \$ 407,653   | \$ 1,532,992 |
| Amortization of basis differential | 1,019,028    | 590,671    | 10,325       | 1,620,024    |
| Equity in income of Mortgage Funds | \$ 2,087,569 | \$ 647,469 | \$ 417,978   | \$ 3,153,016 |

**Nine months ended September 30, 2003**

|                                       | <b>GIT II</b> | <b>GIT</b>   | <b>Total Other<br/>Investments<br/>in Mortgage<br/>Funds</b> | <b>Combined</b> |
|---------------------------------------|---------------|--------------|--|-----------------|
| Revenues                              | \$ 9,951,024  | \$ 6,224,592 | \$ 5,312,667   | \$ 21,488,283   |
| Expenses                              | 1,937,250     | 787,575      | 1,556,517  | 4,281,342       |
| Net income                            | 8,013,774     | 5,437,017    | 3,756,150  | 17,206,941      |
| Net income prior to exchange          | (3,289,729)   | (2,147,316)  | (1,269,095)  | (6,706,140)     |
| Net income attributable to investment | \$ 4,724,045  | \$ 3,289,701 | \$ 2,487,055   | \$ 10,500,801   |
| Company's share of net income         | \$ 1,360,997  | \$ 1,011,912 | \$ 701,364   | \$ 3,074,273    |
| Amortization of basis differential    | 1,166,414     | 710,940      | (68,825)   | 1,808,529       |
| Equity in income of Mortgage Funds    | \$ 2,527,411  | \$ 1,722,852 | \$ 632,539   | \$ 4,882,802    |

The Company acquired its interest in the Mortgage Funds on April 4 and April 18, 2003. The company recognized its proportional share of the Mortgage Funds net income beginning on those dates.

The Company received liquidating distributions of \$549,439 and \$731,168 from KIP and KIP III, respectively, during September 2004.

The Company expects to receive liquidation proceeds from GIT in the fourth quarter of 2004.

**5. INVESTMENT IN MULTIFAMILY JOINT VENTURE**

Effective May 1, 2004, the Company consummated the Multifamily Joint Venture with the JV Partner whereby each of the parties to the agreement will participate, on a pro rata basis, in the economic benefits of the ownership of Marina Mile. Under the terms of the limited liability company agreement governing the Multifamily Joint Venture, the JV Partner contributed, in cash, 65% of the total Multifamily Joint Venture equity in exchange for a 65% interest in the L.L.C. The Operating Partnership contributed its interest in Marina Mile, L.L.C., the fee simple owner of the property, in exchange for a 35% interest in the L.L.C. and a cash distribution of approximately \$3,594,693 net of \$387,236 of additional capital invested by the Operating Partnership. Both parties will receive proportional distributions of available cash up to the effective

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10% Preferred Return. After payment of the Preferred Return and the return of each party's capital contribution, the Operating Partnership will be entitled to additional distributions equal to approximately 30% of the distributions otherwise payable to the JV Partner. The Operating Partnership is the managing member for the Multifamily Joint Venture. The Company evaluated its investment in the Multifamily Joint Venture and concluded that the investment did not fall under the requirements of FIN 46R, therefore the Company accounted for the investment under Statement of Position 78-9, Accounting for Investments in Real Estate ( SOP 78-9 ) as an equity method investment.

The summarized balance sheet of the Multifamily Joint Venture is as follows:

|  | <b>September 30, 2004</b> |
|--|---------------------------|
| <b>ASSETS</b>  |                           |
| Multifamily apartment communities, net                                     | \$ 23,229,839             |
| Cash and cash equivalents  | 117,241                   |
| Other assets   | 1,292,289                 |
|  | <hr/>                     |
| Total Assets   | \$ 24,639,369             |
|  | <hr/>                     |
| <b>LIABILITIES AND OWNERS' EQUITY</b>                                      |                           |
| Mortgage notes payable   | \$ 17,400,000             |
| Other liabilities  | 648,378                   |
| Owners' equity   | 6,590,991                 |
|  | <hr/>                     |
| Total liabilities and owners' equity                                       | \$ 24,639,369             |
|  | <hr/>                     |
| Company's share of equity  | \$ 2,306,847              |
|  | <hr/>                     |
| Carrying value of the Company's investment<br>in Multifamily Joint Venture | \$ 2,306,847              |
|  | <hr/>                     |

The summarized statement of operations of the Multifamily Joint Venture for the three months ended September 30, 2004 is as follows:

|   | <b>Three Months Ended<br/>September 30, 2004</b> |
|---|--|
| Revenues                                    | \$ 804,615                                       |
| Expenses                                    | 970,257  |
|   | <hr/>  |
| Net loss                                    | \$ (165,642)                                     |
|   | <hr/>  |
| Equity in loss of Multifamily Joint Venture | \$ (58,105)                                      |
|   | <hr/>  |
|   | <b>Nine Months Ended<br/>September 30, 2004</b>  |
|   | <hr/>  |
| Revenues                                    | \$ 2,078,591                                     |
| Expenses                                    | 2,745,391  |
|   | <hr/>  |
| Net loss                                    | (666,800)  |



**Nine Months Ended  
September 30, 2004**

Net loss included in consolidated results

207,805

Net loss attributable to investment

\$ (458,995)

Equity in loss of Multifamily Joint Venture

\$ (160,778)

To the extent that the Company contributes assets to a joint venture, the Company's investment in the joint venture is recorded at the Company's cost basis in the assets which were contributed to the joint venture. To the extent that the Company's cost basis is different than the basis reflected at the joint venture level, the basis difference is amortized over the life of the related asset and included in the Company's share of equity in net income of joint venture. In accordance with the provisions of SOP 78-9, the Company recognizes gains on the contribution of real estate to joint ventures, relating solely to the outside partner's interest, to the extent the economic substance of the transaction is a sale.

As a result of the Multifamily Joint Venture, Marina Mile, as a multifamily apartment community, is excluded in the consolidated balance sheet and the results of operations after May 1, 2004 is included in the caption, Equity in loss of Multifamily Joint Venture. The Company's interest in the Multifamily Joint Venture is included on the consolidated balance sheet as Investment in Multifamily Joint Venture.

## 6. MORTGAGE NOTES PAYABLE

On August 16, 2004, the Company secured a \$3,320,000 first mortgage on Laurel Woods Apartments in Houston, Texas. Under the terms of the mortgage, the mortgage bears interest at a variable rate of the Reference Bill plus 2.20%, which was 3.73% at September 30, 2004, and matures on September 1, 2011.

## 7. DECLARATION OF DIVIDEND AND DISTRIBUTIONS

On May 11, 2004, the Board authorized the general partner of the Operating Partnership to distribute two quarterly distributions of \$250,000 each from its operating cash flows to common general and common limited partners, payable on May 15, 2004 and August 15, 2004. On the same day, the Board also declared a common dividend of \$.004656 per share on the Company's Class B common stock payable concurrently with the Operating Partnership distributions.

On August 19, 2004, the Company's Board of Directors (the Board) authorized the general partner of the Operating Partnership to distribute two additional quarterly distributions of \$250,000 each from its operating cash flows to common general and common limited partners, payable on November 15, 2004 and February 15, 2005. On the same day, the Board also declared a common dividend of \$0.004656 per share on the Company's Class B common stock payable concurrently with the Operating Partnership distributions.

The Company's policy to provide for distributions is based on available cash and Board approval.

## 8. COMMITMENTS AND CONTINGENCIES

The Company is party to certain legal actions arising in the ordinary course of its business, such as those related to tenant issues. All such proceedings taken together are not expected to have a material adverse effect on the Company.

On September 8, 2004, the Company locked interest rates on \$20,962,500 of first mortgage debt to be collateralized by Bridgewater on the Lake and Trellis at Lee's Mills Apartments, which are to-be-acquired properties currently under purchase and sale agreements. Under the terms of the rate lock agreement, the Company was required to make a good faith deposit equal to three percent of the committed loan amounts, or \$628,875. The Company closed on the financings on November 3, 2004, concurrent with the acquisition of the properties.

On September 22, 2004, the Company locked the interest rate on \$42,800,000 of first mortgage debt to refinance the current first mortgage debt on Dorsey's Forge and Hannibal Grove Apartments. The terms of the debt commitments include fixed interest rates of 4.86%, a maturity date of November 1, 2013 and an interest only option for the first two years with amortization based on a 360 month payment term beginning in year three. Under the terms of the rate lock agreement, the Company was required to make a good faith deposit equal to two percent of the committed loan amount, or \$856,000. The Company closed on these refinancings on November 1, 2004.

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On September 28, 2004, the Company locked the interest rate on \$29,520,000 of first mortgage debt to refinance the current first mortgage debt on Century Apartments. The terms of the debt commitment include a fixed interest rate of 4.87% and a maturity date of November 1, 2013 and an interest only option for the first two years with amortization based on a 360 month payment term beginning in year three. Under the terms of the rate lock agreement, the Company was required to make a good faith deposit equal to two percent of the committed loan amounts, or \$590,400. The Company closed on these refinancings on November 1, 2004.

### 9. MINORITY INTERESTS

#### Minority Interest in Operating Partnership

In accordance with the Emerging Issues Task Force Issue (EITF) No. 94-2, Treatment of Minority Interest in Certain Real Estate Investment Trusts, KRF Company and affiliates' common limited partnership interest in the Operating Partnership are being reflected as Minority Interest in Operating Partnership in the financial statements of the Company. Upon completion of the Offering on April 4, 2003 and April 18, 2003, the net equity to the common and general partner interests in the Operating Partnership was less than zero after an allocation to the Company and affiliates' preferred interest in the Operating Partnership. Further, KRF Company and affiliates have no obligation to fund such deficit. Accordingly, for financial reporting purposes, KRF Company and affiliates' minority interest in the Operating Partnership has been reflected as zero with common stockholders' equity being reduced for the deficit amount.

In accordance with the guidance in EITF No. 95-7, Implementation Issues Related to the Treatment of Minority Interests in Certain Real Estate Investment Trusts, earnings of the Operating Partnership are first being allocated to the preferred interests held by the Company. The remainder of earnings, if any, are allocated to the Company's general partner and KRF Company and affiliates' common limited partnership interests in accordance with their relative ownership percentages. The excess of the allocation of income to KRF Company and affiliates over cash distributed to them will be credited directly to the Company's equity (with a corresponding debit to minority interest) until the minority interest deficit that existed upon the completion of the Offering is eliminated. Distributions to the minority holders in excess of their investment basis are recorded in the Company's statement of operations as Minority Interest in the Operating Partnership.

The Company's results of operations for the nine months ended September 30, 2004 is a net loss of \$1,898,170. This net loss, combined with the preferred dividend distribution, results in a loss available for common equity. Since there is no positive basis in the Operating Partnership, there is no allocation of the loss to the minority common interest in the Operating Partnership at September 30, 2004 except to the extent distributions were paid or accrued.

The following table sets forth a summary of the items affecting the minority interest in the Operating Partnership for the nine months ended September 30, 2004:

|   | <b>Minority<br/>Common<br/>Interest in<br/>Operating<br/>Partnership</b> | <b>Company's<br/>Interest in<br/>Operating<br/>Partnership</b> | <b>Total<br/>Common<br/>Owners' Deficit</b> |
|---|--|--|---|
| Balance at December 31, 2003                              | \$ (23,693,916)  | \$ 1,254,634   | \$ (22,439,282)                             |
| Distributions to common interest in Operating Partnership | (732,075)  | (17,925)   | (750,000)                                   |
| Minority common interest in Operating Partnership         | (6,043,751)  | (147,982)  | (6,191,733)                                 |
| <b>Balance at September 30, 2004 (1)</b>                  | <b>\$ (30,469,742)</b>   | <b>\$ 1,088,727</b>  | <b>\$ (29,381,015)</b>                      |

(1) Minority common interest in Operating Partnership is carried at zero on the balance sheet due to the minority interest having no obligation to fund losses/deficits.

As of September 30, 2004, the minority common interest in the Operating Partnership consisted of 5,242,223 Operating Partnership units held by parties other than the Company.

**10. RELATED PARTY TRANSACTIONS**

During the nine months ended September 30, 2004 and 2003, the Company paid acquisition fees to its advisor on the following acquisitions:

| <b>Acquisition</b> | <b>2004</b> |                | <b>2003</b> |                |
|--------------------|-------------|----------------|-------------|----------------|
| Laurel Woods       | \$          | 52,500         |             | --             |
| Bear Creek         |             | 49,000         |             | --             |
| Windward Lakes     |             | --             | \$          | 190,000        |
| Gables             |             | --             |             | 69,250         |
| <b>Total</b>       | <b>\$</b>   | <b>101,500</b> | <b>\$</b>   | <b>259,250</b> |

The respective acquisition fees have been paid pursuant to the advisory services agreement, and have been capitalized and included in Multifamily apartment communities in the accompanying Consolidated Balance Sheet, except for Windward Lakes, which was expensed. The acquisitions of Laurel Woods and Bear Creek occurred in the first quarter of 2004. There were no acquisitions in the quarter ended September 30, 2004. Further, the Multifamily Joint Venture paid the advisor an acquisition fee of \$230,000 upon the consummation of the Joint Venture on May 1, 2004.

Amounts accrued or paid to the Company's affiliates for the three and nine months ended September 30, 2004 and 2003 are as follows:

|                          | <b>Three months ended<br/>September 30,</b> |                     | <b>Nine months ended<br/>September 30,</b> |                     |
|--------------------------|---|---------------------|--|---------------------|
|                          | <b>2004</b>                                 | <b>2003</b>         | <b>2004</b>                                | <b>2003</b>         |
| Property management fees | \$ 376,321                                  | \$ 288,788          | \$ 1,110,600                               | \$ 942,092          |
| Expense reimbursements   | 56,488                                      | 91,586              | 175,559                                    | 154,088             |
| Salary reimbursements    | 1,057,697                                   | 732,068             | 3,074,056                                  | 1,979,203           |
| Asset management fees    | 271,077                                     | 175,908             | 812,152                                    | 440,898             |
| <b>Total</b>             | <b>\$ 1,761,583</b>                         | <b>\$ 1,288,350</b> | <b>\$ 5,172,367</b>                        | <b>\$ 3,516,281</b> |

Expense reimbursements due to affiliates of \$1,927,423 and \$1,706,171 are included in Due to affiliates at September 30, 2004 and December 31, 2003, respectively, in the accompanying Consolidated Balance Sheets.

Expense reimbursements due from affiliates of \$1,060,133 and \$741,280 are included in Due to affiliates at September 30, 2004 and December 31, 2003, respectively, in the accompanying Consolidated Balance Sheets.

Additional amounts due to affiliates of \$353,864 at September 30, 2004 and December 31, 2003, respectively, in the accompanying Consolidated Balance Sheets represent accrued expenses related to Windward Lakes Apartments, development fees and shared services.

The Company purchased Laurel Woods, located in Austin, Texas, from an affiliate of the Company for \$5,250,000 funded with available cash. The acquisition was approved by the audit committee of the Company's Board of Directors, which is composed solely of directors who are independent under applicable rules and regulations of the Securities and Exchange Commission and American Stock Exchange.

The Company has an investment in the Mortgage Funds, which are affiliates of the Company, which it does not control. The investment, which is recorded on the equity method, is included in the Consolidated Balance Sheet, and the related equity in income of Mortgage Funds in the Consolidated Statements of Operations is included as a component of net income.

**11. SUBSEQUENT EVENTS**

On November 1, 2004, the Company completed the refinancings of its Dorsey's Forge, Hannibal Grove and Century apartments. The new first mortgage debt is as follows:

| <b>Property</b> | <b>Mortgage Amount</b> | <b>Interest Rate</b> | <b>Maturity Date</b> |
|-----------------|------------------------|----------------------|----------------------|
| Dorsey's Forge  | \$ 16,200,000          | 4.86%                | November 1, 2013     |
| Hannibal Grove  | \$ 26,600,000          | 4.86%                | November 1, 2013     |
| Century         | \$ 29,250,000          | 4.87%                | November 1, 2013     |

On November 3 and 4, 2004, the Operating Partnership, through its newly formed and wholly owned subsidiaries, BIR Bridgewater, L.L.C., BIR Trellis, L.L.C., BIR Arboretum, L.L.C. and BIR Silver Hill, L.L.C., consummated the acquisition of the following multifamily apartment communities:

| <b>Property</b>          | <b>Units</b> | <b>Location</b>  | <b>Purchase Price</b> |
|--------------------------|--------------|------------------|-----------------------|
| Bridgewater on the Lake  | 216          | Hampton, VA      | \$ 18,950,000         |
| Trellis at Lee's Mill    | 176          | Newport News, VA | \$ 8,825,000          |
| Arboretum Place          | 184          | Newport News, VA | \$ 10,575,000         |
| Silver Hill at Arboretum | 153          | Newport News, VA | \$ 4,350,000          |

The total purchase price was paid through a combination of cash and assumed debt.

In addition, on November 4, 2004, the Company acquired the vacant land adjacent to Arboretum Place for \$1,500,000.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS OF BERKSHIRE INCOME REALTY, INC. (FORMERLY BERKSHIRE INCOME REALTY PREDECESSOR GROUP)**

You should read the following discussion in conjunction with the Company's financial statements and their related notes and other financial information included in this report. For further information please refer to the Company's financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2003 and Forms 8-K/A filed on April 12, 2004 for the significant acquisition of Marina Mile, as well as the Form 8-K filed on April 14, 2004 for the acquisitions of Laurel Woods and Bear Creek.

**Overview**

The Company is engaged primarily in the ownership, acquisition, operation and rehabilitation of multifamily apartment communities in the Baltimore/Washington D.C., Southeast and Southwest areas of the United States. We conduct substantially all of our business and own, either directly or through subsidiaries, substantially all of our assets through the Operating Partnership. The Company's wholly owned subsidiary, BIR GP, L.L.C., a Delaware limited liability company, is the sole general partner of the Operating Partnership. As of November 12, 2004, the Company is the owner of 100% of the preferred limited partner units of the Operating Partnership, whose terms mirror the terms of the Preferred Stock and, through BIR GP, L.L.C., owns 100% of the general partner interest of the Operating Partnership, which represents approximately 2.39% of the common economic interest of the Operating Partnership.

Our general and limited partner interests in the Operating Partnership entitle us to share in cash distributions from, and in the profits and losses of, the Operating Partnership in proportion to our percentage interest therein. The other partners of the Operating Partnership are affiliates who contributed their direct or indirect interests in certain properties to the Operating Partnership in exchange for common units of limited partnership interest in the Operating Partnership.

The three month period ended September 30, 2004 was highlighted by the signing of eight purchase and sale agreements to acquire multifamily apartment communities in three states. Four of the communities are located in the Norfolk area of Virginia, two are located outside of Chicago, Illinois and two are located in Maryland. All of these acquisitions are expected to close during the fourth quarter of 2004. These eight acquisitions will allow the Company to employ approximately \$23,000,000 of its available capital.

Further, the Company and its subsidiaries have locked in fixed interest rates on approximately \$111,000,000 of first mortgage debt at an average interest rate of 4.95% during the nine months ended September 30, 2004. We believe that the interest rate levels we have achieved on first mortgage debt this year will pay substantial dividends in the future as the overall economy recovers and rental rates return to their historical rates.

**11. SUBSEQUENT EVENTS**

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To date, earnings from the Company's investments in the Mortgage Funds have been a substantial component of the Company's overall earnings. As expected, these investments have been liquidating at a steady rate and the Company expects that their impact on earnings will diminish dramatically during the next year. The Company expects that earnings from multifamily apartment community investments will continue to grow, both as a result of growth in the existing portfolio and as a result of acquisitions, including those acquisitions discussed herein. The Company expects the growth in real estate earnings to substantially make up for the drop in earnings from the investments in the Mortgage Funds and does not foresee the Company having any problems making distributions on its Series A 9% Cumulative Redeemable Preferred Stock.

### General

The Company detailed a number of significant trends and specific factors affecting the real estate industry in general and the Company's business in particular in Management's Discussion and Analysis of Financial Condition and Results of Operations Item 7 of our Annual Report on Form 10-K for the year ending December 31, 2003. The Company believes those trends and factors continue to be relevant to the Company's performance and financial condition.

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### Forward Looking Statements

Certain statements contained in this report, including information with respect to our future business plans, constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements, subject to a number of risks and uncertainties that could cause actual results to differ significantly from those described in this report. These forward-looking statements include statements regarding, among other things, our business strategy and operations, future expansion plans, future prospects, financial position, anticipated revenues or losses and projected costs and objectives of management. Without limiting the foregoing, the words may, will, should, could, expects, plans, anticipates, believes, estimates, potential, or continue or the negative of such terms and other comparable terminology are intended to identify forward-looking statements. There are a number of important factors that could cause our results to differ materially from those indicated by such forward-looking statements. These factors include, but are not limited to, changes in economic conditions generally and the real estate and bond markets specifically, legislative/regulatory changes including changes to laws governing the taxation of real estate investment trusts (REITs), availability of capital, interest rates and interest rate spreads, changes in GAAP and policies and guidelines applicable to REITs, those set forth in the Risk Factors section of the Company's Form 10-K for the year ended December 31, 2003 and other risks and uncertainties as may be detailed from time to time in our public announcements and SEC filings. The risks listed herein are not exhaustive. Other sections of this report may include additional factors that could adversely affect our business and financial performance. Moreover, we operate in a competitive and rapidly changing environment. New risk factors emerge from time to time and it is not possible for management to predict all such risk factors, nor can it assess the impact of all such risk factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Given these risks and uncertainties, investors should not place undue reliance on forward-looking statements as a prediction of actual results.

### New Accounting Pronouncements

In January 2003, the FASB issued Financial Interpretation No. 46 Consolidation of Variable Interest Entities (FIN 46), as further revised in December 2003 (FIN 46R), which clarifies the application of Accounting Research Bulletin No. 51, Consolidated Financial Statements, to certain entities in which equity investors do not have a controlling interest or sufficient equity at risk for the entity to finance its activities without additional financial support. FIN 46 requires that if a business entity has a controlling financial interest in a variable interest entity, the financial statements must be included in the consolidated financial statements of the business entity. The adoption of FIN 46 for all interests in variable interest entities created after January 31, 2003 was effective immediately. For variable interest entities created before February 1, 2003, it was effective July 1, 2003. The Company adopted FIN 46R during the first quarter of 2004. The Company evaluated its investments in the Mortgage Funds and its investment in the Multifamily Joint Venture and concluded that the investments did not meet the requirements for consolidation under FIN 46R.

In March 2004, the Emerging Issues Task Force (EITF) reached a final consensus regarding Issue 03-6, Participating Securities and the Two-Class Method under FAS 128. Issue 03-6 addresses a number of questions regarding the computation of earnings per share (EPS) by companies that have issued securities other than common stock that participate in dividends and earnings of the issuing entity. Such securities are contractually entitled to receive dividends when and if the entity declares dividends on common stock. Issue 03-6 also provides further guidance in applying the two-class method of calculating EPS once it is determined that a security is participating. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. Issue 03-6 is effective for the period ended June 30, 2004, and should be applied by restating prior period earnings per share. The Company has determined that this consensus has no impact on the Company's EPS calculations.

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### Liquidity and Capital Resources

## 11. SUBSEQUENT EVENTS

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### Cash and Cash Flows

As of September 30, 2004 and December 31, 2003, the Company had \$53,514,669 and \$60,634,361 of cash and cash equivalents and short term investments, respectively.

The Company's principal liquidity demands are expected to be distributions to its preferred shareholders, capital improvements, rehabilitation projects, repairs and maintenance for the properties, acquisition of additional properties and debt repayments.

The Company intends to meet its short-term liquidity requirements through net cash flows provided by operating activities and cash distributions from its investments, including the Company's investments in the Mortgage Funds and its investment in the Multifamily Joint Venture. The Company considers its ability to generate cash to be adequate to meet all operating requirements and make distributions to its stockholders in accordance with the provisions of the Internal Revenue Code of 1986, as amended, applicable to REITs.

The Company intends to meet its long-term liquidity requirements through distributions of principal from its investments in the Mortgage Funds and property debt refinancing. The Company may continue to expand its purchasing power through the use of joint venture relationships with other companies. Management has not concluded that the sale of any properties in the Company's portfolio would be beneficial strategically or otherwise, although we cannot be certain that no such dispositions will actually occur.

On September 8, 2004, the Company locked interest rates on \$20,962,500 of first mortgage debt to be secured by Bridgewater on the Lake and Trellis at Lee's Mills apartments, which are to-be-acquired properties currently under purchase and sale agreements. Under the terms of the rate lock agreement, the Company was required to make a good faith deposit equal to three percent of the committed loan amounts, or \$628,875. The Company closed on the financings on November 3, 2004, concurrent with the acquisition of the properties.

On September 22, 2004 the Company locked interest rates on \$42,800,000 of first mortgage debt to refinance the current first mortgage debt on Dorsey's Forge and Hannibal Grove Apartments. The terms of the debt commitment include a fixed interest rate of 4.86%, a maturity date of November 1, 2013 and an interest only option for the first two years with amortization based on a 360 month payment term beginning in year three. After payment of the current first mortgages and prepayment premiums associated therewith, the Company expects to realize approximately \$16,040,000 before costs associated with the refinancings.

On September 28, 2004 the Company locked interest rates on \$29,520,000 of first mortgage debt to refinance the current first mortgage debt on Century Apartments. The terms of the debt commitment include a fixed interest rate of 4.87%, a maturity date of November 1, 2013 and an interest only option for the first two years with amortization based on a 360 month payment term beginning in year three. After payment of the current first mortgages and prepayment premiums associated therewith, the Company expects to realize approximately \$6,549,000 before costs associated with the refinancings.

The Company plans to obtain a mortgage on its Bear Creek property in the next quarter, which will provide the Company with additional funds.

### Capital Expenditures

The Company incurred \$2,123,307 and \$2,819,741 in recurring capital expenditures during the nine months ended September 30, 2004 and 2003, respectively. Recurring capital expenditures typically include items such as appliances, carpeting, flooring, HVAC equipment, kitchen and bath cabinets, site improvements and various exterior building improvements.

The Company incurred \$5,381,829 and \$1,115,947 in renovation related capital expenditures during the nine months ended September 30, 2004 and 2003, respectively. Renovation related capital expenditures generally include capital expenditures of a significant non-recurring nature, where the Company expects to see a financial return on the expenditure or where the Company believes the expenditure preserves the status of a property within its sub-market.

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In April 2003, the Company began a significant renovation project at its Seasons of Laurel property. The renovation involved substantial upgrades to the kitchens and bathrooms in all of the property's 1,088 apartment units and was originally expected to cost approximately \$8,100,000, or \$7,444 per apartment unit. In 2004, the original contractor sent notification to the Company of its desire to renegotiate the contract. As a result of that notification, the Company sought new bids from several contractors and ultimately dismissed the original contractor and awarded the contract to a new company based on the new bids. The current cost estimate is now approximately \$8,450,000, an increase of approximately 5% over the original cost estimate. As of September 30, 2004, the project is approximately 50% complete, approximately \$3,740,000 has been spent to date and the project is on track to meet the adjusted cost estimate. During 2004, the Company also completed construction on the new fitness center at Seasons.

In January 2004, the Company authorized the renovation of 251 apartment units at its Hannibal Grove property to provide for in-unit washer and dryer hookups. The total cost of the project is expected to be approximately \$1,455,000, or \$5,775 per apartment unit, and is expected to be

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completed by August 2005. As of September 30, 2004, the project is approximately 20% complete, approximately \$286,000 has been spent to date and the project is on track to meet the original cost estimate. The Company believes the renovations are necessary to maintain the property's competitiveness in its sub-market and that the property will also achieve significant growth in rental rates as a result of the renovations.

In addition to the washer and dryer program, the Company renovated 15 apartment units at its Hannibal Grove property at a cost of approximately \$200,000. These units were renovated as part of a test program to determine if the market would be willing to pay a premium for renovated apartment units. Management is currently evaluating the results of the test program and is expected to make a final recommendation on a full renovation project before the end of the year. If management recommends moving forward with a full renovation project, the Company expects to accept that recommendation. In July 2004, the Company finished replacing all of the windows at Hannibal Grove at a total cost of \$714,815.

In April 2004 the Company approved changes to the scope of the clubhouse renovation plan implemented at its Windward Lakes property, which it acquired in 2003. The changes in the original scope of the plan and final bidding on items within the original scope resulted in an increase of the overall project cost from approximately \$365,000 to approximately \$692,000. The renovations were completed, on budget, in October 2004.

In July 2004, the Company completed replacing all windows at its Dorsey's Forge property at a total cost of \$213,280.

The Company is currently evaluating renovation strategies at other properties in its portfolio, including the renovation of test units at various properties to test anticipated market acceptance and financial assumptions. As of September 30, 2004, the Company has not made any material commitments with respect to these additional projects. However, if after the appropriate level of evaluation is completed the Company believes there are sufficient economic benefits to implementing additional renovation programs it is prepared to do so.

### Acquisitions

On January 28, 2004, the Operating Partnership, through its newly formed and wholly owned subsidiary Marina Mile L.L.C., purchased Pond Apple Creek Apartments (subsequently renamed The Berkshires at Marina Mile (Marina Mile)), a 306-unit multifamily apartment community located in Fort Lauderdale, Florida, from Pond Apple Creek Associates Limited Partnership. The seller was an unaffiliated third party. The purchase and sale agreement, as amended, was agreed upon through arms length negotiations and provided for the purchase price of \$23,000,000 to be paid in cash. Effective May 1, 2004, the Company consummated a joint venture relationship (Multifamily Joint Venture) with an unrelated third party (the JV Partner) whereby each of the parties to the agreement will participate, on a pro rata basis, in the economic benefits of Marina Mile. Under the terms of the limited liability company agreement governing the Multifamily Joint Venture, the JV Partner contributed, in cash, 65% of the total joint venture equity in exchange for a 65% interest in the newly formed entity, JV Marina Mile, L.L.C. (the L.L.C.). The Operating Partnership contributed its interest in Marina Mile, L.L.C., the fee simple owner of the property, in exchange for a 35% interest in the L.L.C. and a cash distribution of approximately \$3,594,693 net of \$387,236 of additional capital invested by the Operating Partnership. Both parties will receive proportional distributions of available cash up to an effective 10% internal rate of return on each party's capital (the Preferred Return). After payment of the Preferred Return and the return of each party's capital contribution, the Operating Partnership will be entitled to additional distributions equal to approximately 30% of the distributions otherwise payable to the JV Partner. The Operating Partnership is the managing member for the L.L.C.

On March 30, 2004, the Operating Partnership, through its newly formed and wholly owned subsidiary BIR Laurel Woods Limited Partnership, purchased Laurel Woods Apartments (Laurel Woods), a 150-unit multifamily apartment community located in Austin, Texas, from Berkshire Mortgage Finance Limited Partnership (the Seller), an affiliate of the Company. The acquisition was approved by the audit committee of the Company's Board of Directors (the Board), which is composed solely of directors who are independent under applicable rules and regulations of the Securities Exchange Commission and the American Stock Exchange. The Seller acquired the property through foreclosure on February 2, 2004. The purchase price of \$5,250,000 was funded with available cash.

On March 31, 2004, the Operating Partnership, through its newly formed and wholly owned subsidiary BIR Bear Creek Limited Partnership, purchased Bear Creek Apartments (Bear Creek) from an unaffiliated third party. The purchase price of \$4,900,000 was funded with available cash. Bear Creek is a 152-unit multifamily apartment community located in Dallas, Texas. Prior to the sale, the seller had acquired the property through foreclosure.

### Declaration of Dividends and Distributions

On May 11, 2004, the Board authorized the general partner of the Operating Partnership to distribute two quarterly distributions of \$250,000 each from its operating cash flows to common general and common limited partners, payable on May 15, 2004 and August 15, 2004. On the same day, the Board also declared a common dividend of \$.004656 per share on the Company's Class B common stock payable concurrently with the Operating Partnership distributions. The Company's policy to provide for distributions is based on available cash and Board approval.

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On August 19, 2004, the Board authorized the general partner of the Operating Partnership to distribute two additional quarterly distributions of \$250,000 each from its operating cash flows to common general and common limited partners, payable on November 15, 2004 and February 15, 2005. On the same day, the Board also declared a common dividend of \$0.004656 per share on the Company's Class B common stock payable concurrently with the Operating Partnership distributions.

Results of Operations and Financial Condition

As a result of changes in the composition of the Company's current portfolio of properties (the Total Property Portfolio), the financial statements show significant changes in revenue and expenses from period to period. The Company does not believe that its period-to-period financial data is comparable. Therefore, the comparison of operating results for the quarters ended September 30, 2004 and 2003 show changes attributable to the properties that were owned by the Company throughout each period compared (the Same Property Portfolio). Following the comparison of the operating results for the quarters ended September 30, 2004 and 2003 based on Same Property Portfolio results is a comparison of selected changes in results that the Company has identified that warrant disclosure on a Total Property Portfolio basis.

The entities comprising the Berkshire Income Realty Predecessor Group are deemed to be our predecessors for accounting purposes.

*Comparison of the three months ended September 30, 2004 to the three months ended September 30, 2003.*

The table below reflects selected operating information for the Same Property Portfolio and the Total Property Portfolio. The Same Property Portfolio consists of the 6 properties acquired or placed in service on or prior to January 1, 2003 and owned through September 30, 2004. The Total Property Portfolio includes the effect of the additional multifamily apartment communities acquired after January 1, 2003.

|                          | Same Property Portfolio<br>Three months September 30, |              |                        |             | Total Property Portfolio<br>Three months September 30, |              |                         |             |
|--------------------------|---|--------------|------------------------|-------------|--|--------------|-------------------------|-------------|
|                          | 2004  | 2003         | Increase/<br>Decrease) | %<br>Change | 2004   | 2003         | Increase/<br>(Decrease) | %<br>Change |
| Revenue:                 |   |              |                        |             |  |              |                         |             |
| Rental                   | \$ 7,049,131  | \$ 6,660,114 | 389,017                | 5.84%       | \$ 9,190,568   | \$ 6,908,604 | 2,281,964               | 33.03%      |
| Interest                 | 1,990   | 5,487        | (3,497)                | (63.73)%    | 153,997  | 11,519       | 142,478                 | 1236.90%    |
| Utility                  |   |              |                        |             |  |              |                         |             |
| reimbursement            | 111,763   | 132,671      | (20,908)               | (15.76)%    | 132,474  | 132,671      | (197)                   | (0.15)%     |
| Other                    | 383,735   | 366,504      | 17,231                 | 4.70%       | 463,604  | 374,448      | 89,156                  | 23.81%      |
| Total revenue            | 7,546,619   | 7,164,776    |                        |             | 9,940,643  | 7,427,242    |                         |             |
| Operating Expenses:      |   |              |                        |             |  |              |                         |             |
| Operating                | 1,891,442   | 1,720,889    | 170,553                | 9.91%       | 2,542,538  | 1,912,239    | 630,299                 | 32.96%      |
| Maintenance              | 648,349   | 696,378      | (48,029)               | (6.90)%     | 782,811  | 714,588      | 68,223                  | 9.55%       |
| Real estate              |   |              |                        |             |  |              |                         |             |
| taxes                    | 608,953   | 595,988      | 12,965                 | 2.18%       | 1,085,799  | 643,050      | 442,749                 | 68.85%      |
| General and              |   |              |                        |             |  |              |                         |             |
| administrative           | 112,291   | 112,261      | 30                     | 0.03%       | 355,951  | 476,240      | (120,289)               | (25.26)%    |
| Organizational           |   |              |                        |             |  |              |                         |             |
| costs                    | --  | --           | --                     | 0.00%       | --   | --           | --                      | 0.00%       |
| Management               |   |              |                        |             |  |              |                         |             |
| fees                     | 287,463   | 278,531      | 8,932                  | 3.21%       | 647,398  | 464,696      | 182,702                 | 39.32%      |
| Total operating expenses | 3,548,498   | 3,404,047    |                        |             | 5,414,497  | 4,210,813    |                         |             |



|                   | Same Property Portfolio<br>Three months September 30, |                  |          |           | Total Property Portfolio<br>Three months September 30, |                  |          |           |
|-------------------|---|------------------|----------|-----------|--|------------------|----------|-----------|
| Net Operating     |   |                  |          |           |  |                  |          |           |
| Non-operating     | 3,998,121   | 3,760,729        |          |           | 4,526,146  | 3,216,429        |          |           |
| expenses:         |   |                  |          |           |  |                  |          |           |
| Depreciation      | 1,949,139   | 1,718,628        | 230,511  | 13.41%    | 2,751,854  | 1,818,769        | 933,085  | 51.30%    |
| Amortization      |   |                  |          |           |  |                  |          |           |
| of acquired       |   |                  |          |           |  |                  |          |           |
| in-place          |   |                  |          |           |  |                  |          |           |
| leases and        |   |                  |          |           |  |                  |          |           |
| tenant            |   |                  |          |           |  |                  |          |           |
| relationships     | --  | --               | --       | 0.00%     | 361,251  | --               | 361,251  | 100.00%   |
| Loss on sale      |   |                  |          |           |  |                  |          |           |
| of securities     | --  | --               | --       | 0.00%     | --   | --               | --       | 0.00%     |
| Loss on the       |   |                  |          |           |  |                  |          |           |
| extinguishment    |   |                  |          |           |  |                  |          |           |
| of debt           | --  | 86,748           | (86,748) | (100.00)% | --   | 86,748           | (86,748) | (100.00)% |
| Interest          | 2,144,308   | 1,799,163        | 345,145  | 19.18%    | 2,638,987  | 1,829,877        | 809,110  | 44.22%    |
|                   | <u>4,093,447</u>                                      | <u>3,604,539</u> |          |           | <u>5,752,092</u>                                       | <u>3,735,394</u> |          |           |
| Total             |   |                  |          |           |  |                  |          |           |
| non-operating     |   |                  |          |           |  |                  |          |           |
| expenses          |   |                  |          |           |  |                  |          |           |
| Income (loss)     |   |                  |          |           |  |                  |          |           |
| before minority   |   |                  |          |           |  |                  |          |           |
| interest in       |   |                  |          |           |  |                  |          |           |
| properties,       |   |                  |          |           |  |                  |          |           |
| equity in loss of |   |                  |          |           |  |                  |          |           |
| Multifamily       |   |                  |          |           |  |                  |          |           |
| Joint Venture,    |   |                  |          |           |  |                  |          |           |
| equity in         |   |                  |          |           |  |                  |          |           |
| income of         |   |                  |          |           |  |                  |          |           |
| Mortgage          |   |                  |          |           |  |                  |          |           |
| Funds, minority   |   |                  |          |           |  |                  |          |           |
| common            |   |                  |          |           |  |                  |          |           |
| interest in       |   |                  |          |           |  |                  |          |           |
| Operating         |   |                  |          |           |  |                  |          |           |
| Partnership       |   |                  |          |           |  |                  |          |           |
| and gain on       |   |                  |          |           |  |                  |          |           |
| transfer of       |   |                  |          |           |  |                  |          |           |
| property to       |   |                  |          |           |  |                  |          |           |
| Multifamily       |   |                  |          |           |  |                  |          |           |
| Joint Venture     | \$ (95,326)   | \$ 156,190       |          |           | \$ (1,225,946)   | \$ (518,965)     |          |           |

Comparison of the three months ended September 30, 2004 to the three months ended September 30, 2003.

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Of the \$2,281,964 increase in rental revenue, \$1,892,947 is attributable to newly acquired apartment communities. The balance of the increase, or \$389,017, is from the Same Property Portfolio which is due to a 4.96% increase in effective rental income plus an increase in average physical occupancy from 88.38% to 91.72% for the three months ended September 30, 2003 and 2004, respectively.

The overall increase in interest income of \$142,478 is attributable to the significant amounts of cash that has been available to the Company since late 2003. This cash is primarily the result of the liquidation of the Company's investments in the Mortgage Funds. When the Company is fully invested, interest income is expected to return to historical levels.

Other income, which consists primarily of the various fees charged to tenants and potential tenants, including pet fees, application fees, late charges and similar items, increased \$89,156, of which \$71,925 is attributable to newly acquired apartment communities. The balance of the increase, or \$17,231, is from the Same Property Portfolio and is generally tied to normal fluctuations in the various fees charged and collected during the period.

Operating expense increased \$630,299, of which \$459,746 is attributable to newly acquired apartment communities. The balance of the increase, or \$170,553, is from the Same Property Portfolio and is related to increases in payroll and benefits costs, \$86,671, and utility expenses, \$97,758, partially offset by limited savings in other operating expense categories. Payroll and benefits costs increased as a result of general increases in salaries and wages as well as benefits costs, including health insurance across the entire portfolio. We expect the upward trends in these areas to continue for the foreseeable future.

Maintenance expense increased \$68,223, of which newly acquired apartment communities accounted for a \$116,252 increase, which was offset by a decrease of \$48,029 from the Same Property Portfolio. The Same Property Portfolio decrease is attributable to general maintenance savings associated with the renovation work currently underway at Seasons of Laurel and Hannibal Grove apartments. We expect this downward trend to stabilize in the near term and then move in an upward direction as the general costs of goods and services increases.

Real estate taxes increased \$442,749, of which \$455,714 is attributable to newly acquired apartment communities, which was offset by a decrease of \$12,965 from the Same Property Portfolio as a combination of abatements and increases in property valuations resulted in generally flat expenses. We expect the general trend in real estate taxes to be upward as local and state governments continue to use real estate taxes to prop up sagging revenues.

The \$120,289 decrease in general and administrative expense is primarily attributable to the additional costs associated with our offering shares of our 9% series A Cumulative Redeemable Preferred Stock in exchange for interests in six mortgage funds in 2003.

Management fees increased \$182,702, of which newly acquired apartment communities accounted for \$173,770. The Same Property Portfolio increased \$8,932, which is in line with increases in the gross revenues on which property management fees are based.

Depreciation expense increased \$933,085, of which newly acquired apartment communities accounted for \$702,574. The Same Property Portfolio increased \$230,511, due primarily to rehabilitation capital expenditures at Seasons of Laurel and Hannibal Grove apartments.

Of the \$809,110 increase in interest expense, \$463,965 is attributable to newly acquired apartment communities. The Same Property Portfolio increased \$345,145 as a result of the addition of approximately \$28,000,000 of mortgage debt secured by the Same Property Portfolio from August through October 2003. The Company continues to take advantage of the historically low interest rates available on multifamily mortgages and expects this trend to continue as it maintains mortgage levels in line with increasing property values.

Equity in income of Mortgage Funds decreased \$1,593,172, this decrease is primarily attributable to the liquidation of the Company's investment in Mortgage Funds. The Company expects this trend to continue through 2005 and into 2006, at which point it is the Company believes the Mortgage Funds will be fully liquidated.

*Comparison of the nine months ended September 30, 2004 to the nine months ended September 30, 2003.*

The table below reflects selected operating information for the Same Property Portfolio and the Total Property Portfolio. The Same Property Portfolio consists of the 6 properties acquired or placed in service on or prior to January 1, 2003 and owned through September 30, 2004. The Total Property Portfolio includes the effect of the additional multifamily apartment communities acquired after January 1, 2003.

| <b>Same Property Portfolio</b>   |             |                                 |                     | <b>Total Property Portfolio</b>  |             |                                 |                     |
|----------------------------------|-------------|---------------------------------|---------------------|----------------------------------|-------------|---------------------------------|---------------------|
| <b>Nine months September 30,</b> |             |                                 |                     | <b>Nine months September 30,</b> |             |                                 |                     |
| <b>2004</b>                      | <b>2003</b> | <b>Increase/<br/>(Decrease)</b> | <b>%<br/>Change</b> | <b>2004</b>                      | <b>2003</b> | <b>Increase/<br/>(Decrease)</b> | <b>%<br/>Change</b> |

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|   | Same Property Portfolio<br>Nine months September 30, |               |           |           | Total Property Portfolio<br>Nine months September 30, |               |           |           |
|---|--|---------------|-----------|-----------|---|---------------|-----------|-----------|
| Revenue:  |  |               |           |           |   |               |           |           |
| Rental  | \$ 20,542,030  | \$ 20,057,422 | 484,608   | 2.42%     | \$ 27,079,335   | \$ 20,597,848 | 6,481,487 | 31.47%    |
| Interest  | 11,673   | 28,927        | (17,254)  | (59.65)%  | 640,010   | 78,235        | 561,775   | 718.06%   |
| Utility reimbursement   | 342,710  | 339,974       | 2,736     | 0.80%     | 395,860   | 339,975       | 55,885    | 16.44%    |
| Other   | 869,199  | 911,133       | (41,934)  | (4.60)%   | 1,159,968   | 926,784       | 233,184   | 25.16%    |
| Total revenue   | 21,765,612   | 21,337,456    |           |           | 29,275,173  | 21,942,842    |           |           |
| Operating Expenses:   |  |               |           |           |   |               |           |           |
| Operating   | 5,429,503  | 4,927,529     | 501,974   | 10.19%    | 7,304,839   | 5,187,303     | 2,117,536 | 40.82%    |
| Maintenance   | 1,738,313  | 1,769,435     | (31,122)  | (1.76)%   | 2,102,462   | 1,783,680     | 318,782   | 17.87%    |
| Real estate taxes   | 1,761,715  | 1,720,592     | 41,123    | 2.39%     | 3,236,604   | 1,817,100     | 1,419,504 | 78.12%    |
| General and administrative  | 333,662  | 347,615       | (13,953)  | (4.01)%   | 1,074,150   | 1,148,700     | 74,550    | 6.45%     |
| Organizational costs  | --   | --            | --        | 0.00%     | --  | 213,428       | (213,428) | (100.00)% |
| Management fees   | 838,029  | 919,849       | (81,820)  | (8.89)%   | 1,922,754   | 1,572,990     | 349,764   | 22.24%    |
| Total operating expenses  | 10,101,222   | 9,685,020     |           |           | 15,640,809  | 11,723,201    |           |           |
| Net Operating Income  | 11,664,390   | 11,652,436    |           |           | 13,634,364  | 10,219,641    |           |           |
| Non-operating expenses:   |  |               |           |           |   |               |           |           |
| Depreciation  | 5,675,742  | 5,260,228     | 415,514   | 7.90%     | 8,194,823   | 5,453,969     | 2,740,854 | 50.25%    |
| Amortization of acquired in-place leases and tenant relationships | --   | --            | --        | 0.00%     | 1,134,188   | --            | 1,134,188 | 100.00%   |
| Loss on sale of securities  | --   | --            | --        | 0.00%     | 163,630   | --            | 163,630   | 100.00%   |
| Loss on extinguishment of debt                                    | --   | 337,832       | (337,832) | (100.00)% | --  | 337,832       | (337,832) | (100.00)% |
| Interest  | 6,412,141  | 5,550,005     | 862,136   | 15.53%    | 8,093,230   | 5,580,719     | 2,512,511 | 45.02%    |
| Total non-operating expenses                                      | 12,087,883   | 11,148,065    |           |           | 17,585,871  | 11,372,520    |           |           |

|   | <b>Same Property Portfolio</b>   |           | <b>Total Property Portfolio</b>  |             |
|---|----------------------------------|-----------|----------------------------------|-------------|
|   | <b>Nine months September 30,</b> |           | <b>Nine months September 30,</b> |             |
|   | <hr/>                            |           | <hr/>                            |             |
| Income (loss)<br>before minority<br>interest in<br>properties,<br>equity in loss of<br>Multifamily<br>Joint Venture,<br>equity in<br>income of<br>Mortgage<br>Funds, minority<br>interest in<br>Operating<br>Partnership and<br>gain on<br>transfer of<br>property to<br>Multifamily<br>Joint Venture | <hr/>                            | <hr/>     | <hr/>                            | <hr/>       |
|   | \$                               | (423,493) | \$                               | (3,951,507) |
|   |                                  | 504,371   |                                  | (1,152,879) |
|   |                                  | <hr/>     |                                  | <hr/>       |

Comparison of the nine months ended September 30, 2004 to the nine months ended September 30, 2003.

Rental revenue increased \$6,481,487 and of that increase \$5,996,879 is attributable to newly acquired apartment communities. The Same Property Portfolio increased \$484,608 as an effective rental rate increase of 4.96% was partially offset by a decrease in average occupancy from 92.09% to 90.96% for the nine months ended September 30, 2003 and 2004, respectively.

Interest income increased \$561,775 due to substantial amounts of cash and cash equivalents available for short-term investments during the nine months ended September 30, 2004 as compared to the same period in 2003. When the Company is fully invested, interest income is expected to return to historical levels.

Of the \$55,885 increase in utility reimbursements, \$53,149 is attributable to newly acquired apartment communities.

Other revenue increased \$233,184 and of the increase \$275,118 is from newly acquired apartment communities which offset a decrease of \$41,934 from the Same Property Portfolio. The Same Property Portfolio decrease is generally tied to normal fluctuations in the various fees charged and collected during the period.

Of the \$2,117,536 increase in operating expense, \$1,615,562 is attributable to newly acquired apartment communities. The remaining increase of \$501,974 is attributable to the Same Property Portfolio. About half of the increase, or \$264,900, is attributable to increases in payroll and benefits costs including health insurance costs with utility costs, at \$199,353, making up much of the balance of the increase. The Company expects the costs in these areas to continue to rise faster than inflation rates given the national issues surrounding health care and the increasing cost of oil and gas.

While maintenance costs increased \$318,782, the costs related to newly acquired apartment communities, \$349,904, were offset by a decrease in costs for the Same Property Portfolio of \$31,122. The Same Property Portfolio decrease is attributable to general maintenance savings associated with the renovation work currently underway at the Seasons of Laurel and Hannibal Grove apartments. We expect this downward trend to stabilize in the near term and then move in an upward direction as the general costs of goods and services increases.

Real estate taxes increased \$1,419,504. Of this increase, \$1,378,381 is attributable to the newly acquired apartment communities.

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While general and administrative costs increased \$74,550, the costs of newly acquired apartment communities, \$88,503, were offset by a small decrease in costs for the Same Property Portfolio of \$13,953.

While management fees increased \$349,764, the fees associated with newly acquired apartment communities, \$431,584, were offset by a decrease in fees for the Same Property Portfolio of \$81,820 which is primarily the result of a change in the property management fee rate from 5% of gross revenue to 4% of gross revenue effective April 1, 2003.

Of the \$2,740,854 increase in depreciation expense, \$2,325,340 is attributable to the newly acquired apartment communities. The remaining increase of \$415,514 is attributable to the Same Property Portfolio and is the result of depreciation on approximately \$5,877,000 in capital expenditures made in 2004. The Company expects depreciation expense to continue to rise as the renovation of several apartment communities continues through 2005.

Of the \$2,512,511 increase in interest expense, \$1,650,375 is attributable to the newly acquired apartment communities. The remaining increase of \$862,136 is the result of increases in mortgage debt on the Same Property Portfolio. The Company continues to take advantage of the historically low interest rates available on multifamily mortgages and expects this trend to continue as it maintains mortgage levels in line with increasing property values.

Equity in income of Mortgage Funds decreased \$2,058,088, this decrease is primarily attributable to the liquidation of the Company's investment in Mortgage Funds. The Company expects this trend to continue through 2005 and into 2006, at which point it is the Company believes the Mortgage Funds will be fully liquidated.

### Mortgage Debt to Fair Market Value of Real Estate Assets

The Company's total mortgage debt summary and debt maturity schedule, as of September 30, 2004, is as follows:

#### Mortgage Debt Summary as of September 30, 2004

|  | \$                    | Weighted<br>Average<br>Rate |
|--|-----------------------|-----------------------------|
| Collateralized - Fixed Rate                                  | \$ 182,777,772        | 5.44%                       |
| Collateralized - Variable                                    | 3,314,984             | 3.73%                       |
| <b>Total Debt Maturity Schedule as of September 30, 2004</b> | <b>\$ 186,092,756</b> | <b>5.39%</b>                |

| Year         | \$                    | % of Total     |
|--------------|-----------------------|----------------|
| 2004         | \$ 345,351            | 0.19%          |
| 2005         | 2,228,354             | 1.20%          |
| 2006         | 2,821,570             | 1.52%          |
| 2007         | 48,832,070            | 26.24%         |
| 2008         | 2,324,414             | 1.25%          |
| Thereafter   | 129,540,997           | 69.60%         |
| <b>Total</b> | <b>\$ 186,092,756</b> | <b>100.00%</b> |

The Company's Mortgage Debt to-Fair Market Value of Real Estate Assets as of September 30, 2004 is presented in the following table. The Company calculates the fair market value of real estate assets based on the most recently available third party appraisal. The following information is presented in lieu of information regarding the Company's Debt-to-Total Market Capitalization Ratio, which is a commonly used measure in our industry, because the Company's market capitalization is not readily determinable since there was no public market for its common equity during the periods presented in these financial statements.

The information regarding Mortgage Debt to-Fair Market Value of Real Estate Assets is presented to allow investors to calculate our loan-to-value ratios in a manner consistent with those used by management and others in our industry including those used by our current and potential lenders. Management uses this information when making decisions about financing or refinancing properties. Management also uses fair market value information when making decisions about selling assets as well as when evaluating acquisition opportunities within markets where we have assets. The most directly comparable financial measure of our property value, calculated and presented in accordance with

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GAAP, is net book value, shown on the balance sheet as multifamily apartment communities, net of accumulated depreciation. At September 30, 2004, the aggregate net book value of our real estate assets was \$154,399,789.

### Fair Market Value of Real Estate as of September 30, 2004

| Fair Market Value | Mortgage Debt  | Loan-to-Value |
|-------------------|----------------|---------------|
| \$ 258,745,000    | \$ 186,092,756 | 71.92%        |

The fair market values are based on third party appraisals or recent purchase prices obtained between June 2002 and March 2004 for all of the properties within the portfolio. The individual property values range from \$4,900,000 to \$90,500,000.

### Funds From Operations

The Company has adopted the revised definition of Funds from Operations adopted by the Board of Governors of the National Association of Real Estate Investment Trusts ( NAREIT ). Management considers Funds from Operations ( FFO ) to be an appropriate measure of performance of an equity REIT. We calculate FFO by adjusting net income (loss) (computed in accordance with GAAP, including non-recurring items) for gains (or losses) from sales of properties and real estate related depreciation and amortization. Management believes that in order to facilitate a clear understanding of the historical operating results of the Company, FFO should be considered in conjunction with net income (loss) as presented in the financial statements included elsewhere herein. Management considers FFO to be a useful measure for reviewing the comparative operating and financial performance of the Company because, by excluding gains and losses related to sales of previously depreciated operating real estate assets and excluding real estate asset depreciation and amortization (which can vary among owners of identical assets in similar condition based on historical cost accounting and useful life estimates), FFO can help one compare the operating performance of a company s real estate between periods or as compared to different companies.

The Company s calculation of FFO may not be directly comparable to FFO reported by other REITs or similar real estate companies that have not adopted the term in accordance with the current NAREIT definition or that interpret the current NAREIT definition differently. FFO should not be considered as an alternative to net income (loss) (determined in accordance with GAAP) as an indication of our performance. FFO does not represent cash generated from operating activities determined in accordance with GAAP and is not a measure of liquidity or an indicator of our ability to make cash distributions. We believe that to further understand our performance, FFO should be compared with our reported net income (loss) and considered in addition to cash flows in accordance with GAAP, as presented in our financial statements.

The following table presents a reconciliation of net income (loss) to Funds from Operations for the three and nine months ended September 30, 2004 and 2003:

|   | Three Months ended<br>September 30, |              | Nine Months ended September<br>30, |              |
|---|-------------------------------------|--------------|------------------------------------|--------------|
|   | 2004                                | 2003         | 2004                               | 2003         |
| Net Income (loss)   | \$ 29,350                           | \$ 2,114,976 | \$ (1,898,170)                     | \$ 3,116,645 |
| Add:  |                                     |              |                                    |              |
| Depreciation of real property                                     | 2,160,486                           | 1,915,149    | 6,543,521                          | 4,652,562    |
| Minority interest in Operating Partnership                        | 244,025                             | 488,050      | 732,075                            | 488,050      |
| Minority interest in properties                                   | 2,418                               | 31,025       | 111,228                            | 125,228      |
| Amortization of acquired in-place leases and tenant relationships | 361,251                             | --           | 1,134,188                          | --           |
| Equity in loss of Multifamily Joint Venture                       | 58,105                              | --           | 160,778                            | --           |
| Funds from Operations of Multifamily Joint Venture                | 43,908                              | --           | 10,562                             | --           |
| Less:   |                                     |              |                                    |              |
| Minority interest in properties share of Funds from Operations    | (111,770)                           | (132,660)    | (275,309)                          | (260,029)    |
| Gain on transfer of property to Multifamily Joint Venture         | --                                  | --           | (232,704)                          | --           |
| Funds from Operations   | \$ 2,787,773                        | \$ 4,416,539 | \$ 6,286,169                       | \$ 8,122,456 |

### Inflation and Economic Conditions

## 11. SUBSEQUENT EVENTS

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Substantially all of the leases at the properties are for a term of one year or less, which enables the Company to seek increased rents for new leases or upon renewal of existing leases. These short-term leases minimize the potential adverse effect of inflation on rental income, although residents may leave without penalty at the end of their lease terms and may do so if rents are increased significantly.

Historically, real estate has been subject to a wide range of cyclical economic conditions, which affect various real estate sectors and geographic regions with differing intensities and at different times. In 2002 and 2003, many regions of the United States experienced varying degrees of economic recession and certain recessionary trends, such as increased cost of obtaining sufficient property and liability insurance coverage, reductions in short-term interest rates and a temporary reduction in occupancy. In light of this, we intend to continue to review our business strategy. However, we believe that given our property type, garden style residential apartment communities, and the geographic regions in which our properties are located, these recessionary trends have not had a material effect on our financial performance and we do not anticipate any changes in our strategy.

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### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

The Company's mortgage notes are primarily fixed rate instruments, therefore the majority of the Company's debt is not sensitive to changes in the capital market except upon maturity. The table below provides information about the Company's financial instruments that are sensitive to changes in interest rates, specifically debt obligations. The table presents principal cash flows and related weighted average interest rates by expected maturity dates.

#### Mortgage Debt, Including Current Portion

|                       | 2004       | 2005         | 2006         | 2007          | 2008         | Thereafter     | Total          |
|-----------------------|------------|--------------|--------------|---------------|--------------|----------------|----------------|
| Fixed Rate Debt       | \$ 330,907 | \$ 2,207,900 | \$ 2,761,040 | \$ 48,769,233 | \$ 2,259,517 | \$ 126,449,174 | \$ 182,777,772 |
| Average Interest Rate | 5.52%      | 5.53%        | 5.44%        | 5.93%         | 5.26%        | 5.26%          |                |
| Variable Rate debt    | \$ 14,440  | \$ 60,232    | \$ 62,552    | \$ 64,962     | \$ 67,133    | \$ 3,045,660   | \$ 3,314,984   |
| Average Interest Rate | 3.73%      | 3.73%        | 3.73%        | 3.73%         | 3.73%        | 3.73%          |                |

The table above reflects the mortgage notes payable as of September 30, 2004.

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## PART II. OTHER INFORMATION

### ITEM 6. EXHIBITS

- 31.1 Certification of Principal Executive Officer Pursuant to 18 U.S.C Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certification of Principal Executive Officer and Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

November 15, 2004

**BERKSHIRE INCOME REALTY,  
INC.**

/s/ David C. Quade  
David C. Quade  
President and Chief Financial Officer

SIGNATURES

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