# CEO ANNUAL LETTER

# 2013

KILROY

*"The KRC enterprise has evolved into the preeminent West Coast office landlord – providing new generation work environments to some of the most innovative businesses on the planet."*

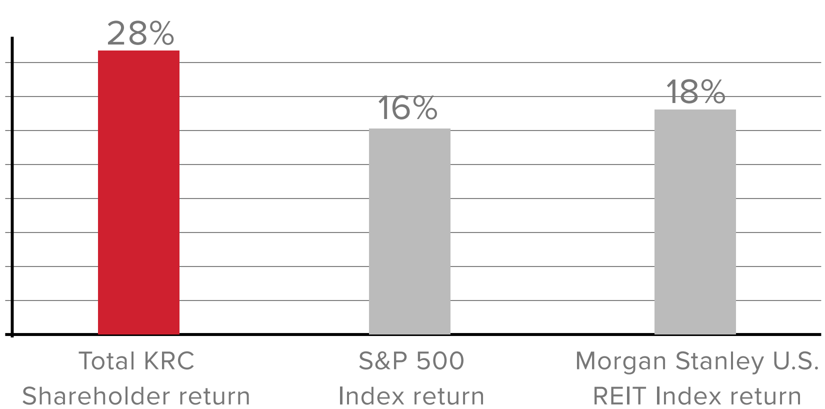
# To Our Shareholders

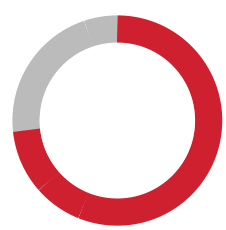
KRC entered 2012 a significantly larger and more diverse enterprise, strengths that we leveraged to deliver an immensely productive and successful year. We executed with discipline and delivered on our goals – creating significant value through leasing, strategic acquisitions, pre-leased development and capital recycling. With a bigger geographic footprint, a deeper talent bench, a broader operating platform, and a stronger financial position, we continued to capture share in each of our markets up and down the West Coast, from Seattle to San Diego.

And with growing recognition for the quality of our properties, the ingenuity with which we approach new projects, and the commitment we have made to sustainable real estate practices, we have evolved into the preeminent West Coast office landlord - providing new generation work environments to some of the most innovative businesses on the planet.

Our success can be seen in our total shareholder return performance last year of 28%, which outpaced the S&P 500 Index return of 16% and the Morgan Stanley U.S. REIT Index return of 18%. Our three-year cumulative total return to shareholders has been an impressive 73%. And just recently, we were upgraded to the S&P MidCap 400 Index from the S&P SmallCap 600 Index, further demonstrating the growth and stability of our franchise.

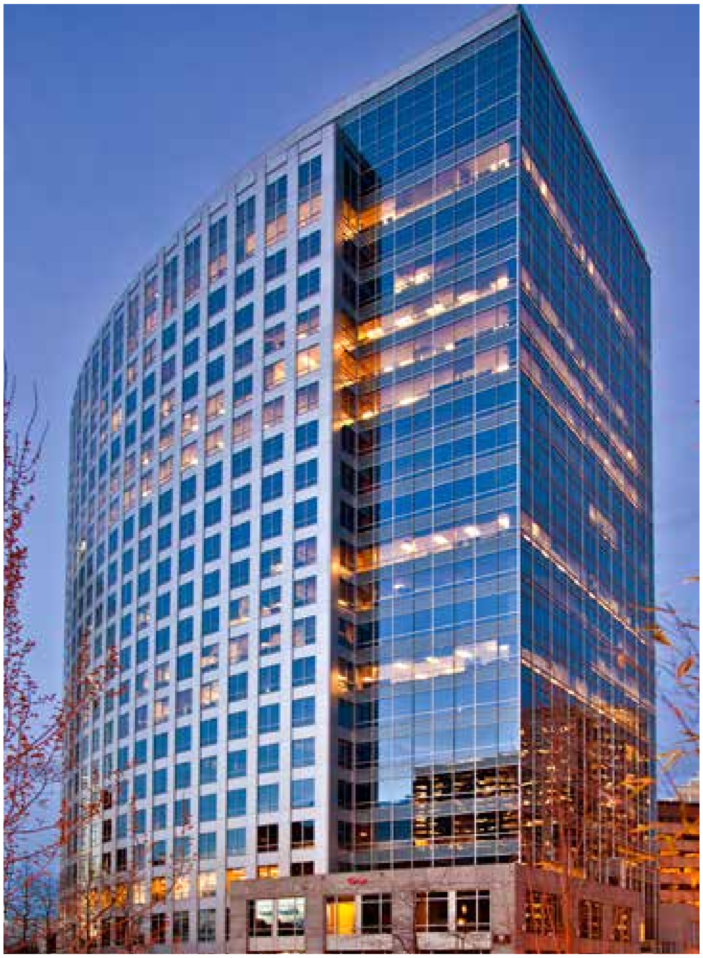
## TOTAL SHAREHOLDER RETURN PERFORMANCE



**73%**

3-year cumulative total return to shareholders



*Key Center, Pacific Northwest*

*350 Mission, San Francisco Bay Area*

# Strong Execution on All Fronts

## Leasing.

We signed new or renewing leases on more than 2.3 million square feet of office space in 2012, including 1.3 million square feet in the final quarter of the year. That topped our 2011 results and produced the best leasing performance in our company's history as a public company.

Over the past three years, our leasing momentum has driven up the occupancy of our stabilized portfolio by 1,000 basis points. At year-end 2012, the portfolio was 92.8% occupied and 94.3% leased.

**1.8**
**MILLION SF**
of office space added to portfolio

**6**
**PROJECTS**
added to development pipeline

**$500**
**MILLION**
in gross proceeds from selling entire industrial portfolio

**2.3**
**MILLION SF**
in new or renewing leases signed in 2012

**20%**
**CLIMB**
of continuing operations revenues

We added significant new names to our roster of top quality tenants last year, including salesforce.com, LinkedIn, Synopsys, Adobe, TD Ameritrade, Concur Technologies, and the Lucille Packard Stanford Hospital. In San Francisco alone, where technology leasing made up more than 4.5 million square feet of 2012 activity, KRC accounted for nearly one of every five square feet leased.

**Acquisitions** continued to reshape our portfolio in 2012. We completed seven transactions last year valued at an aggregate $674 million that added 1.8 million square feet of office space to our stabilized portfolio. These transactions broadened our presence in many of the most attractive submarkets of greater Seattle, added to our extensive San Francisco Bay Area portfolio, and significantly enlarged our platform of media and entertainment properties in Los Angeles.

**Development** reemerged last year as an important force in our portfolio's evolution. Northern California, in particular, provided us with several economically compelling opportunities to acquire fully entitled, pre-leased projects. These now form the foundation of an exciting new development pipeline for KRC, one in which we are pioneering new paradigms in office design, efficiency and sustainability.

In total, we added six projects to our development pipeline, representing an aggregate investment of approximately $1.2 billion. Five of the six are located in the Bay Area; four are under construction and fully preleased to some of the most high-growth, well-established technology companies today – salesforce.com, LinkedIn Corporation, Synopsys, Inc. and Audience, Inc.

**Dispositions** remain an important strategy in the management of our portfolio. Last year, capitalizing on strong market interest for fully leased commercial real estate, we took the significant step of selling 46 buildings, including our entire industrial portfolio, for gross proceeds totaling $500 million. Our success in disposing of these non-strategic assets at full-value pricing played a meaningful role in our ability to fund acquisitions and development projects, while maintaining a strong balance sheet.

*Columbia Square, Greater Los Angeles*

## Financial Performance.

Our revenues from continuing operations climbed 20% last year, to $405 million, fueled by an expanding office portfolio and higher average occupancy. Net operating income (NOI) generated by our stabilized portfolio also showed substantial improvement, with adjusted same-store NOI up 4.8% on a cash basis. Our adjusted cash same-store NOI has now risen for 10 consecutive quarters. Funds from operations (FFO) grew 27% in 2012 to $172 million after adjusting for non-cash costs associated with our two preferred stock offerings.

## Balance Sheet.

Our long standing track record of conservatism and prudent balance sheet management translated into strong support from the debt and equity investor community, which has helped us to continue to lower our cost of capital. We issued $700 million of equity through two very successful marketed offerings as well as effective utilization of our At-The-Market program. We completed two new preferred stock offerings totaling $200 million and redeemed three existing, more expensive preferred issuances, lowering our preferred dividend payments by almost 13% on an annual basis. We actively managed our debt portfolio by refinancing maturing, higher cost debt and extending our maturity profile. We remain committed to maintaining a conservative leverage profile – evidenced by an 800 bps decrease in net debt to market capitalization since the beginning of 2010. We ended the year with a net debt to market capitalization of 31%, among the lowest ratios in our peer group.

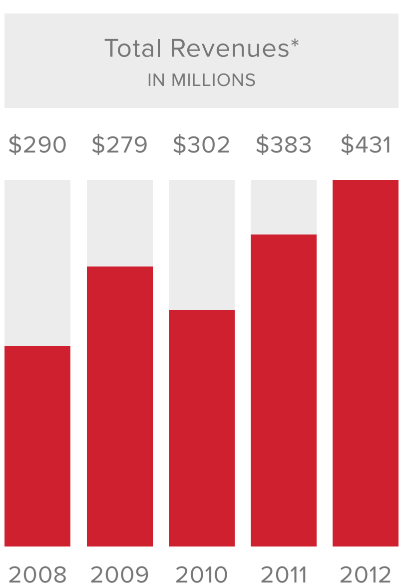
# 2012 Financials

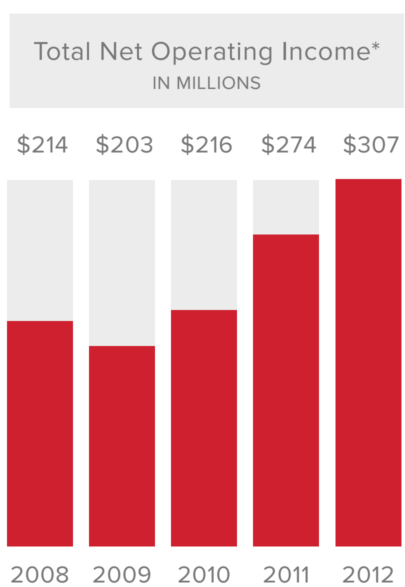
## Financial Data IN THOUSANDS EXCEPT PER SHARE DATA

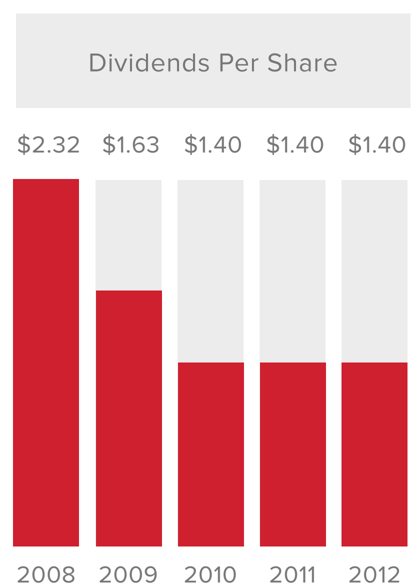
| | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| Total Revenues* | $431,473 | $383,133 | $301,980 | $279,434 | $290,167 |
| Net Income | $249,826 | $50,819 | $4,512 | $21,794 | $29,829 |
| Funds from Operations (FFO) | $165,455 | $136,173 | $106,639 | $107,159 | $113,972 |
| FFO per Share | $2.25 | $2.29 | $2.05 | $2.60 | $3.26 |
| Dividends per Share | $1.40 | $1.40 | $1.40 | $1.63 | $2.32 |

## Rentable Square Footage AT DECEMBER 31st

| | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| Office Properties | 13,249,780 | 11,421,112 | 10,395,208 | 8,708,466 | 8,650,126 |
| Industrial Properties | ------------- | 3,413,354 | 3,602,896 | 3,654,463 | 3,718,663 |
| Occupancy | 93% | 92% | 89% | 83% | 89% |




*INCLUDES DISCOUNTED OPERATIONS

**Sustainability** is an essential element in our portfolio's ongoing evolution. KRC continues to play an industry-leading role in the adoption and promotion of environmentally sound practices in commercial real estate. We now field an in-house team dedicated to the sustainability of our properties, and our development and management practices.

With the completion of our current development pipeline, approximately 50% of our portfolio will have Leadership in Energy and Environmental Design (LEED) designation, an international industry rating system that addresses environmental impact across the entire lifecycle of a property. Further, approximately 50% of our portfolio has achieved Energy Star certification, the national standard for energy efficiency developed by the U.S. Environmental Protection Agency. These statistics rank us among the top public REITs in overall sustainability performance.

## Platform for continued growth and value creation.

We are building enterprise value for the long term as the KRC organization grows in size and capabilities. Our office properties are better designed and equipped to meet emerging tenant needs for greater adaptability, cost-efficiency and sustainability in their real estate choices.

Our portfolio as a whole is better diversified across the highest growth and innovation-driven real estate markets on the West Coast. San Francisco, among the world's top-performing markets today, and greater Seattle, a smaller, but equally powerful magnet for the region's fastest-growing companies, now represent close to half of our total net operating income on a pro forma basis.

Our expanding development and redevelopment pipeline is allowing us to deepen commercial and community relationships in our key markets and build our reputation as a real estate innovator. We are now working alongside many of the world's most dynamic companies in the creation of cutting-edge commercial office space.

Perhaps most importantly, our management team is among the most talented and experienced group of real estate professionals operating on the West Coast today. As our core markets generate stronger economic growth, job creation, and demand for high quality work space, we have the organizational strength and capacity to execute our plans with energy and precision.

It's exciting and satisfying to see our carefully planned strategies succeed. And we believe there is much more to come. We will continue to pursue opportunities in a thoughtful and disciplined manner, for the long-term to benefit our shareholders.

As always, we appreciate your continuing support.

Cordially,

John B. Kilroy, CEO

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