AvalonBay Communities, Inc.

Annual Report

1998

Welcome to AvalonBay

A HIGH QUALITY LIVING EXPERIENCE AND OUTSTANDING CUSTOMER SERVICE ARE THE KEYSTONES OF AVALONBAY COMMUNITIES. The Company is a self-administered and self-managed equity REIT that develops, redevelops, acquires and manages multifamily apartment communities in high barrier-to-entry markets. At year-end, AvalonBay owned or held ownership interests in 141 apartment communities containing 41,172 apartment homes in 16 states and the District of Columbia.

To Our Stockholders

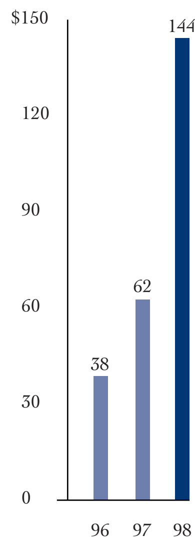
WELCOME TO AVALONBAY!

Avalon merged with Bay in June of 1998. Since then, we've built a new company, with a new strategic vision and new ideas. It was unusual for two strong companies to merge, as each enjoyed good markets, strong earnings growth and, as a result, strong valuations. In the end, investors and analysts were convinced that the merger served the best interests of the stockholders.

The benefits were many. We expanded each company's markets for improved diversification and cash flow stability. We combined two strong management teams and studied and implemented the "best practices" of each company. We identified synergies to avoid redundant costs and reduce other costs, providing accelerated earnings growth. We achieved corporate credit rating upgrades and improved our financial flexibility and strength—which proved fortunate, given the unexpected turn in the financial markets.

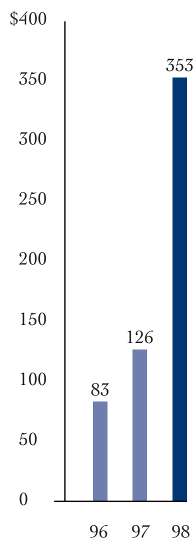
FFO

$ in millions



TOTAL REVENUE

$ in millions



We're positioned well in the industry for growth and stability. AvalonBay owns more than 41,000 Class A, institutional quality apartment homes in 141 communities, spanning 29 markets and 16 states. With a total market capitalization of approximately $4.2 billion, AvalonBay is the nation's 3rd largest multifamily REIT. Our scale provides benefits not available to smaller companies, but we don't want to lead by size alone. We prefer to be, and believe we are, the leader in serving the true high-barrier markets of the country, which are generally the most sought-after apartment markets in America.

If you look inside the company, you will see familiar surroundings. We continue our focus on high-barrier markets. This strategy was preserved and enhanced by the merger. Approximately 80% of our operating income is now derived from the top 10 high-barrier markets of the country. We also maintain a core management team that is deep, seasoned and has

operated in these markets for many years. We continue to invest in high quality assets in "infill" urban locations that will provide long-term value creation.

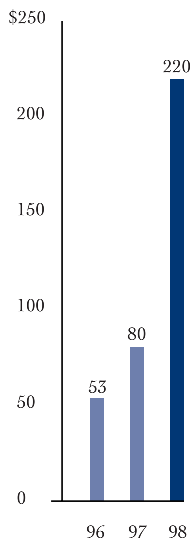
Other aspects of the merger are discussed in more detail later in this report. In the balance of our letter, we want to convey the essentials of the Company's 1998 performance and then discuss our goals and strategies for the future.

1998 PERFORMANCE REVIEW

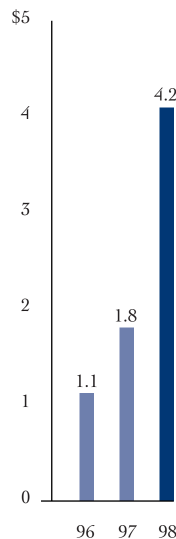
Early Evidence that 1+1=3: Strong FFO Growth Driven by Internal Growth

So far, the results are encouraging, and suggest we're on track toward achieving a 1+1=3 effect, under which the combined company is stronger than the sum of its parts. In 1998, Funds from Operations (FFO) grew 17.1% to $2.87 per share. Earnings growth is greater than the two predecessor companies would have achieved separately and supported a dividend increase of 21.4% while preserving a conservative payout ratio of 67.9%. Such a ratio provides both security for the dividend and cost effective retained cash to pursue new accretive investments. Diversified markets also benefited the combined company. While internal earnings growth in our Northern California markets moderated during 1998, the East Coast strengthened. This resulted in strong, balanced earnings growth that would not have been possible without diversification among these high-barrier markets. Interestingly, same-store EBITDA has increased at a 7.7% average annual rate since 1995, compared with approximately 4.9% industry-wide. Our performance continues to be among the best in the apartment sector.

GROSS EBITDA
$ in millions



TOTAL MARKET VALUATION
$ in billions



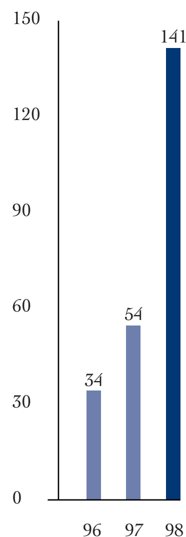
These results reflect the depth of our management team, validate our business strategy and demonstrate that our team can deliver excellent operating results while merging two great companies.

External Growth was Strong: Development & Redevelopment Activity

Responding to the capital environment, we shifted away from

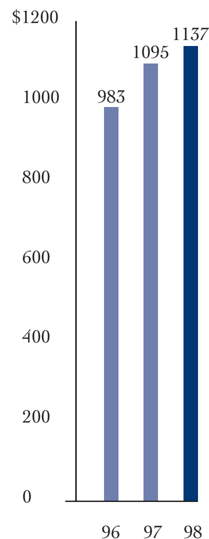
acquisitions during the year and doubled our focus on our development and redevelopment programs, which continue to provide substantial margins over our cost of capital. We started $237.9 million of new development communities, which we estimate will produce an average yield of 10.5% on invested capital when completed and delivered. Redevelopment remains a unique focus to AvalonBay, and $431.3 million in such programs was started and $196 million delivered at yields of 9.2% and 9.8%, respectively.

TOTAL APARTMENT COMMUNITIES



Includes development communities

WEIGHTED AVERAGE MONTHLY REVENUE PER OCCUPIED HOME



A NEW STRATEGIC VISION FOR THE FUTURE

Our Strategic Plan

Our early merger integration effort focused on developing our new strategic plan. Our goal is to be an evergreen company, successful for a hundred years in both growing and challenging market environments, through the creation and preservation of superior communities.

The foundation of our plan is a set of core values that all successful organizations share. Our culture is based on shared values of integrity, caring and constant improvement with effective business practices and an efficient style of doing business that preserves and enhances the value of our franchise.

…A Plan for Growth…

We seek to more deeply penetrate certain targeted markets in which we now operate, using our core competencies in development, redevelopment, construction, reconstruction and operations. We are in some markets that don't meet our strategic vision, and we will likely begin exiting those markets over the coming year and redeploy capital into targeted markets. Asset acquisitions, dispositions and strategic combinations are all methods we may use to achieve asset concentration in targeted markets. We will gradually expand our corporate housing program, test active senior housing markets and expand our revenue base from non-traditional revenue sources.

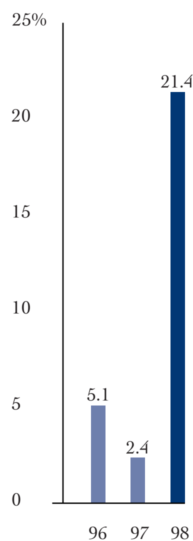
…But we must be prepared…

The current national economic expansion cannot last forever, and our plan anticipates this. We will monitor various "trip wires" to alert us to future market downturns, and we have determined in advance the specific steps we will take to manage through a downturn. We call this the preparedness element of our plan. These steps should minimize the negative impact of a market downturn and prepare us for a stronger industry role during the ensuing recovery.

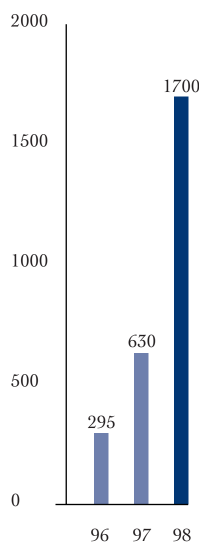
…and the Financial Strategy for all cases…

The final element of our plan is a financial strategy that is designed to serve us well, regardless of the market and economic environment. We have established key balance sheet statistics to monitor the financial health of our company on both a current and forward looking basis. In addition we have established steps to preserve financial capacity so as to seize opportunities that may emerge during all phases of the economic cycle.

QUARTERLY DIVIDEND GROWTH RATES



NUMBER OF ASSOCIATES



GROWING IN HIGH-BARRIER MARKETS DURING A CAPITAL CONSTRAINED ENVIRONMENT

Challenges and Opportunities of High-Barrier Markets

Presently, AvalonBay has one of the industry's largest and most attractive development pipelines, concentrated in the urban infill locations of the Northeast, West Coast and the metropolitan areas of Chicago and Minneapolis. Growing in high-barrier markets is a challenge since these markets are, by definition, the most difficult to enter and develop. Our answer to this challenge is the concept of "local sharpshooters": real estate experts located in each of our key markets who use their years of local experience to identify and develop opportunities that often slip under the radar screens of more nationally focused competitors without a local presence. Our redevelopment program is recognized as the finest in the industry. Since these communities are already zoned and producing income, we can often earn higher returns at a lower risk through redevelopment than with acquisitions or developments.

Financing Growth

Funding growth in a capital constrained environment is challenging but achievable. We enjoy significant flexibility in deferring the start of specific development and redevelopment communities. Therefore, while our pipeline is large, it is, to some extent, a "flexible pipeline" in which we can control its flow and pursue new development to the extent that capital is available on reasonable terms. Our foundation, however, for managing growth in this environment is a strong balance sheet. We have the capacity to issue debt to finish our construction and reconstruction underway. We also expect to retain a significant level of free cash flow, $50 million in 1999 and $72 million in 2000, after dividends and capital expenditures. Finally, we plan to recycle capital from asset sales into accretive new development communities. This may be more dilutive short-term than selling stock, but provides superior long-term returns to investors. With that goal in mind, we sold communities valued at $170 million during 1998 and expect more sales in 1999. We expect these capital sources to be adequate to fund our development and redevelopment activity currently underway while retaining our financial flexibility.

The current capital environment provides us a competitive advantage in that it favors companies with strong internal growth, solid balance sheets and flexible pipelines of new business over those that rely disproportionately on spread investing for growth. It rewards companies that can create the most value with the least capital. The foundation of our 1999 earnings will come from our existing communities, which we believe will produce incremental cash flow during 1999 of approximately $15 million. We have avoided using derivative financings such as interest-rate hedge agreements, treasury locks, forward equity arrangements or other derivative transactions that could result in a loss or financially

PRO FORMA 1998
FINANCING ACTIVITY

The Company raised over $673.4 million in cost effective capital, demonstrating significant financial flexibility in a turbulent capital markets environment. The following is a summary demonstrating the diversity and flexibility of the Company's access to capital markets during 1998.

- *Raised $673.4 million in capital:*
  - *$500 million in notes*
  - *$73.4 million in equity*
  - *$100 million preferred equity*
- *New expanded $600 million credit line at lower rates.*
- *In January 1999, raised $125 million in notes.*

impair the company. We have avoided significant unfunded commitments without the liquidity to meet those commitments. Instead, we will continue to preserve and enhance our financial flexibility, utilizing retained cash flow, selling select assets as opportunities arise and entering the capital markets when conditions are favorable and when the use of the capital is accretive.

LOOKING AHEAD

The year ahead will be challenging. We will focus on the final stages of merger integration. We will also need to manage through a capital constrained environment. We will lean heavily on our new strategic plan and have already implemented key elements, including reducing acquisitions and the pace of new development while accelerating asset sales. If capital market conditions tighten, we will take additional, measured steps.

In closing, we would like to thank our associates for dedication that can only be described as remarkable. With their steadfast commitment, we are confident that AvalonBay will continue on track toward becoming a truly great, evergreen company.

Welcome to AvalonBay!

NEW DEVELOPMENT COMMUNITIES
Size/Total Capital Cost

Avalon at Faxon Park
171 Apt. Homes/$14.6 million

Avalon at Fair Lakes
234 Apt. Homes/$23.2 million

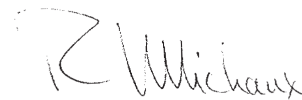
Avalon Fields II
96 Apt. Homes/$8.3 million

Avalon Gardens
504 Apt. Homes/$53.4 million

Avalon at Cameron Court
460 Apt. Homes/$42.8 million

Toscana
710 Apt. Homes/$119.6 million

GILBERT M. MEYER
Chairman of the Board



RICHARD L. MICHAUX
Chief Executive Officer and President

The Company's highly integrated development skills provide us distinct competitive advantages, particularly in a capital constrained market environment where the value of spread investing is minimized and the market rewards companies that can create value with less capital. We are able to achieve growth without having to pursue acquisitions that may not fit our niche or are overpriced.

AvalonBay's development skills received industry recognition during the year, including "Development Firm of the Year" Award from the National Association of HomeBuilders (NAHB). The NAHB also named the Company's Avalon Grove community as "Best Mid-or High Rise Apartment Community of the Year."

During 1998, we completed six development communities with a total cost of $261.9 million. The yield on these communities was 11.4% further demonstrating the accretive value of our high barrier-to-entry markets.

Our focus remains on those opportunities where we can generate the highest returns. We started 1999 with a development pipeline of 14 communities under construction at a total estimated cost of $533 million. We expect these assets will have an estimated weighted average return on cost of 10.2 percent when completed and stabilized. However, we will continue to use option terms to extend closing dates and manage the deployment of capital. We also possess development rights for an additional 27 well located, urban infill sites that represent future growth opportunities.

AVALON AT CAMERON COURT *Alexandria, Virginia*

AvalonBay's ability to successfully develop communities in high barrier-to-entry urban markets is a distinguishing feature which creates long-term value for shareholders.

REDEVELOPMENT

AvalonBay's success at generating high returns from reconstructed communities has been a pillar of the Company's growth. We have developed a national reputation for taking underperforming and undermanaged assets in desirable urban infill locations and adding significant value through major reconstruction programs, skilled management and a high level of customer service. In virtually every case, we have acquired and redeveloped these communities at well below replacement cost.

Our strategy is to utilize our local "sharpshooter" capabilities in high-barrier, supply-constrained markets to identify opportunities where the risks are lower than with acquisition or development programs. These markets are characterized by high population and economic growth, growing apartment market demand and high rents and occupancy levels.

The Company's reconstruction programs are more than simple face-lifts. We do extensive exterior reconstruction, add new fixtures, cabinets, appliances, floor and wall coverings and upgrade the landscaping, leasing and fitness facilities. We carefully manage reconstruction programs to ensure the highest possible occupancy levels and thus maximize return on investment.

The Company completed reconstruction programs at eight communities with a total reconstruction costs of $64.3 million. These communities generated an initial year weighted average return of 9.8 percent.

Currently, 13 communities are under reconstruction representing a total investment of $98 million. Our reconstruction pipeline also includes seven communities that were acquired over the past two years for a total acquisition cost of $289.2 million. We anticipate a 9.2% weighted average return on total cost for the seven future redevelopment communities.

HAMPTON PLACE *Fremont, California*

Our "local sharpshooter" approach to markets facilitates our track record of adding value to underperforming assets through extensive reconstruction programs.

AvalonBay

DEPTH OF MANAGEMENT

As a result of the merger, AvalonBay now has a team of more than 1,700 highly committed and empowered associates, supported by a senior management team with hundreds of years of combined real estate experience.

Our people represent the true measure of the Company's long-term value. The fact that we were able to complete a sizable merger successfully while generating excellent financial results is evidence of the depth of our management and our ability to increase shareholder value.

Revenue grew by 179 percent over 1997 and net operating income (NOI) increased by 175 percent. Pro forma NOI from Established Communities increased 6.9 percent during 1998, reflecting balanced growth from a geographically diversified portfolio.

The Company's Funds From Operations (FFO) increased 17.1 percent to $2.87 per share, while the rate of quarterly distributions to shareholders increased 21.4 percent. At the same time, we were able to maintain a conservative payout ratio of 68 percent in 1998.

We continue to support our human resources with major investments in technology—as we prudently invest ahead of growth—and in industry-leading training programs to develop the skills of our people.

LAFAYETTE PLACE *Costa Mesa, California*

Combining two successful, well-managed companies has improved our financial performance and established a foundation for future value creation.

Legendary Service is more than just a motto; it is a passion shared by all AvalonBay associates. We honor numerous associates each year for their acts of Legendary Service. Not only does this reinforce the importance of customer service throughout the organization, but it also provides recognition of its value in aiding resident retention, reducing turnover, and generating higher rents and occupancy levels.

The story of Jessica Vega, Community Manager at Avalon Fields in North Potomac, MD, demonstrates how our associates go the extra mile.

One day last August, Jessica found herself faced with a resident in tears—not the result of something that occurred at the community—but because she was dissatisfied with her wedding dress. With matrimony less than two weeks away, the bride-to-be was frantically, and unsuccessfully, calling bridal shops in the area in search of the perfect gown.

While offering assistance and consolation, Jessica realized that the resident's dream gown sounded very much like her own. She brought the gown in for the resident to try on. Now, the bride-to-be was crying tears of joy; it was the gown of her dreams. A few minor alterations later, the resident was off to her wedding carrying a keepsake from, and fond thoughts of, the people of AvalonBay.

AVALON FIELDS *North Potomac, Maryland*

The associates of AvalonBay go the extra mile to serve our residents. The efforts of Jessica Vega, Community Manager at Avalon Fields, exemplify our practice of providing Legendary Service.

A Stronger Company

$$+\frac{1}{1}{3}$$

A Stronger Future

AVALON TOWERS BY THE BAY *San Francisco, CA*

With a year of transition behind us, we are now ready to capture further benefits from the combined strengths of the Company. Our community under construction in downtown San Francisco, Avalon Towers by the Bay, symbolizes the strength of the Company. It is located in a highly desirable urban, infill location in one of San Francisco's fastest growing neighborhoods. When completed, this community will be a premier residential address. Our new strategic plan calls for similar urban, infill communities in the future.

A Stronger Future *through national*

ROSEWALK AT WATERFORD PARK
San Jose, CA

AVALON AT DANADA FARMS
Wheaton, IL

VILLA SERENA
Rancho Santa Margarita, CA

THE VERANDAS AT BEAR CREEK
Redmond, WA

The merger of Avalon and Bay was unlike most in our industry in that it combined two strong equals. We believed the synergies between the two companies would create long-term value and to date our financial performance supports that premise. During 1998, we combined the best elements of these two highly

diversity in high barrier-to-entry markets.

AVALON CRESCENT
McLean, VA

AVALON AT FAXON PARK
Quincy, MA

AVALON AT GEIST
Indianapolis, IN

AVALON GROVE
Stamford, CT

complementary organizations. We used merger integration consultants and reviewed 500 Best Practices of both companies. Examples of this integration include Bay's human resources department and reconstruction expertise filling voids at Avalon, while Avalon's technology capabilities enhanced Bay's existing systems.

1998

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AVALONBAY BOARD OF DIRECTORS

FROM LEFT TO RIGHT

GILBERT M. MEYER
Chairman of the Board
AvalonBay Communities, Inc.

RICHARD L. MICHAUX
Chief Executive Officer & President
AvalonBay Communities, Inc.

THOMAS H. NIELSEN
Independent Director
Consultant, The Nielsen Company

LANCE R. PRIMIS
Independent Director
Managing Partner,
Lance R. Primis & Partners, LLC

ALLAN D. SCHUSTER
Independent Director
Private Investor

BRUCE A. CHOATE
Independent Director
Chief Financial Officer,
Watson Land Company

MICHAEL A. FUTTERMAN
Independent Director
Chairman,
American Realty Capital

JOHN J. HEALY, JR.
Independent Director
Founder and President,
Hyde Street Holdings, Inc.

RICHARD W. MILLER
Independent Director
Former Senior Executive Vice President
& Chief Financial Officer, AT&T

BRENDA J. MIXSON
Independent Director
Chief Financial Officer & Investment Officer
& Managing Director,
Prime Capital Holdings, LLC

CHRISTOPHER B. LEINBERGER
Independent Director
Managing Director,
Robert Charles Lesser & Co.
Partner, Arcadia Land Co.

SELECTED FINANCIAL DATA

The following table provides historical consolidated financial, operating and other data for the Company and the Greenbriar Group. The table should be read with the consolidated financial statements of the Company and the notes included in this report.

(Dollars in thousands, except per share information)	Company [1]					The Greenbriar Group [2]
	Years ended				3-17-94 through	1-1-94 through
	12-31-98	12-31-97	12-31-96	12-31-95	12-31-94	3-16-94
OPERATING INFORMATION:						
Revenue:						
Rental income	$ 352,017	$ 126,375	$ 82,833	$ 53,190	$ 31,621	$5,104
Management fees	793	—	—	—	—	—
Other income	74	31	5	89	97	13
Total revenue	352,884	126,406	82,838	53,279	31,718	5,117
Expenses:						
Operating expenses	95,980	32,434	21,391	13,764	7,847	1,821
Property taxes	29,778	9,539	6,381	4,349	2,786	459
Interest expense	54,003	14,113	14,276	11,472	4,782	2,358
Depreciation and amortization	78,359	27,009	18,689	13,714	8,366	1,111
General and administrative	7,674	4,106	1,823	1,155	744	107
Total expenses	265,794	87,201	62,560	44,454	24,525	5,856
Equity in income of unconsolidated joint ventures	1,525	—	—	—	—	—
Interest income	3,191	206	178	242	310	23
Minority interest	(1,342)	(470)	(319)	(19)	(17)	—
Income (loss) before gain on sale of communities and extraordinary item	90,464	38,941	20,137	9,048	7,486	(716)
Gain on sale of communities	3,970	—	—	2,412	—	—
Income (loss) before extraordinary item	94,434	38,941	20,137	11,460	7,486	(716)
Extraordinary item	—	—	(511)	—	—	—
Net income	94,434	38,941	19,626	11,460	7,486	(716)
Dividends attributable to preferred stock	(25,874)	(7,480)	(4,264)	(917)	—	—
Net income available to common stockholders	$ 68,560	$ 31,461	$ 15,362	$ 10,543	$ 7,486	$ (716)
Per Common Share and Share Information:						
Income before extraordinary item—basic [3]	$ 1.39	$ 1.40	$ 1.06	$ 0.91	$ 0.65	N/A
Income before extraordinary item—diluted [3]	$ 1.37	$ 1.40	$ 1.06	$ 0.91	$ 0.65	N/A
Extraordinary item	$ —	$ —	$ (0.03)	$ —	$ —	N/A
Net income—basic [3]	$ 1.39	$ 1.40	$ 1.03	$ 0.91	$ 0.65	N/A
Net income—diluted [3]	$ 1.37	$ 1.40	$ 1.03	$ 0.91	$ 0.65	N/A
Cash dividends declared [3]	$ 1.95	$ 1.66	$ 1.61	$ 1.55	$ 1.20	N/A
Weighted average common shares and units outstanding—basic [3]	49,488,868	22,472,394	14,985,160	11,544,287	11,544,287	N/A
Weighted average common shares and units outstanding—diluted [3]	50,146,909	22,472,394	14,985,160	11,544,287	11,544,287	N/A
OTHER INFORMATION:						
Funds from Operations [4]	$ 144,152	$ 62,417	$ 38,293	$ 21,884	$ 15,430	$ 395
Gross EBITDA [5]	$ 219,635	$ 79,857	$ 52,924	$ 33,992	$ 20,324	$2,730
Stabilized apartment communities [6]	113	54	34	25	19	10

SELECTED FINANCIAL DATA

(Dollars in thousands)	Company (1)					The Greenbriar Group (2)
	Years ended				3-17-94 through	1-1-94 through
	12-31-98	12-31-97	12-31-96	12-31-95	12-31-94	3-16-94
BALANCE SHEET INFORMATION:						
Real estate, before accumulated depreciation	$4,033,994	$1,373,515	$ 750,347	$ 498,210	$ 398,333	N/A
Total assets	$4,030,204	$1,317,650	$ 711,909	$ 477,190	$ 390,016	N/A
Notes payable and Unsecured Facilities	$1,484,371	$ 487,484	$ 273,688	$ 227,801	$ 181,731	N/A
CASH FLOW INFORMATION:						
Net cash flows from operating activities	$ 191,229	$ 62,650	$ 39,224	$ 22,598	$ 17,654	$ 647
Net cash flows used in investing activities	$ (619,229)	$ (574,970)	$(216,000)	$ (87,247)	$(189,430)	$(2,211)
Net cash flows from (used in) financing activities	$ 433,702	$ 514,588	$ 176,019	$ 61,628	$ 175,168	$ (446)

NOTES TO SELECTED FINANCIAL DATA

(1) See consolidated financial statements of the Company and the related notes included in this report.

(2) The Greenbriar Group is the Company's predecessor.

(3) Share and per share information is only presented for the Company because no common stock was outstanding during periods presented for the Greenbriar Group. The first full year operating as a public company was 1995.

(4) Management generally considers Funds from Operations to be an appropriate measure of the operating performance of the Company because it provides investors an understanding of the ability of the Company to incur and service debt and to make capital expenditures. The Company believes that in order to facilitate a clear understanding of the operating results of the Company, FFO should be examined in conjunction with net income as presented in the consolidated financial statements included elsewhere in this report. FFO is determined in accordance with a definition adopted by the Board of Governors of the National Association of Real Estate Investment Trusts ("NAREIT") and is defined as net income (loss) computed in accordance with generally accepted accounting principles ("GAAP"), excluding gains (or losses) from debt restructuring and sales of property, plus depreciation of real estate assets and after adjustments for unconsolidated partnerships and joint ventures. FFO does not represent cash generated from operating activities in accordance with GAAP and therefore should not be considered an alternative to net income as an indication of the Company's performance or to net cash flows from operating activities as determined by GAAP as a measure of liquidity and is not necessarily indicative of cash available to fund cash needs. Further, FFO as calculated by other REITs may not be comparable to the Company's calculation of FFO. The calculation of FFO for the periods presented is reflected in the following table:

Summary Calculation of Funds from Operations

(Dollars in thousands)	Company (1)					The Greenbriar Group (2)
	Years ended				3-17-94 through	1-1-94 through
	12-31-98	12-31-97	12-31-96	12-31-95	12-31-94	3-16-94
Net income	$ 68,560	$ 31,461	$ 15,362	$ 10,543	$ 7,486	(716)
Convertible preferred dividend requirement	1,174	4,640	4,264	917	—	—
Depreciation (real estate related)	76,412	25,962	17,800	12,319	7,480	1,111
Joint venture adjustments	428	—	—	—	—	—
Amortization of non-recurring costs	360	354	356	517	464	—
Minority interest	1,188	—	—	—	—	—
Gain on sale of communities	(3,970)	—	—	(2,412)		
Extraordinary item	—	—	511	—	—	—
Funds from Operations	$ 144,152	$ 62,417	$ 38,293	$ 21,884	$ 15,430	$ 395
Weighted average common shares and units outstanding—diluted	50,146,909	25,508,309	17,817,623	12,196,003	11,544,287	—

(5) Gross EBITDA represents earnings before interest, income taxes, depreciation and amortization, gain on sale of communities and extraordinary items. Gross EBITDA is relevant to an understanding of the economics of the Company because it indicates cash flow available from Company operations to service fixed obligations. Gross EBITDA should not be considered as an alternative to operating income, as determined in accordance with GAAP, as an indicator of the Company's operating performance, or to cash flows from operating activities (as determined in accordance with GAAP) as a measure of liquidity. See "Communities" for property EBITDA and the related definition.

(6) These amounts include communities only after stabilized occupancy has occurred. A community is considered by the Company to have achieved stabilized occupancy on the earlier of (i) the first day of any month in which the community reaches 95% physical occupancy or (ii) one year after completion of construction. These amounts also include joint venture investments.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

Certain statements in this Annual Report, including the footnotes to the Company's financial statements, constitute "forward-looking statements" as that term is defined under the Private Securities Litigation Reform Act of 1995 (the "Reform Act"). The words "believe," "expect," "anticipate," "intend," "estimate," "assume" and other similar expressions which are predictions of or indicate future events and trends and which do not solely report historical matters identify forward-looking statements. In addition, information concerning construction, occupancy and completion of Development and Redevelopment Communities and Development Rights (as each term is hereinafter defined) and related cost, yield and EBITDA estimates, as well as the cost, timing and effectiveness of Year 2000 compliance, are forward-looking statements. Reliance should not be placed on forward-looking statements as they involve known and unknown risks, uncertainties and other factors, which are in some cases beyond the control of the Company and which may cause the actual results, performance or achievements of the Company to differ materially from the anticipated future results, performance or achievements expressed or implied by such forward-looking statements.

Certain factors that might cause such differences include, but are not limited to, the following: the Company may not be successful in managing its current growth in the number of apartment communities and the related growth of its business operations; the Company's expansion into new geographic market areas may not produce financial results that are consistent with its historical performance; acquisitions of portfolios of apartment communities may result in the Company acquiring communities that are more expensive to manage and portfolio acquisitions may not be successfully completed, resulting in charges to earnings; the Company may fail to secure or may abandon development opportunities; construction costs of a community may exceed original estimates; construction and lease-up of Development and Redevelopment Communities may not be completed on schedule, resulting in increased debt service expense, construction costs and reduced rental revenues; occupancy rates and market rents may be adversely affected by local economic and market conditions which are beyond management's control; financing may not be available on favorable terms, and reliance on cash flow from operations and access to cost effective capital may be insufficient to enable the Company to pursue opportunities or develop its pipeline of Development Rights; the Company's cash flow may be insufficient to meet required payments of principal and interest, and existing indebtedness may not be able to be refinanced or the terms of such refinancing may not be as favorable as the terms of existing indebtedness; and the Company and its suppliers and service providers may experience unanticipated delays or expenses in achieving Year 2000 compliance.

The following discussion should be read in conjunction with the consolidated financial statements and notes included in this report.

GENERAL

The Company is a real estate investment trust ("REIT") that is focused on the ownership and operation of institutional-quality apartment communities in high barrier-to-entry markets of the United States. These markets are located in Northern and Southern California and selected states in the Mid-Atlantic, Northeast, Midwest and Pacific Northwest regions of the country. The Company is the surviving corporation from the merger (the "Merger") of Avalon Properties, Inc. ("Avalon") with and into the Company (sometimes hereinafter referred to as "Bay" before the Merger) on June 4, 1998. The Merger was accounted for as a purchase of Avalon by Bay. In conjunction with the Merger, the Company changed its name from Bay Apartment Communities, Inc. to AvalonBay Communities, Inc.

The Company is a fully-integrated real estate organization with in-house acquisition, development, redevelopment, construction, reconstruction, financing, marketing, leasing and management expertise. With its experience and in-house capabilities, the Company believes it is well-positioned to continue to pursue opportunities to develop and acquire upscale apartment homes in its target markets, although the Company may be constrained by the need to access cost effective capital to finance this activity.

The Company's real estate investments as of March 1, 1999 consist primarily of apartment communities in various stages of the development cycle and land or land options held for development. Such investments can be divided into three categories:

	Number of communities	Number of apartment homes
Current Communities	127	37,910
Development Communities	14	3,262
Development Rights	27	7,239 (*)

(*) Represents an estimate

"Current Communities" are apartment communities where construction is complete and the community has either reached stabilized occupancy or is in the initial lease-up process or under redevelopment. Current Communities include the following sub-classifications:

- *Stabilized Communities.* Represents all Current Communities that have completed initial lease-up by attaining physical occupancy levels of at least 95% or have been completed for one year, whichever occurs earlier. For evaluation purposes, the Company regards each Stabilized Community as falling into one of three categories:

  West Coast Established Communities. Represents all Stabilized Communities owned by Bay as of January 1, 1997, with stabilized operating costs as of January 1, 1997 such that a comparison of 1997 operating results to 1998 operating results is meaningful. As of March 1, 1999, there were 22 West Coast Established Communities containing 5,702 apartment homes. When used in connection with a comparison of 1997 and 1996 results, the term "Established Communities" refers to communities that were stabilized as of January 1, 1996.

  East Coast Established Communities. Represents all Stabilized Communities owned by Avalon as of January 1, 1997 and subsequently acquired by the Company in connection with the Merger, with stabilized operating costs as of January 1, 1997 such that a comparison of 1997 operating results to 1998 operating results is meaningful. As of March 1, 1999, there were 34 East Coast Established Communities containing 10,171 apartment homes.

  Other Stabilized Communities. Represents Stabilized Communities as defined above, but which attained such classification or were acquired after January 1, 1997. As of March 1, 1999, there were 57 Other Stabilized Communities containing 16,473 apartment homes.

- *Lease-Up Communities.* Represents all Current Communities where construction has been complete for less than one year and the communities are in the initial lease-up process. As of March 1, 1999, there was one Lease-Up Community containing 710 apartment homes.

- *Redevelopment Communities.* Represents all Current Communities where substantial redevelopment has either begun or is scheduled to begin. Redevelopment is considered substantial when additional capital invested during the reconstruction effort exceeds the lesser of $5 million or 10% of the community's acquisition cost. As of March 1, 1999, there were 13 Redevelopment Communities containing 4,854 apartment homes.

"Development Communities" are communities that are under construction and may be partially complete and operating and for which a final certificate of occupancy has not been received.

"Development Rights" are development opportunities in the early phase of the development process for which the Company has an option to acquire land or owns land to develop a new community and where related pre-development costs have been incurred and capitalized in pursuit of these new developments.

Of the Current Communities, the Company holds a fee simple ownership interest in 109 operating communities (one of which is on land subject to a 149 year land lease); a general partnership interest in four partnerships that hold a fee simple interest in four other operating communities; a general partnership interest in four partnerships structured as "DownREITs" (as described more fully below) that own 13 communities; and a 100% interest in a senior participating mortgage note secured by one community. The Company holds a fee simple ownership interest in each of the Development Communities except for two communities that are owned by partnerships in which the Company holds a general partnership interest. In each of the four partnerships structured as "DownREITs," the Company is the general partner and there are one or more limited partners whose interest in the partnership is denominated in "units of limited partnership interest" ("Units"). For each DownREIT partnership, limited partners who hold Units are entitled to receive certain distributions (a "Stated Distribution") prior to any distribution that such DownREIT partnership makes to the general partner. The Stated Distributions that are paid in respect of the DownREIT Units currently approximate the dividend rate applicable to Common Stock of the Company. Each DownREIT partnership has been structured in a manner that makes it unlikely that the limited partners thereof will be entitled to any greater distribution than the Stated Distribution. Each holder of Units has the right to require the DownREIT partnership that issued a Unit to redeem that Unit at a cash price equal to the then fair market value of a share of Common Stock of the Company, except that the Company has the right to acquire any Unit so presented for redemption for one share of Common Stock. As of March 1, 1999, there were 894,144 Units outstanding. The DownREIT partnerships are consolidated for financial reporting purposes.

The Company's management ("Management") believes apartment communities present an attractive investment opportunity compared to other real estate investments because a broad potential resident base results in relatively stable demand during all phases of a real estate cycle. The Company intends to pursue appropriate new investments (both acquisitions of communities and new developments) in markets where constraints to new supply exist and where new household formations have out-paced multifamily permit activity in recent years.

At December 31, 1998, Management had positioned the Company's portfolio of Stabilized Communities, excluding communities owned by joint ventures, to an average physical occupancy level of 95.3% and achieved an average economic occupancy of 96.2% and 95.7% for the years ended December 31, 1998 and 1997, respectively. This continued high occupancy was achieved through aggressive marketing efforts combined with limited and targeted pricing adjustments. This positioning has resulted in overall growth in rental revenue from Established Communities between periods. It is Management's strategy to maximize total rental revenue through management of rental rates and occupancy levels. If market and economic conditions change, Management's strategy of maximizing total rental revenue could lead to lower occupancy levels. Given the high occupancy level of the portfolio, Management anticipates that any rental revenue and net income gains from the Company's Established Communities would be achieved primarily through higher rental rates and enhanced operating cost leverage provided by high occupancy.

The Company elected to be taxed as a REIT for federal income tax purposes for the year ended December 31, 1994 and has not revoked that election. The Company was incorporated under the laws of the State of California in 1978 and was reincorporated in the State of Maryland in July 1995. Its principal executive offices are located at 2900 Eisenhower Avenue, Suite 300, Alexandria, Virginia 22314, and its telephone number at that location is (703) 329-6300. The Company also maintains super-regional offices in San Jose, California and Wilton, Connecticut and acquisition, development, redevelopment, construction, reconstruction or administrative offices in or near Boston, Massachusetts; Chicago, Illinois; Minneapolis, Minnesota; New York, New York; Newport Beach, California; Princeton, New Jersey; Richmond, Virginia; and Seattle, Washington.

RECENT DEVELOPMENTS

Sales of Existing Communities. During 1998, the Company completed a strategic planning effort resulting in a decision to pursue a disposition strategy for certain assets in markets that did not meet its long-term strategic direction. In connection with this disposition strategy, during 1998 the Company sold seven communities, totaling 2,039 apartment homes. Net proceeds from the sale of these communities totaled $73.9 million resulting in a net gain of $4.0 million. The proceeds from the sale of these communities will be directed to the development and redevelopment of communities currently under construction or reconstruction.

In connection with an agreement executed by Avalon in March 1998 which provided for the buyout of certain limited partners in DownREIT V Limited Partnership, the Company sold two communities in July 1998. Net proceeds from the sale of the two communities, containing an aggregate of 758 apartment homes, were approximately $44 million.

Special Meeting of Stockholders. On October 2, 1998, the Company held a Special Meeting of Stockholders at which stockholders approved (i) amendments to the charter reducing the number of authorized shares of the Company's common stock from 300,000,000 to 140,000,000, and (ii) an amendment to the charter changing the Company's name from "Avalon Bay Communities, Inc." to "AvalonBay Communities, Inc."

Preferred Offering. On October 15, 1998, the Company completed the sale of 4,000,000 shares of 8.7% Series H Cumulative Redeemable Preferred Stock at a public offering price of $25 per share (the "Offering"). The net proceeds from the Offering of approximately $96.2 million were used to reduce borrowings under the Company's Unsecured Facility. These shares of Preferred Stock may not be redeemed by the Company until October 15, 2008 except in order to preserve the Company's status as a REIT.

Medium-Term Notes. In January 1999, the Company issued $125 million of medium-term notes. Interest on the notes is payable semi-annually on February 15 and August 15 and the notes will mature on February 15, 2004. The notes bear interest at 6.58%. The net proceeds of approximately $124.3 million were used to repay amounts outstanding under the Company's variable-rate unsecured credit facility (the "Unsecured Facility").

Organizational Changes. In February 1999, the Company announced certain management changes. The management changes included the departures of Charles H. Berman, the Company's President, Chief Operating Officer and a director; Jeffrey B. Van Horn, Senior Vice President–Investments; and Max L. Gardner, Senior Vice President-Development/Acquisitions. Other announced management changes included the promotion of Bryce Blair, then Senior Vice President–Development/Acquisitions, to Chief Operating Officer, and the promotion of Robert H. Slater, then Senior Vice President–Property Operations, to Executive Vice President. Messrs. Berman, Gardner and Van Horn are entitled to severance benefits in accordance with the terms of their employment agreements with the Company dated as of March 9, 1998. The Company expects to record a non-recurring charge in the first quarter of 1999 relating to this management realignment and certain related organizational adjustments. Because a complete plan of management realignment was not in existence on June 4, 1998, the date of the Company's merger with Avalon, this charge is not

considered a part of the Company's purchase price for Avalon and, accordingly, the expenses associated with the management realignment will be treated as a non-recurring charge. Management and the terminated officers are currently determining the amount of severance that each terminated officer is entitled to receive pursuant to their employment agreements and the valuations, if any, that must be performed pursuant to the terms of their employment agreements. Management is also completing an evaluation of the additional charge related to the other organizational changes. However, management currently estimates that the non-recurring charge that will be incurred in connection with these organizational adjustments, including severance payments and contract termination costs, costs to relocate accounting functions and office space reductions, will be approximately $16 million. No assurance can be given as to the amount of such non-recurring charge, which could be greater or less than the estimate provided.

RESULTS OF OPERATIONS

The changes in operating results from period-to-period (on a historical basis) are primarily the result of increases in the number of apartment homes owned due to the Merger as well as the development and acquisition of additional communities. Where appropriate, comparisons are made on a weighted average basis for the number of occupied apartment homes in order to adjust for such changes in the number of apartment homes. For Stabilized Communities (excluding communities owned by joint ventures), all occupied apartment homes are included in the calculation of weighted average occupied apartment homes for each reporting period. For communities in the initial lease-up phase, only apartment homes of communities that are completed and occupied are included in the weighted average number of occupied apartment homes calculation for each reporting period.

Comparisons are also made between West and East Coast Established Communities for rental income, operating expenses and property taxes. East Coast Established Communities are compared on a pro forma basis for the years ended December 31, 1998 and 1997, as if the Merger had occurred as of January 1, 1997. Management closely reviews these results as an indication of market strength and the effectiveness with which the communities are operated.

COMPARISON OF YEAR ENDED DECEMBER 31, 1998 TO YEAR ENDED DECEMBER 31, 1997

Net income increased $55,493,000 (142.5%) to $94,434,000 for the year ended December 31, 1998 compared to $38,941,000 for the year ended December 31, 1997. The primary reason for the increase is additional operating income from the communities owned by Avalon prior to the Merger. The increase is also attributable to additional operating income from communities developed or acquired during 1998 and 1997, as well as growth in operating income from West Coast Established Communities.

Rental income increased $225,642,000 (178.5%) to $352,017,000 for the year ended December 31, 1998 compared to $126,375,000 for the year ended December 31, 1997. Of the increase, $4,991,000 relates to rental revenue increases from West Coast Established Communities, $144,213,000 relates to rental revenue attributable to the former Avalon communities and $76,438,000 is attributable to the addition of newly completed or acquired apartment homes.

- Overall Portfolio—The $225,642,000 increase is primarily due to increases in the weighted average number of occupied apartment homes as well as an increase in the weighted average monthly rental income per occupied apartment home. The weighted average number of occupied apartment homes increased from 8,084 apartment homes for the year ended December 31, 1997 to 20,524 apartment homes for the year ended December 31, 1998 as a result of additional apartment homes from the former Avalon communities and the development and acquisition of new communities. For the year ended December 31, 1998, the weighted average monthly revenue per occupied apartment home increased $42 (3.8%) to $1,137 compared to $1,095 for the year ended December 31, 1997.

- West Coast Established Communities—Rental revenue increased $4,991,000 (6.8%) for the year ended December 31, 1998 compared to the preceding year due to market conditions that allowed for higher average

rents, but lower economic occupancy levels. For the year ended December 31, 1998, weighted average monthly revenue per occupied apartment home increased $81 (7.4%) to $1,172 compared to $1,091 for the preceding year. The average economic occupancy decreased from 97.7% for the year ended December 31, 1997 to 97.1% for the year ended December 31, 1998.

- The Company's West Coast Established Communities consist entirely of communities located within the Northern California market. Compared to the prior year, most of the sub-markets within Northern California where the Company's communities are located have maintained a strong economic environment that has allowed for high occupancy levels and rent growth. However, Management believes that, beginning in October 1998, certain Northern California sub-markets that are primarily dependent on Silicon Valley employment have softened, in part due to Asian economic difficulties. These impacted sub-markets have experienced reduced rent growth and occupancy compared to other Northern California sub-markets.

- East Coast Established Communities—Rental revenue (on a pro forma basis) increased $5,079,000 (4.7%) for the year ended December 31, 1998 compared to the preceding year due to market conditions that allowed for higher average rents at higher economic occupancy levels. For the year ended December 31, 1998, weighted average monthly revenue per occupied apartment home increased $40 (4.4%) to $969 compared to $929 for the preceding year. The average economic occupancy increased from 96.0% for the year ended December 31, 1997 to 96.3% for the year ended December 31, 1998.

Management fees totaling $793,000 for the year ended December 31, 1998 represent revenue from certain third-party contracts the Company succeeded to in connection with the Merger.

Operating expenses increased $63,546,000 (195.9%) to $95,980,000 for the year ended December 31, 1998 compared to $32,434,000 for the preceding year.

- Overall Portfolio—The increase in operating expenses for the year ended December 31, 1998 is primarily due to additional operating expenses from the former Avalon communities and, secondarily, due to the addition of newly developed, redeveloped or acquired apartment homes. Maintenance, insurance and other costs associated with Development and Redevelopment Communities are expensed as communities move from the initial construction and lease-up phase to the stabilized operating phase.

- West Coast Established Communities—Operating expenses for the West Coast Established Communities increased $97,000 (.6%) to $15,127,000 for the year ended December 31, 1998 compared to $15,030,000 for the preceding year. The net change is the result of higher payroll and maintenance costs, offset by lower utility, administrative and insurance costs. Lower insurance costs are directly attributable to better pricing and risk sharing provided by the merger with Avalon.

- East Coast Established Communities—Operating expenses for the East Coast Established Communities (on a pro forma basis) increased $597,000 (2.3%) to $26,251,000 for the year ended December 31, 1998 compared to $25,654,000 for the preceding year. The net change is the result of higher payroll and maintenance costs, offset by lower utility and insurance costs. Lower insurance costs are attributable to the Merger due to better pricing.

Property taxes increased $20,239,000 (212.2%) to $29,778,000 for the year ended December 31, 1998 compared to $9,539,000 for the preceding year.

- Overall Portfolio—The increase in 1998 property taxes is primarily due to additional expense from the former Avalon communities and secondarily due to the addition of newly developed, redeveloped or acquired apartment

homes. Property taxes on Development and Redevelopment Communities are expensed as communities move from the initial construction and lease-up phase to the stabilized operating phase.

- West Coast Established Communities—Property taxes for the West Coast Established Communities increased $230,000 (4.6%) to $5,246,000 for the year ended December 31, 1998 compared to $5,016,000 for the comparable period of the preceding year. The increase is primarily the result of lower than estimated property tax assessments that resulted in a reduction in 1997 of previously accrued expenses.

- East Coast Established Communities—Property taxes for the East Coast Established Communities (on a pro forma basis) increased $348,000 (3.6%) to $10,062,000 for the year ended December 31, 1998 compared to $9,714,000 for the preceding year. The increase is primarily the result of increased assessments of property values and increased property tax rates.

Interest expense increased $39,890,000 (282.6%) to $54,003,000 for the year ended December 31, 1998 compared to $14,113,000 for the comparable period of the preceding year. The increase is primarily attributable to $643,410,000 of debt assumed in connection with the Merger and secondarily due to the issuance of unsecured senior notes in 1998 and 1997.

Depreciation and amortization increased $51,350,000 (190.1%) to $78,359,000 for the year ended December 31, 1998 compared to $27,009,000 for the preceding year. The increase is primarily attributable to additional expense from the former Avalon communities and secondarily to acquisitions and development of communities in 1998 and 1997.

General and administrative expenses increased $3,568,000 (86.9%) to $7,674,000 for the year ended December 31, 1998 compared to $4,106,000 for the preceding year. The increase is primarily due to the Merger.

Equity in income of unconsolidated joint ventures of $1,525,000 for the year ended December 31, 1998 represents the Company's share of income of certain joint ventures that the Company succeeded to in connection with the Merger.

Interest income increased $2,985,000 to $3,191,000 for the year ended December 31, 1998 compared to $206,000 for the preceding year. The increase is primarily due to the interest on the Avalon Arbor promissory note that the Company succeeded to in connection with the Merger and on the Fairlane Woods promissory note acquired in August 1998.

COMPARISON OF YEAR ENDED DECEMBER 31, 1997 TO YEAR ENDED DECEMBER 31, 1996

Net income increased $19,315,000 (98.4%) to $38,941,000 for the year ended December 31, 1997 compared to $19,626,000 for the year ended December 31, 1996. The primary reason for the increase is additional rental income from communities acquired during the latter half of 1996 and throughout 1997, as well as growth in operating income from Established Communities.

Rental income increased $43,542,000 (52.6%) to $126,375,000 for the year ended December 31, 1997 compared to $82,833,000 for the year ended December 31, 1996. Of the increase, $6,539,000 relates to rental revenue increases from Established Communities and $37,003,000 is attributable to the addition of newly completed or acquired apartment homes.

- Overall Portfolio—The $43,542,000 increase is primarily due to increases in the weighted average number of occupied apartment homes as well as an increase in the weighted average monthly rental income per occupied

apartment home. The weighted average number of occupied apartment homes increased from 7,545 apartment homes for the year ended December 31, 1996 to 8,084 apartment homes for the year ended December 31, 1997 as a result of the development and acquisition of new communities. For the year ended December 31, 1997, the weighted average monthly revenue per occupied apartment home increased $112 (11.4%) to $1,095 compared to $983 for the year ended December 31, 1996.

- Established Communities—Rental revenue increased $6,539,000 (10.0%) for the year ended December 31, 1997 compared to the preceding year primarily due to an increase in rental rates and increased occupancy. For the year ended December 31, 1997, weighted average monthly revenue per occupied apartment home increased $87 (9.3%) to $1,020 compared to $933 for the preceding year. The average economic occupancy increased from 96.8% for the year ended December 31, 1996 to 97.5% for the year ended December 31, 1997.

Operating expenses increased $11,043,000 (51.6%) to $32,434,000 for the year ended December 31, 1997 compared to $21,391,000 for the preceding year.

- Overall Portfolio—The increase for the year ended December 31, 1997 is primarily due to additional expense from the acquisition of new communities as well as the addition of newly completed homes for which maintenance, insurance and other costs are expensed as communities move from the initial construction and lease-up phase to the stabilized operating phase.

- Established Communities—Operating expenses increased $1,034,000 (7.1%) to $15,675,000 for the year ended December 31, 1997 compared to $14,641,000 for the preceding year. The net change is primarily attributable to the completion of certain redevelopment communities and to higher maintenance costs, and secondarily to increased earthquake insurance costs due to the purchase of portfolio wide coverage.

Property taxes increased $3,158,000 (49.5%) to $9,539,000 for the year ended December 31, 1997 compared to $6,381,000 for the preceding year.

- Overall Portfolio—The increase in 1997 is primarily due to additional expense from the acquisition of new communities as well as the addition of newly completed homes for which property taxes are expensed as communities move from the initial construction and lease-up phase to the stabilized operating phase.

- Established Communities—Property taxes decreased $50,000 (1.0%) to $4,950,000 for the year ended December 31, 1997 compared to $5,000,000 for the comparable period of the preceding year. The decrease is primarily the result of lower than estimated property tax assessments that resulted in a reduction in 1997 of previously accrued expenses.

Interest expense decreased $163,000 (1.1%) to $14,113,000 for the year ended December 31, 1997 compared to $14,276,000 for the twelve months ended December 31, 1996. The decrease is primarily attributable to higher capitalization of interest from increased development, construction and reconstruction activity financed primarily with common and preferred stock issuances, offset in part by increased borrowing for new acquisitions.

Depreciation and amortization increased $8,320,000 (44.5%) to $27,009,000 for the year ended December 31, 1997 compared to $18,689,000 for the preceding year. The increase reflects additional expense from the acquisitions, development and redevelopment of communities in 1997 and 1996.

General and administrative expenses increased $2,283,000 (125.2%) to $4,106,000 for the year ended December 31, 1997 compared to $1,823,000 for the preceding year. The increase is primarily due to staff additions and other costs related to the growth of the Company's portfolio.

Interest income increased $28,000 (15.7%) to $206,000 for the twelve months ended December 31, 1997 compared to $178,000 for the preceding year, primarily due to higher average cash balances during 1997 as compared to 1996.

CAPITALIZATION OF FIXED ASSETS AND COMMUNITY IMPROVEMENTS

The Company maintains a policy with respect to capital expenditures that generally provides that only non-recurring expenditures are capitalized. Improvements and upgrades are capitalized only if the item exceeds $15,000, extends the useful life of the asset and is not related to making an apartment home ready for the next resident. Under this policy, virtually all capitalized costs are non-recurring, as recurring make ready costs are expensed as incurred, including costs of carpet and appliance replacements, floor coverings, interior painting and other redecorating costs. Purchases of personal property (such as computers and furniture) are capitalized only if the item is a new addition (i.e., not a replacement) and only if the item exceeds $2,500. The application of these policies for the year ended December 31, 1998 resulted in non-revenue generating capitalized expenditures for Stabilized Communities of approximately $158 per apartment home on a pro forma basis for the Merger. For the year ended December 31, 1998 the Company charged to maintenance expense, including carpet and appliance replacements, a total of approximately $24,500,000 for Stabilized Communities or $946 per apartment home on a pro forma basis. Management anticipates that capitalized costs per apartment home will gradually rise as the Company's portfolio of communities matures.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity. A primary source of liquidity to the Company is cash flows from operations. Operating cash flows have historically been determined by the number of apartment homes, rental rates, occupancy levels and the Company's expenses with respect to such apartment homes. The cash flows provided by financing activities and used in investing activities have historically been dependent on the capital markets environment, and thus the number of apartment homes under active development and construction as well as those that were acquired during any given period.

Cash and cash equivalents increased from $3,188,000 at December 31, 1997 to $8,890,000 at December 31, 1998 due to the excess of cash provided by financing and operating activities over cash flow used in investing activities.

- Net cash provided by operating activities increased by $128,579,000 from $62,650,000 for the year ended December 31, 1997 to $191,229,000 for the year ended December 31, 1998 primarily due to an increase in operating income from the former Avalon communities as well as the existing Bay communities.

- Cash used in investing activities increased $44,259,000 from $574,970,000 for the year ended December 31, 1997 to $619,229,000 for the year ended December 31, 1998. This increase in expenditures reflects increased construction and reconstruction activity, net of a decrease in acquisition activity (which is attributable to the purchase of the Southern California Travelers portfolio in 1997 not present in 1998 combined with higher yield requirements in 1998 that constrained investing activity) and the proceeds from the sale of communities in 1998.

- Net cash provided by financing activities decreased by $80,886,000 from $514,588,000 for the year ended December 31, 1997 to $433,702,000 for the year ended December 31, 1998 primarily due to reduced financing activity in response to unfavorable capital markets. The increase is also attributable to an increase in dividends paid, as a result of a 21% Common Stock dividend increase in July 1998 and additional common and preferred shares issued in connection with the Merger.

Cash and cash equivalents increased from $920,000 at December 31, 1996 to $3,188,000 at December 31, 1997 due to the excess of cash provided by financing and operating activities over cash flow used in investing activities.

- Net cash provided by operating activities increased by $23,426,000 from $39,224,000 for the year ended December 31, 1996 to $62,650,000 for the year ended December 31, 1997 primarily due to an increase in operating income from acquisition and existing communities.

- Cash used in investing activities increased by $358,970,000 from $216,000,000 for the year ended December 31, 1996 to $574,970,000 for the year ended December 31, 1997. This increase reflects the increase in expenditures for communities acquired in Southern California, and the amounts used to acquire, develop, construct and reconstruct the Development and Redevelopment Communities.

- Net cash provided by financing activities increased by $338,569,000 from $176,019,000 for the year ended December 31, 1996 to $514,588,000 for the year ended December 31, 1997 primarily due to higher net proceeds from securities offerings and borrowings under the unsecured credit facility in 1997 as compared to 1996, offset by an increase in dividends paid.

The Company regularly reviews its short-term liquidity needs and the adequacy of Funds from Operations ("FFO") and other expected liquidity sources to meet these needs. The Company believes that its principal short-term liquidity needs are to fund normal recurring operating expenses, debt service payments, the distribution required with respect to the Preferred Stock and the minimum dividend payments required to maintain the Company's REIT qualification under the Internal Revenue Code of 1986, as amended. Management anticipates that these needs will be fully funded from cash flows provided by operating activities. Any short-term liquidity needs not provided by current operating cash flows would be funded from the Company's Unsecured Facility.

Management anticipates that no significant portion of the principal of any indebtedness will be repaid prior to maturity and if the Company does not have funds on hand sufficient to repay such indebtedness, it will be necessary for the Company to refinance this debt. Such refinancing may be accomplished through additional debt financing, which may be collateralized by mortgages on individual communities or groups of communities, by uncollateralized private or public debt offerings or by additional equity offerings. There can be no assurance that such additional debt financing or debt or equity offerings will be available or, if available, that they will be on terms satisfactory to the Company.

Capital Resources. Management intends to match the long-term nature of its real estate assets with long-term cost effective capital. The Company has benefited from regular and continuous access to the capital markets since its initial public offering, raising approximately $2.5 billion, on a pro forma basis. Approximately $800 million, on a pro forma basis, has been raised in capital markets offerings since January 1, 1998. The following table summarizes capital market activity for both Avalon and the Company since January 1, 1998:

Date	Company	Description of Offerings
January 1998	Avalon	$100 million unsecured senior notes offering
January 1998	Avalon	$26.9 million direct placement of common stock to an institutional investor
January 1998	Bay	$150 million unsecured senior notes offering
April 1998	Bay	$46.5 million public offering of Common Stock
July 1998	AvalonBay	$250 million unsecured senior notes offering
October 1998	AvalonBay	$100 million public offering of Series H Cumulative Redeemable Preferred Stock
January 1999	AvalonBay	$125 million medium term notes offering

Management follows a focused strategy to help facilitate uninterrupted access to capital. This strategy includes:

1. Hire, train and retain associates with a strong resident service focus, which should lead to higher rents, lower turnover and reduced operating costs;
2. Manage, acquire and develop institutional quality communities with in-fill locations that should provide consistent, sustained earnings growth;
3. Operate in markets with growing demand (as measured by household formation and job growth) and high barriers-to-entry. These characteristics combine to provide a favorable demand-supply balance, which the Company believes will create a favorable environment for future rental rate growth while protecting existing and new communities from new supply. This strategy is expected to result in a high level of quality to the revenue stream;
4. Maintain a conservative capital structure largely comprised of equity and with modest, cost-effective leverage. Secured debt will generally be avoided and used primarily to secure low cost, tax-exempt debt. Management believes that such a capital structure should promote an environment whereby current ratings levels can be maintained;
5. Follow accounting practices that provide a high level of quality to reported earnings; and
6. Provide timely, accurate and detailed disclosures to the investment community.

Management believes these strategies provide a disciplined approach to capital access to help position the Company to fund portfolio growth.

Recent volatility in the capital markets has decreased the Company's access to cost effective capital. See "Future Financing and Capital Needs" for a discussion of Management's response to the current capital markets environment.

The following is a discussion of specific capital transactions, arrangements and agreements that are important to the capital resources of the Company.

UNSECURED FACILITY

The Company's Unsecured Facility is furnished by a consortium of banks that provides for $600,000,000 in short-term credit and is subject to an annual facility fee of $900,000. The Unsecured Facility bears interest at varying levels tied to the London Interbank Offered Rate ("LIBOR") based on ratings levels achieved on the Company's senior unsecured notes and on a maturity selected by the Company. The current pricing is LIBOR plus .6% per annum and matures in July 2001, with two one-year extension options. The Unsecured Facility, which was put into place during June 1998, replaced three separate credit facilities previously available to the separate companies prior to the Merger that had terms similar to the Unsecured Facility. A competitive bid option (which allows banks that are part of the lender consortium to bid to make loans to the Company at a rate that is lower than the stated rate provided by the Unsecured Facility) is available for up to $400,000,000 which may result in lower pricing if market conditions allow. Pricing under the competitive bid option resulted in average pricing of LIBOR plus .48% for balances most recently placed under the competitive bid option. At March 1, 1999, $285,500,000 was outstanding, $30,200,000 was used to provide letters of credit and $284,300,000 was available for borrowing under the Unsecured Facility. The Company will use borrowings under the Unsecured Facility for capital expenditures, acquisitions of developed or undeveloped communities, construction, development and renovation costs, credit enhancement for tax-exempt bonds and for working capital purposes.

INTEREST RATE PROTECTION AGREEMENTS

The Company is not a party to any long-term interest rate agreements, other than interest rate protection and swap agreements on certain tax-exempt indebtedness. The Company intends, however, to evaluate the need for long-term interest rate protection agreements as interest rate market conditions dictate and has engaged a consultant to assist in managing the Company's interest rate risks and exposure.

FINANCING TRANSACTIONS COMPLETED

In January 1998, Avalon completed a $100,000,000 offering of unsecured senior notes. The notes bear interest at 6.625% payable semi-annually on January 15 and July 15 and will mature on January 15, 2005. The Company used the net proceeds of approximately $99,000,000 to repay amounts outstanding under Avalon's unsecured credit facilities.

In January 1998, Avalon completed the sale of 923,856 shares of common stock to The Prudential Insurance Company of America at a net purchase price of $29.09 per share. The net proceeds of approximately $27,000,000 were used to retire indebtedness under Avalon's unsecured credit facilities.

In January 1998, Bay issued $150,000,000 of senior unsecured notes, of which $50,000,000 of the notes bear interest at 6.25% and will mature in January 2003, $50,000,000 of the notes bear interest at 6.5% and will mature in January 2005 and $50,000,000 of the notes bear interest at 6.625% and will mature in January 2008. Semi-annual interest payments are payable on January 15 and July 15. The net proceeds of approximately $149,000,000 were used to reduce borrowings under Bay's then existing unsecured credit facility.

In April 1998, Bay sold 1,244,147 shares of Common Stock in an underwritten public offering at a public offering price of $37.375 per share. The net proceeds to Bay of approximately $44,000,000 were used to reduce borrowings under the Company's unsecured credit facility.

In July 1998, the Company issued $250,000,000 of senior unsecured notes, of which $100,000,000 of the notes bear interest at 6.5% and will mature in July 2003 and $150,000,000 of the notes bear interest at 6.8% and will mature in July 2006. Semi-annual interest payments are payable on January 15 and July 15. The net proceeds of $248,000,000 were used to reduce borrowings under the Company's Unsecured Facility.

In October 1998, the Company completed an underwritten public offering of 4,000,000 shares of 8.7% Series H Cumulative Redeemable Preferred Stock at a public price of $25 per share. Quarterly dividends are payable on March 15, June 15, September 15 and December 15. The net proceeds of approximately $97,000,000 were used to reduce borrowings under the Company's Unsecured Facility.

In January 1999, the Company issued $125,000,000 of medium-term unsecured notes bearing interest at 6.58% and maturing in February 2004. Semi-annual interest payments are payable on February 15 and August 15. The net proceeds of approximately $124,000,000 were used to reduce borrowings under the Company's Unsecured Facility.

REGISTRATION STATEMENTS FILED IN CONNECTION WITH FINANCINGS

On August 18, 1998, the Company filed a shelf registration statement on Form S-3 with the Securities and Exchange Commission relating to the sale of up to $750,000,000 of securities. The registration statement provides for the issuance of Common Stock, Preferred Stock and debt securities.

FUTURE FINANCING AND CAPITAL NEEDS

As of December 31, 1998, the Company had 24 new communities under construction by the Company or by others for the Company (for which the Company has entered into forward purchase commitments) with a total estimated cost of $497,000,000 remaining to be invested as of that date. In addition, the Company had a total of 13 communities that were under reconstruction of which an estimated $68,000,000 remained to be invested as of that date.

Substantially all of the capital expenditures to complete the communities currently under construction and reconstruction will be funded from the Unsecured Facility, the sale of existing communities, retained operating cash or the issuance of debt or equity securities. Management expects to continue to fund deferred development costs related to future developments from FFO and borrowings under the Unsecured Facility as these sources of capital are expected to be adequate to take the proposed communities to the point in the development cycle where construction can commence.

The industry and the Company have seen a reduction in the availability of cost effective capital over the last nine months. No assurance can be provided that cost effective capital will be available to meet future expenditures required to commence planned reconstruction activity or the construction of the Development Rights. Before planned reconstruction activity or the construction of a Development Right commences, the Company intends to arrange adequate liquidity sources to complete such undertakings, although no assurance can be given in this regard.

Management estimates that a significant portion of the Company's liquidity needs will be met from retained operating cash and borrowings under the Company's Unsecured Facility. To meet the balance of the Company's liquidity needs, it will be necessary to arrange additional capacity under the Company's existing Unsecured Facility, sell additional existing communities and/or issue additional debt or equity securities. While Management believes the Company has the financial position to expand its short term credit capacity and support such capital markets activity, no assurance can be provided that the Company will be successful in completing these arrangements, offerings or sales. If these transactions cannot be completed on a cost-effective basis, then a continuation of the current capital market conditions described herein could have a material adverse impact on the operating results and financial condition of the Company, including the abandonment of deferred development costs and a resultant charge to earnings.

During 1998, the Company determined that it would pursue a disposition strategy for certain assets in markets that did not meet its long-term strategic direction. In connection with this decision, the Company's Board of Directors authorized Management to pursue the disposition of certain communities. The Company will solicit competing bids from unrelated parties for these individual assets, and will consider the sales price and tax ramifications of each proposal. Management intends to actively seek buyers for these assets during 1999. However, there can be no assurance that such assets can be sold on terms that are satisfactory to the Company. The Company disposed of the following communities in connection with this disposition strategy (dollars in thousands) as of March 1, 1999:

Communities	Location	Period disposed	Apartment homes	Debt	Gross sales price	Net proceeds
Arbor Park	Upland, CA	3Q98	260	$ —	$ 12,580	$12,540
Avalon Pointe	Stafford, VA	4Q98	140	6,380	9,450	2,920
Avalon Ridge	Silver Spring, MD	4Q98	432	26,815	35,210	7,700
Chase Lea	Owings Mill, MD	4Q98	296	16,835	21,840	4,500
Avalon at Carter Lake	Reston, VA	4Q98	259	—	16,800	16,560
Reflections	Fresno, CA	4Q98	516	—	22,420	21,980
Sommerset	Vacaville, CA	4Q98	136	—	7,900	7,700
			2,039	$50,030	$126,200	$73,900

To facilitate the sale of Sommerset, the Company provided financing to the purchaser for 80% of the gross sales price. Accordingly, $6,320,000 of the net proceeds will be received at maturity of this financing.

The proceeds from the sale of these communities will be re-deployed to the development and redevelopment communities currently under construction or reconstruction. Pending such redeployment, the proceeds from the sale of these communities were primarily used to repay amounts outstanding under the Company's Unsecured Facility.

The remaining assets that have been identified for disposition include land, buildings and improvements and furniture, fixtures and equipment. At December 31, 1998, total real estate, net of accumulated depreciation, of all communities currently identified for sale totaled $231,492,000. Certain individual assets are secured by mortgage indebtedness which may be assumed by the purchaser or repaid by the Company from the net sales proceeds. The Company's consolidated statements of operations includes net income from the communities held for sale of $3,916,000, $1,633,000 and $1,301,000 for the years ended December 31, 1998, 1997 and 1996, respectively.

In connection with an agreement executed by Avalon in March 1998 which provided for the buyout of certain limited partners in DownREIT V Limited Partnership, the Company sold two communities in July 1998. Gross proceeds from the sale of the two communities, containing an aggregate of 758 apartment homes, were approximately $44 million.

Because the proceeds from the sale of communities are used initially to reduce borrowings under the Unsecured Facility, the immediate effect of a sale of a community is to reduce earnings, as the yield on a community that is sold exceeds the interest rate on borrowings under the Unsecured Facility. Therefore, changes in the timing, number of dispositions and the redeployment of the net proceeds therefrom may have a material and adverse effect on the Company's earnings.

INFLATION

Substantially all of the leases at the Current Communities are for a term of one year or less, which may enable the Company to realize increased rents upon renewal of existing leases or commencement of new leases. Such short-term leases generally minimize the risk to the Company of the adverse effects of inflation, although these leases generally permit residents to leave at the end of the lease term without penalty. Short-term leases combined with relatively consistent demand allow rents, and, therefore, cash flow from the Company's portfolio of apartments, to provide an attractive inflation hedge.

YEAR 2000 COMPLIANCE

The statements in the following section include "Year 2000 readiness disclosure" within the meaning of the Year 2000 Information and Readiness Disclosure Act of 1998.

The Year 2000 compliance issue concerns the inability of computer systems to accurately calculate, store or use a date after December 31, 1999. This could result in a system failure causing disruptions of operations or create erroneous results. The Year 2000 issue affects virtually all companies and organizations.

Management has been taking steps to understand the nature and extent of the work required to make its information computer systems ("IT Systems") and non-information embedded systems ("Non-IT Systems") Year 2000 compliant, as well as to determine what effects non-compliance by the Company's significant business partners may have on the Company. Management has assigned key personnel to the Company's Year 2000 Task Force ("the Task Force") to coordinate compliance efforts. The Task Force is represented by executive, financial and community operation functions. An outside consulting firm ("Y2K Consultants") has been engaged by the Company to assist the Task Force

in detecting Non-IT Systems that are not Year 2000 compliant. The Y2K Consultants will aid in assessing the compliance of the Company's Non-IT Systems and, for non-compliant systems, will recommend replacement, upgrades or alternative solutions based on the system's importance to business operations or financial impact, likelihood of failure, life safety concerns and available contingency options.

Management has identified certain phases necessary to become Year 2000 compliant and has established an estimated timetable for completion of those phases, as shown below:

Phase	Definition	Estimated completion date as of March 1, 1999
1. Designate Task Force	Assign key management personnel to the Company's Year 2000 Task Force ("the Task Force") to coordinate compliance efforts	Completed
2. Introduce Year 2000 Awareness	Communicate the Year 2000 issue to the Company. Ensure current and future acquisition, development and operation processes address Year 2000 compliance	Completed
3. Inventory System 3.1 Initial Review 3.2 Follow-up Review	Initial Review: Identify the Company's information computer systems ("IT Systems") and non-information embedded systems ("Non-IT Systems") and provide findings to Y2K Consultant Follow-up Review: Utilize Y2K Consultant analysis of the Initial Review to detect previously unknown Non-IT systems	Initial Review: Completed Follow-up Review: March 31, 1999
4. Contact Vendors	Contact vendors of all IT and Non-IT Systems to request assurance regarding the compliance of those systems	IT Systems: Completed Non-IT Systems: April 15, 1999
5. Prioritize and Budget	Prioritize non-compliant IT and Non-IT Systems and prepare initial budget for cost of becoming compliant	April 30, 1999
6. Identify Solutions	Identify the course of action necessary to become Year 2000 compliant, and engage third party service providers where needed	April 30, 1999
7. Contingency Plan 7.1 General Community 7.2 Site Specific	Develop contingency plans to minimize disruptions and data processing errors in the event impacted IT and Non-IT Systems are not Year 2000 compliant on January 1, 2000. General Community contingency plans will be developed for each community type. Where necessary (as determined by system inventory) Site Specific contingency plans will be developed	General Comm: May 15, 1999 Site Specific: October 31, 1999
8. Replace/Upgrade and Test Solutions	Replace or upgrade certain non-compliant IT and Non-IT Systems and test functionality of critical systems	Replace/Upgrade: July 31, 1999 Test: October 31, 1999
9. Communicate to Residents	Communicate to residents steps the Company has taken towards becoming Year 2000 compliant and remaining IT and Non-IT Systems that may still be impacted	October 31, 1999

The Year 2000 Task Force has completed the Inventory System Phase for computerized IT Systems. The assessment determined that it will be necessary to modify, update or replace limited portions of the Company's computer hardware and software applications.

The Company anticipates that replacing and upgrading certain existing IT Systems (both hardware and software) in the normal course of business will result in Year 2000 compliance by the end of the second quarter of 1999. The vendor that provides the Company's existing accounting software has a compliant version of its product, but growth in the Company's operations requires a general ledger system with scope and functionality that is not present in either the system currently in use or the Year 2000 compliant version of that system. Accordingly, the Company is replacing the current general ledger system with an enhanced system that, in addition to increased functionality, is Year 2000 compliant. The new general ledger system has been selected and is expected to be implemented by the third quarter of 1999. The Company is not treating the cost of this new system as a Year 2000 expense because the implementation date has not been accelerated due to Year 2000 compliance concerns. The cost of the new general ledger system, after considering anticipated efficiencies provided by the new system, is not currently expected to have a material effect (either beneficial or adverse) on the Company's financial condition or results of operations.

The Task Force has also completed the Initial Review of the Inventory System Phase of the Company's Non-IT Systems (e.g., security, heating and cooling, fire and elevator systems) at each community that may not be Year 2000 compliant and has identified areas of risks for non-compliance by community type. The high-rises, mid-rises and newer garden communities represent the greatest risk of non-compliant systems as they have the most systems per community. In conjunction with the Y2K Consultants, the Task Force is currently conducting an assessment of these systems at all communities to identify and evaluate the changes and modifications necessary to make these systems compliant for Year 2000 processing. The Task Force is currently conducting the Follow-up Review of the Inventory System Phase to ensure any previously undetected Non-IT Systems are addressed for Year 2000 compliance. This review is expected to be completed by March 31, 1999.

The Y2K Consultants are currently in the process of verifying inventory and obtaining risk assurance regarding Year 2000 compliance of detected Non-IT Systems, and this process is expected to be completed by April 15, 1999. The Task Force and Y2K Consultants will prioritize the non-compliant systems, if any, and proceed according to the phases described above. No assurance, however, can be given that completion of the above phases will identify all non-compliant systems.

Upon completion of each of the above described upgrades and replacements of the Company's IT and Non-IT Systems, the Company will commence testing to ensure Year 2000 compliance. Testing will be performed on systems:

- which are critical to business operations or life safety;
- which entail a material financial impact in the event of non-compliance;
- with a high likelihood of failure;
- for which the Task Force is unable to obtain reliable third party assurance that the detected system is Year 2000 compliant; and
- which are not deemed to have acceptable contingency options.

The Company currently expects its testing to be completed during the fourth quarter of 1999. While the Company anticipates such tests will be successful in all material respects, the Task Force intends to closely monitor the

Company's Year 2000 compliance progress and will develop contingency plans in the event Non-IT Systems are not compliant. The Task Force will create functional contingency plans by community type that will encompass substantially all of the Company's existing portfolio, discussed above as General Community contingency plans. For certain communities, primarily communities with high-rise buildings, specific contingency plans will be required, discussed above as Site Specific contingency plans. The Task Force will continue to review both compliance and contingency plans, throughout all of the above phases, in an effort to detect if any systems will not be compliant on time.

Management currently anticipates that the costs of becoming Year 2000 compliant for all impacted Non-IT Systems will be approximately $750,000, based on the current progress towards the completion of the Prioritize and Budget Phase. Based on available information, the Company believes that the ultimate cost of achieving Year 2000 compliance will not have a material adverse effect on its business, financial condition or results of operations. However, no assurance can be given that the Company will be Year 2000 compliant by December 31, 1999 or that the Company will not incur significant costs pursuing Year 2000 compliance.

The third parties with which the Company has material relationships include the Company's utility providers and the vendor that will provide the Company's new accounting software system. The Company, together with the Y2K Consultants, is communicating with these and other third party vendors to determine the efforts being made on their part for compliance and to request representation that their systems will be Year 2000 compliant. No assurance can be given that such representations will be received by the Company or that they will prove to be accurate. As described above, the Company expects that its accounting software will be Year 2000 compliant.

The Company is not aware of third parties, other than its residents and owners of communities for which the Company provides community management services, to which it could have potential material liabilities should its IT or Non-IT Systems be non-compliant on January 1, 2000. The inability of the Company to achieve Year 2000 compliance on its Non-IT Systems by January 1, 2000 may cause disruption in services that could potentially lead to declining occupancy rates, rental concessions, or higher operating expenses, and other material adverse effects, which are not quantifiable at this time. These disruptions may include, but are not limited to, disabled fire control systems, lighting controls, utilities, telephone and elevator operations.

Currently, the Company has not delayed any information technology or non-information technology projects due to the Year 2000 compliance efforts. However, the Company can neither provide assurance that future delays in such projects will not occur as a result of Year 2000 compliance efforts, nor anticipate the effects of such delays on the Company's operations.

FUNDS FROM OPERATIONS

Management generally considers Funds from Operations to be an appropriate measure of the operating performance of the Company because it provides investors an understanding of the ability of the Company to incur and service debt and to make capital expenditures. The Company believes that in order to facilitate a clear understanding of the operating results of the Company, FFO should be examined in conjunction with net income as presented in the consolidated financial statements included elsewhere in this report. FFO is determined in accordance with a definition adopted by the Board of Governors of the National Association of Real Estate Investment Trusts®, and is defined as net income (loss) computed in accordance with generally accepted accounting principles ("GAAP"), excluding gains (or losses) from debt restructuring and sales of property, plus depreciation of real estate assets and after adjustments for unconsolidated partnerships and joint ventures. FFO does not represent cash generated from

operating activities in accordance with GAAP and therefore should not be considered an alternative to net income as an indication of the Company's performance or to net cash flows from operating activities as determined by GAAP as a measure of liquidity and is not necessarily indicative of cash available to fund cash needs. Further, FFO as calculated by other REITs may not be comparable to the Company's calculation of FFO.

For the year ended December 31, 1998, FFO increased to $144,152,000 from $62,417,000 for the year ended December 31, 1997. This increase is primarily due to the acquisition of additional communities in connection with the Merger and secondarily to delivery of new development and redevelopment communities. Growth in earnings from West Coast Established Communities as well as acquisition activity in 1998 and 1997 also contributed to the increase.

MANAGEMENT INFORMATION SYSTEMS

The Company believes that a state-of-the-art management information systems infrastructure will be a key element in managing the Company's future growth. The Company employs a proprietary company-wide intranet using a digital network with high-speed digital lines. This network connects all communities and offices back to central servers in Alexandria, Virginia, providing access to Company associates throughout the country from all locations. This infrastructure also allows the Company to employ new "network computers" that are less expensive to purchase and support, which reduces the Company's "total cost of ownership" for each work station. The Company believes that timely and accurate collection of financial and resident profile data will enable the Company to maximize revenue through careful leasing decisions and financial management. During 1998, the Company began the development of a new property management system to enable the capture and analysis of data to an extent that would not be available using existing commercial software. The Company intends to develop this system through a joint venture with one or more public multifamily real estate companies. The Company currently expects that the total development costs over a three-year period will be approximately $7.0 million, and such development costs will be shared on a pro rata basis by those companies that participate in the joint venture. Once developed the Company intends to use the system in place of current property management information systems for which the Company pays license fees to third parties.

INDEPENDENT PUBLIC ACCOUNTANTS

On November 11, 1998, PricewaterhouseCoopers LLP was dismissed and Arthur Andersen LLP was engaged as the principal independent public accountant for the Company. The decision to change accountants was unanimously approved by the Company's Board of Directors.

The reports of PricewaterhouseCoopers LLP on the financial statements of the Company for the years ended December 31, 1996 and 1997 did not contain any adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope, or accounting principles. During the Company's fiscal years ended December 31, 1996 and 1997, and the subsequent interim period through November 11, 1998, there were no disagreements with PricewaterhouseCoopers LLP on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedures, which disagreements, if not resolved to the satisfaction of PricewaterhouseCoopers LLP, would have caused them to make reference thereto in their reports on the financial statements for such years.

During the Company's fiscal years ended December 31, 1996 and 1997, and the subsequent interim period through November 11, 1998, Arthur Andersen LLP was not engaged as an independent accountant to audit either the Company's financial statements or the financial statements of any of its subsidiaries, nor was it consulted regarding the application of the Company's accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on the Company's financial statements.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to certain financial market risks, the most predominant being fluctuations in interest rates. Interest rate fluctuations are monitored by Management as an integral part of the Company's overall risk management program, which recognizes the unpredictability of financial markets and seeks to reduce the potentially adverse effect on the Company's results of operations. The effect of interest rate fluctuations historically has been small relative to other factors affecting operating results, such as rental rates and occupancy. The specific market risks and the potential impact on the Company's operating results are described below.

The Company's operating results are affected by changes in interest rates as a result of borrowing under the Company's Unsecured Facility as well as issuing bonds with variable interest rates. If interest rates under the Unsecured Facility and other variable rate indebtedness had been one percent higher throughout 1998, the Company's annual interest costs would have increased by approximately $2,500,000, based on balances outstanding during the year ending December 31, 1998. Changes in interest rates also impact the fair value of the Company's fixed rate debt. If the market interest rate applicable to fixed rate indebtedness with maturities similar to the Company's fixed rate indebtedness had been one percent higher, the fair value of the Company's fixed debt on December 31, 1998 would have decreased by approximately $67,000,000, based on balances outstanding at December 31, 1998.

The Company currently uses interest rate swap agreements to reduce the impact of interest rate fluctuations on variable rate indebtedness. Under swap agreements, (i) the Company agrees to pay to a counterparty the interest that would have been incurred on a fixed principal amount at a fixed interest rate (generally, the interest rate on a particular treasury bond on the date the agreement is entered into, plus a fixed increment thereto), and (ii) the counterparty agrees to pay to the Company the interest that would have been incurred on the same principal amount at an assumed floating interest rate tied to a particular market index. As of December 31, 1998, the effect of swap agreements is to fix the interest rate on approximately $200 million of the Company's variable rate tax-exempt debt. The swap agreements were not electively entered into by the Company but, rather, were a requirement of either the bond issuer or the credit enhancement provider related to certain of the Company's tax-exempt bond financings. In addition, because the counterparties providing the swap agreements are major financial institutions with AAA credit ratings by the Standard & Poor's Ratings Group, and the interest rates fixed by the swap agreements are significantly higher than current market rates for such agreements, the Company does not believe there is exposure at this time to a default by a counterparty provider.

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except share data)	12-31-98	12-31-97
ASSETS		
Real estate		
Land	$ 705,989	$ 299,885
Buildings and improvements	2,585,247	839,638
Furniture, fixtures and equipment	103,396	63,631
	3,394,632	1,203,154
Less accumulated depreciation	(143,135)	(79,031)
Net operating real estate	3,251,497	1,124,123
Construction in progress (including land)	407,870	170,361
Communities held for sale	231,492	—
Total real estate, net	3,890,859	1,294,484
Cash and cash equivalents	8,890	3,188
Cash in escrow	7,496	1,597
Resident security deposits	10,383	—
Investments in unconsolidated joint ventures	17,211	—
Deferred financing costs, net	12,376	8,174
Deferred development costs	11,768	4,155
Prepaid expenses and other assets	71,221	6,052
Total assets	$4,030,204	$1,317,650
LIABILITIES AND STOCKHOLDERS' EQUITY		
Variable rate unsecured credit facility	$ 329,000	$ 224,200
Unsecured senior notes	710,000	—
Notes payable	445,371	263,284
Dividends payable	43,323	12,591
Payables for construction	48,933	3,853
Accrued expenses and other liabilities	43,074	5,598
Accrued interest payable	19,415	84
Resident security deposits	19,422	6,212
Total liabilities	1,658,538	515,822
Minority interest in consolidated partnerships	32,213	9,133
Commitments and contingencies		
Stockholders' equity		
Preferred Stock, $.01 par value; 50,000,000 and 25,000,000 shares authorized at December 31, 1998 and 1997, respectively; 0 and 2,308,800 shares of Series A outstanding at December 31, 1998 and 1997, respectively; 0 and 405,022 shares of Series B outstanding at December 31, 1998 and 1997 respectively; 2,300,000 shares of Series C outstanding at both December 31, 1998 and 1997; 3,267,700 shares of Series D outstanding at both December 31, 1998 and 1997; 4,455,000 and 0 shares of Series F outstanding at December 31, 1998 and 1997, respectively; 4,300,000 and 0 shares of Series G outstanding at December 31, 1998 and 1997, respectively; and 4,000,000 and 0 shares of Series H outstanding at December 31, 1998 and 1997, respectively	183	83
Common Stock, $.01 par value; 140,000,000 and 40,000,000 shares authorized at December 31, 1998 and 1997, respectively; 63,887,126 and 26,077,518 shares outstanding at December 31, 1998 and 1997, respectively	639	261
Additional paid-in capital	2,423,326	823,520
Deferred compensation	(4,356)	—
Dividends in excess of accumulated earnings	(80,339)	(31,169)
Total stockholders' equity	2,339,453	792,695
Total liabilities and stockholders' equity	$4,030,204	$1,317,650

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in thousands, except per share data)	Year ended 12-31-98	12-31-97	12-31-96
Revenue:			
Rental income	$352,017	$126,375	$82,833
Management fees	793	—	—
Other income	74	31	5
Total revenue	352,884	126,406	82,838
Expenses:			
Operating expenses	95,980	32,434	21,391
Property taxes	29,778	9,539	6,381
Interest expense	54,003	14,113	14,276
Depreciation and amortization	78,359	27,009	18,689
General and administrative	7,674	4,106	1,823
Total expenses	265,794	87,201	62,560
Equity in income of unconsolidated joint ventures	1,525	—	—
Interest income	3,191	206	178
Minority interest in consolidated partnerships	(1,342)	(470)	(319)
Income before gain on sale of communities and extraordinary item	90,464	38,941	20,137
Gain on sale of communities	3,970	—	—
Income before extraordinary item	94,434	38,941	20,137
Extraordinary item	—	—	(511)
Net income	94,434	38,941	19,626
Dividends attributable to preferred stock	(25,874)	(7,480)	(4,264)
Net income available to common stockholders	$ 68,560	$ 31,461	$15,362
Per common share:			
Income before extraordinary item—basic	$ 1.39	$ 1.40	$ 1.06
Income before extraordinary item—diluted	$ 1.37	$ 1.40	$ 1.06
Extraordinary item—basic and diluted	$ —	$ —	$ (0.03)
Net income—basic	$ 1.39	$ 1.40	$ 1.03
Net income—diluted	$ 1.37	$ 1.40	$ 1.03

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(Dollars in thousands, except share data)	Shares issued Preferred Stock	Shares issued Common Stock	Amount Preferred Stock	Amount Common Stock	Additional paid-in capital	Deferred compensation	Dividends in excess of accumulated earnings	Stockholders' equity
Balance at 12-31-95	2,308,800	11,544,287	$ 23	$115	$ 251,163	$ —	$ (13,718)	$ 237,583
Net income	—	—	—	—	—	—	19,626	19,626
Dividends declared to common and preferred stockholders	—	—	—	—	—	—	(29,571)	(29,571)
Issuance of Common Stock, net of offering costs	—	7,463,701	—	75	174,470	—	—	174,545
Issuance of Preferred Stock, net of offering costs	405,022	—	4	—	9,795	—	—	9,799
Minority interest	—	—	—	—	295	—	—	295
Balance at 12-31-96	2,713,822	19,007,988	27	190	435,723	—	(23,663)	412,277
Net income	—	—	—	—	—	—	38,941	38,941
Dividends declared to common and preferred stockholders	—	—	—	—	—	—	(46,447)	(46,447)
Issuance of Common Stock, net of offering costs	—	7,069,530	—	71	253,345	—	—	253,416
Issuance of Preferred Stock, net of offering costs	5,567,700	—	56	—	134,452	—	—	134,508
Balance at 12-31-97	8,281,522	26,077,518	83	261	823,520	—	(31,169)	792,695
Net income	—	—	—	—	—	—	94,434	94,434
Dividends declared to common and preferred stockholders	—	—	—	—	—	—	(143,604)	(143,604)
Issuance of Common Stock, net of offering costs	—	1,945,801	—	19	64,517	—	—	64,536
Issuance of Preferred Stock, net of offering costs	4,000,000	—	40	—	96,195	—	—	96,235
Issuance of Stock in connection with the Merger of Avalon Properties, Inc. with and into the Company	8,755,000	33,149,985	88	331	1,439,094	(6,221)	—	1,433,292
Conversion of Preferred Stock to Common Stock	(2,713,822)	2,713,822	(28)	28	—	—	—	—
Amortization of deferred compensation	—	—	—	—	—	1,865	—	1,865
Balance at 12-31-98	18,322,700	63,887,126	$183	$639	$2,423,326	$(4,356)	$ (80,339)	$2,339,453

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)	Year ended 12-31-98	12-31-97	12-31-96
Cash flows from operating activities:			
Net income	$ 94,434	$ 38,941	$ 19,626
Adjustments to reconcile net income to cash provided by operating activities:			
Depreciation and amortization	78,359	27,009	18,689
Amortization of deferred compensation	1,865	—	—
Equity in income of unconsolidated joint ventures	(1,525)	—	—
Income allocated to minority interest in consolidated partnerships	1,342	470	319
Gain on sale of communities	(3,970)	—	—
Extraordinary item	—	—	511
Increase in cash in escrow	(1,792)	(637)	(960)
Increase in prepaid expenses and other assets	(438)	(6,677)	(1,579)
Increase in accrued expenses, other liabilities and accrued interest payable	22,954	3,544	2,618
Net cash provided by operating activities	191,229	62,650	39,224
Cash flows used in investing activities:			
Investments in unconsolidated joint ventures	(437)	—	—
Increase in construction payables	30,918	2,200	999
Distributions from equity investments	2,136	—	—
Acquisition of participating mortgage note	(24,000)	—	—
Proceeds from the sale of communities, net of selling costs	118,025	—	—
Merger costs and related activities	(27,533)	—	—
Purchase and development of real estate	(718,338)	(577,170)	(216,999)
Net cash used in investing activities	(619,229)	(574,970)	(216,000)
Cash flows from financing activities:			
Issuance of common and preferred stock, net	160,771	383,972	184,251
Dividends paid	(112,872)	(42,795)	(26,052)
Proceeds from sale of unsecured senior notes	400,000	—	—
Payment of deferred financing costs	(5,782)	—	—
Repayments of notes payable	(2,693)	(1,201)	(480)
Borrowings under unsecured facilities	669,676	555,000	174,200
Repayments of unsecured facilities	(673,876)	(379,800)	(155,700)
Distributions to minority partners	(1,522)	(588)	(200)
Net cash provided by financing activities	433,702	514,588	176,019
Net increase (decrease) in cash	5,702	2,268	(757)
Cash and cash equivalents, beginning of year	3,188	920	1,677
Cash and cash equivalents, end of year	$ 8,890	$ 3,188	$ 920
Cash paid during year for interest, net of amount capitalized	$ 33,222	$ 14,846	$ 14,292

See accompanying notes to consolidated financial statements.

SUPPLEMENTAL DISCLOSURES OF NON-CASH INVESTING AND FINANCING ACTIVITIES (DOLLARS IN THOUSANDS):

In connection with the merger of Avalon Properties, Inc. with and into the Company (the "Merger") in June 1998, the Company issued shares of Common and Preferred Stock valued at $1,439,513 in exchange for all of the outstanding capital stock of Avalon Properties, Inc. As a result of the Merger, the Company acquired all of the assets of Avalon Properties, Inc. and also assumed or acquired $643,410 in debt, $6,221 in deferred compensation expense, $67,073 in net other assets, $1,013 in cash and cash equivalents and minority interest of $19,409.

The Company assumed debt in connection with acquisitions totaling $10,400, $39,797 and $27,868 during the years ended December 31, 1998, 1997 and 1996, respectively. The Company issued $3,851, $6,201 and $7,270 in operating partnership units for acquisitions during 1998, 1997 and 1996, respectively. During the years ending December 31, 1998, 1997 and 1996, respectively, 6,818, 162,330 and 3,812 operating partnership units were converted into the Company's Common Stock.

During the year ended December 31, 1998, 2,308,800 shares of Series A Preferred Stock and 405,022 shares of Series B Preferred Stock totaling a par value of $28 were converted into an aggregate of 2,713,822 shares of Common Stock.

Dividends declared but not paid as of December 31, 1998, 1997 and 1996 totaled $43,323, $12,591 and $8,939, respectively.

NOTE 1: ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Organization and Recent Developments. AvalonBay Communities, Inc. (together with its subsidiaries, except as the context may otherwise require, the "Company") is a Maryland corporation that has elected to be taxed as a real estate investment trust ("REIT") under the Internal Revenue Code of 1986, as amended. The Company is focused on the ownership and operation of institutional-quality apartment communities in high barrier-to-entry markets of the United States. These markets include Northern and Southern California and selected states in the Mid-Atlantic, Northeast, Midwest and Pacific Northwest regions of the country. The Company is the surviving corporation from the merger (the "Merger") of Avalon Properties, Inc. ("Avalon") with and into the Company (sometimes hereinafter referred to as "Bay" before the Merger) on June 4, 1998. The Merger was accounted for as a purchase of Avalon by Bay. In connection with the Merger, the Company changed its name from Bay Apartment Communities, Inc. to AvalonBay Communities, Inc.

At December 31, 1998, the Company owned or held an ownership interest in 127 apartment communities containing 37,911 apartment homes in sixteen states and the District of Columbia of which 13 communities containing 4,855 apartment homes were under reconstruction. The Company also owned 14 communities with 3,262 apartment homes under construction and rights to develop an additional 27 communities that will contain an estimated 7,239 apartment homes.

During the period January 1, 1996 through December 31, 1997, the Company acquired 28 existing operating communities containing a total of 8,271 apartment homes from unrelated third parties for an aggregate acquisition price of approximately $651,843 (cumulative capitalized cost of $766,980 as of December 31, 1998).

During the period prior to the Merger, January 1, 1998 through June 4, 1998, the Company acquired five communities containing a total of 1,388 apartment homes from unrelated third parties for an aggregate acquisition price of approximately $103,047 (cumulative capitalized cost of $110,228). The Company also acquired one community during this period which was sold prior to December 31, 1998. Subsequent to the Merger, the Company acquired three communities containing a total of 1,433 apartment homes from unrelated third parties for an aggregate acquisition price of approximately $201,800 (cumulative capitalized costs of $202,747 as of December 31, 1998). The Company also acquired a participating mortgage note for $24,000.

During 1998, the Company completed development of four communities, containing 1,770 apartment homes at a total cost of $224,800. Also, eight communities were redeveloped during 1998, at a total cost of $64,300.

Subsequent to the Merger, the Company disposed of nine communities, containing 2,797 apartment homes. The net proceeds from these dispositions will be directed to the development and redevelopment of communities currently under construction or reconstruction. Pending such redeployment, the proceeds from the sale of these communities (approximately $118,000 after repayment of certain secured indebtedness) were primarily used to repay amounts outstanding under the Company's unsecured credit facility.

Principles of Consolidation. The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned partnerships and subsidiaries and the operating partnerships structured as DownREITs. All significant intercompany balances and transactions have been eliminated in consolidation.

Real Estate. Significant expenditures which improve or extend the life of the asset are capitalized. The operating real estate assets are stated at cost and consist of land, buildings and improvements, furniture, fixtures and equipment, and other costs incurred during development, redevelopment and acquisition. Expenditures for maintenance and repairs are charged to expense as incurred.

The capitalization of costs during the development of assets (including interest and related loan fees, property taxes and other direct and indirect costs) begins when active development commences and ends when the asset is delivered and a final certificate of occupancy is issued. Cost capitalization during redevelopment of assets (including interest and related loan fees, property taxes and other direct and indirect costs) begins when active and substantial redevelopment at a community commences and apartment homes are taken out-of-service for redevelopment and ends when the community's redevelopment is substantially completed, and apartment homes are back in service. The accompanying consolidated financial statements include a provision for deferred development costs related to communities for which the Company's management ("Management") has concluded completion of development is not probable.

Depreciation is calculated on buildings and improvements using the straight-line method over their estimated useful lives, which range from seven to thirty years. Furniture, fixtures and equipment are generally depreciated using the straight-line method over their estimated useful lives, which range from three to seven years.

Lease terms for apartment homes are generally one year or less. Rental income and operating costs incurred during the initial lease-up or post-redevelopment lease-up period are fully recognized in operations as they accrue, as such income and costs relate to apartment homes available for lease.

If there is an event or change in circumstance that indicates an impairment in the value of a community has occurred, the Company's policy is to assess any impairment in value by making a comparison of the current and projected operating cash flows of the community over its remaining useful life, on an undiscounted basis, to the carrying amount of the community. If such carrying amounts are in excess of the estimated projected operating cash flows of the community, the Company would recognize an impairment loss equivalent to an amount required to adjust the carrying amount to its estimated fair market value. The Company has not recognized an impairment loss in 1998, 1997 or 1996 on any of its real estate.

Investments in Unconsolidated Joint Ventures. Investments in real estate joint ventures are accounted for under the equity method as the Company does not control the significant operating and financial decisions of the joint ventures. The joint venture agreements require that a majority voting interest of the partners approve potential sales, liquidations, significant refinancings, as well as operating budget and capital and financing plans.

Income Taxes. The Company elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended, for the year ended December 31, 1994 and has not revoked such election. A corporate REIT is a legal entity which holds real estate interests and, if certain conditions are met (including but not limited to the payment of a minimum level of dividends to stockholders), the payment of federal and state income taxes at the corporate level is avoided or reduced. Management believes that all such conditions for the avoidance of taxes have been met for the periods presented. Accordingly, no provision for federal and state income taxes has been made.

The following summarizes the tax components to stockholders of the Company's common dividends declared for the years ending December 31, 1998, 1997 and 1996:

	% of common dividends declared for:		
	1998	1997	1996
Ordinary income	77%	100%	81%
20% rate gain	9%	—	—
Unrecaptured §1250 gain	14%	—	—
Non-taxable return of capital	—	—	19%

All dividends declared on all series of the Company's Preferred Stock represented ordinary income to preferred stockholders for tax purposes in the year declared.

Deferred Financing Costs. Deferred financing costs include fees and costs incurred to obtain debt financing and are amortized on a straight-line basis, which approximates the effective interest method, over the shorter of the term of the loan or the related credit enhancement facility, if applicable. Unamortized financing costs are written-off when debt is retired before the maturity date. Accumulated amortization related to deferred financing costs was $4,916 and $3,561 as of December 31, 1998 and 1997, respectively.

Cash and Cash Equivalents. Cash and cash equivalents include all cash and liquid investments with an original maturity of three months or less from the date acquired. The majority of the Company's cash, cash equivalents, and cash in escrows is held at major commercial banks.

Earnings per Common Share. The Company has adopted Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings per Share." In accordance with the provisions of SFAS No. 128, basic earnings per share for the years ended December 31, 1998, 1997 and 1996 is computed by dividing earnings available to common shares (net income less preferred stock dividends) by the weighted average number of shares outstanding during the period. Additionally, other potentially dilutive common shares are considered when calculating earnings per share on a diluted basis. The Company's basic and diluted weighted average shares outstanding for the years ended December 31, 1998, 1997 and 1996 are as follows:

	Year Ended		
	12-31-98	12-31-97	12-31-96
Weighted average common shares outstanding—basic	48,845,839	22,472,394	14,985,160
Weighted average units outstanding	643,029	—	—
Weighted average common shares and units outstanding—basic	49,488,868	22,472,394	14,985,160
Shares issuable from assumed conversion of:			
Common stock options	418,813	—	—
Unvested restricted stock grants	239,228	—	—
Weighted average common shares and units outstanding—diluted	50,146,909	22,472,394	14,985,160

On a weighted average basis, at December 31, 1997 and 1996, respectively there were 2,713,822 and 2,571,068 shares of convertible Preferred Stock, 322,093 and 261,395 Common Stock options and 228,230 and 140,987 operating partnership units that were antidilutive. Therefore, for the years ended December 31, 1997 and 1996, there were effectively no dilutive common share equivalents outstanding.

Use of Estimates. The preparation of financial statements in conformity with generally accepted accounting principles ("GAAP") requires management to make certain estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from those estimates.

Reclassifications. Certain reclassifications have been made to amounts in prior years' financial statements to conform with current year presentations.

Newly Issued Accounting Standards. In June 1997, the Financial Accounting Standards Board issued SFAS No. 131 "Disclosure about Segments of an Enterprise and Related Information." SFAS No. 131 establishes standards for determining an entity's operating segments and the type and level of financial information to be disclosed. SFAS No. 131 became effective for the Company for the fiscal year ending December 31, 1998. The Company has adopted SFAS No. 131 effective with the December 31, 1998 reporting period.

In March 1998, the Emerging Issues Task Force of the Financial Accounting Standards Board issued Ruling 97-11 entitled "Accounting for Internal Costs Relating to Real Estate Property Acquisitions," which requires that internal costs of identifying and acquiring operating property be expensed as incurred. Costs associated with the acquisition of non-operating property may still be capitalized. The ruling is effective for acquisitions completed subsequent to March 19, 1998. At December 31, 1998 this ruling does not have a material effect on the Company's consolidated financial statements.

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." This pronouncement establishes accounting and reporting standards requiring that every derivative instrument be recorded in the balance sheet as either an asset or liability measured at its fair value. SFAS No. 133 requires that changes in the derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. SFAS No. 133 is effective for fiscal years beginning after June 15, 1999 and cannot be applied retroactively. The Company currently plans to adopt this pronouncement effective January 1, 2000, and will determine both the method and impact of adoption prior to that date.

NOTE 2: MERGER BETWEEN BAY AND AVALON

In June 1998, the Company completed the Merger with Avalon. The Merger and related transactions were accounted for using the purchase method of accounting in accordance with GAAP. Accordingly, the assets and liabilities of Avalon were adjusted to fair value for financial accounting purposes and the results of operations of Avalon prior to June 4, 1998 are not included in the results of operations of the Company.

In connection with the Merger, the following related transactions occurred:

- The Company issued .7683 of a share of Common Stock for each outstanding share of Avalon common stock;
- The Company issued one share of Series F and G Preferred Stock for each outstanding share of Avalon Series A and B Preferred Stock, respectively.

The following unaudited pro forma information has been prepared as if the Merger and related transactions had occurred on January 1, 1997. The pro forma financial information is presented for informational purposes only and is not necessarily indicative of what actual results would have been nor does it purport to represent the results of operations for future periods had the Merger been consummated on January 1, 1997.

	Year Ended (unaudited)	
	12-31-98	12-31-97
Pro forma total revenue	$448,758	$297,510
Pro forma net income available to common stockholders	$ 82,389	$ 55,815
Per common share:		
Pro forma net income-basic	$ 1.29	$ 1.08
Pro forma net income-diluted	$ 1.28	$ 1.07

NOTE 3: INTEREST CAPITALIZED

Capitalized interest associated with projects under development or redevelopment totaled $16,977, $6,985 and $2,567 for the years ended December 31, 1998, 1997 and 1996, respectively.

NOTE 4: NOTES PAYABLE, UNSECURED SENIOR NOTES AND CREDIT FACILITY

The Company's notes payable, unsecured senior notes and credit facility are summarized as follows:

	12-31-98	12-31-97
Fixed rate notes payable (conventional and tax-exempt)	$ 388,106	$263,284
Variable rate notes payable (tax-exempt)	57,265	—
Fixed rate unsecured senior notes	710,000	—
Total notes payable and unsecured senior notes	1,155,371	263,284
Variable rate unsecured credit facility	329,000	224,200
Total notes payable, unsecured senior notes and credit facility	$1,484,371	$487,484

Fixed and variable rate notes payable are collateralized by certain apartment communities and mature at various dates from July 1999 through December 2036. The weighted average interest rate of variable rate notes (tax-exempt) was 4.8% at December 31, 1998. The weighted average interest rate of fixed rate notes (conventional and tax-exempt) was 6.7% and 6.4% at December 31, 1998 and 1997, respectively.

The Company's unsecured senior notes consist of the following:

Principal	Interest rate	Maturity date
$100,000	7.375%	2002
$ 50,000	6.25%	2003
$100,000	6.5%	2003
$100,000	6.625%	2005
$ 50,000	6.5%	2005
$150,000	6.8%	2006
$110,000	6.875%	2007
$ 50,000	6.625%	2008

The Company's unsecured senior notes contain a number of financial and other covenants with which the Company must comply, including, but not limited to, limits on the aggregate amount of total and secured indebtedness the Company may have on a consolidated basis and limits on the Company's required debt service payments.

Scheduled maturities of notes payable and unsecured senior notes are as follows for the years ending December 31:

1999	$ 4,489
2000	3,766
2001	14,838
2002	104,078
2003	159,050
Thereafter	869,150
Total notes payable	$1,155,371

The Company has a $600,000 variable rate unsecured credit facility (the "Unsecured Facility") with Morgan Guaranty Trust Company of New York, Union Bank of Switzerland and Fleet National Bank, serving as co-agents for a syndicate of commercial banks. The Unsecured Facility bears interest at a spread over the London Interbank Offered Rate ("LIBOR") based on rating levels achieved on the Company's senior unsecured notes and on a maturity selected by the Company. The current pricing is LIBOR plus .6% per annum (6.2% at December 31, 1998). The Unsecured Facility, which was put into place during June 1998, replaced three separate credit facilities previously available to the separate companies prior to the Merger. The terms of the retired facilities were similar to the Unsecured Facility. In addition, the Unsecured Facility includes a competitive bid option for up to $400,000. The Company is subject to certain customary covenants under the Unsecured Facility, including, but not limited to, maintaining certain maximum leverage ratios, a minimum fixed charge coverage ratio, minimum unencumbered assets and equity levels and restrictions on paying dividends in amounts that exceed 95% of the Company's Funds from Operations, as defined therein. The Unsecured Facility matures in July 2001 and has two, one-year extension options.

NOTE 5: STOCKHOLDERS' EQUITY

As of December 31, 1997 the Company had authorized for issuance 40,000,000 and 25,000,000 shares of Common and Preferred Stock, respectively. In connection with the Merger, authorized Common and Preferred Stock was increased to 300,000,000 and 50,000,000 shares, respectively. In October 1998, the Company held a Special Meeting of Stockholders at which stockholders approved an amendment to the Company's Charter reducing the number of authorized shares of the Company's Common Stock from 300,000,000 to 140,000,000.

Dividends on the Series C, Series D, Series F, Series G and Series H Preferred Stock are cumulative from the date of original issue and are payable quarterly in arrears on or before the 15th day of each month as stated in the table below. None of the Series of Preferred Stock are redeemable prior to the date stated in the table below, but on or after the stated date, may be redeemed for cash at the option of the Company in whole or in part, at a redemption price of $25 per share, plus all accrued and unpaid dividends, if any. The Series of Preferred Stock have no stated maturity and are not subject to any sinking fund or mandatory redemptions. In addition, the Preferred Stock are not convertible into any other securities of the Company and may be redeemed solely from proceeds of other capital stock of the Company, which may include shares of other series of preferred stock.

Series	Shares outstanding December 31, 1998	Payable quarterly	Annual rate	Liquidation preference	Non-redeemable prior to
C	2,300,000	March, June, September, December	8.50%	$25	June 20, 2002
D	3,267,700	March, June, September, December	8.00%	$25	December 15, 2002
F	4,455,000	February, May, August, November	9.00%	$25	February 15, 2001
G	4,300,000	February, May, August, November	8.96%	$25	October 15, 2001
H	4,000,000	March, June, September, December	8.70%	$25	October 15, 2008

The Company also has 1,000,000 shares of Series E Junior Participating Cumulative Preferred Stock authorized for issuance pursuant to the Company's Shareholder Rights Agreement. As of December 31, 1998, there were no shares of Series E Preferred Stock outstanding.

During April 1998, the Company completed an offering of Common Stock totaling 1,244,147 shares. The net proceeds of approximately $44,000 were used to retire indebtedness under the Company's then-existing unsecured revolving credit facility. During 1997, the Company completed five offerings of Common Stock totaling 6,733,187 shares. The net proceeds of approximately $244,340 were used to retire indebtedness under the Company's then-existing unsecured revolving credit facility.

NOTE 6: INVESTMENTS IN UNCONSOLIDATED JOINT VENTURES

In connection with the Merger, the Company succeeded to certain investments in unconsolidated joint ventures. At December 31, 1998, these investments consisted of a 50% general partnership interest in Falkland Partners, a 49% equity interest in Avalon Run and a 50% partnership interest in Avalon Grove. The following is a combined summary of the financial position of these joint ventures as of the dates presented (which include the period prior to the Merger):

	Unaudited	
	12-31-98	12-31-97
Assets:		
Real estate, net	$ 96,419	$ 97,964
Other assets	4,532	10,790
Total assets	$100,951	$108,754
Liabilities and partners' equity:		
Mortgage notes payable	$ 26,000	$ 26,000
Other liabilities	4,933	4,164
Partners' equity	70,018	78,590
Total liabilities and partners' equity	$100,951	$108,754

The following is a combined summary of the results of operations of these joint ventures for the periods presented (which includes the periods prior to the Merger):

	Year ended (unaudited)		
	12-31-98	12-31-97	12-31-96
Summary of operations:			
Rental income	$19,799	$16,497	$10,238
Other income	26	44	58
Operating expenses	(5,591)	(5,020)	(4,238)
Mortgage interest expense	(833)	(893)	(849)
Depreciation and amortization	(3,044)	(1,869)	(1,779)
Net income	$10,357	$ 8,759	$ 3,430

NOTE 7: COMMUNITIES HELD FOR SALE

During 1998, the Company completed a strategic planning effort resulting in a decision to pursue a disposition strategy for certain assets in markets that did not meet its long-term strategic direction. In connection with this decision, the Company's Board of Directors authorized management to pursue the disposition of selected communities within specific markets. The Company will solicit competing bids from unrelated parties for these individual assets, and will consider the sales price and tax ramifications of each proposal. Management anticipates these assets will be sold during 1999. However, there can be no assurance that such assets can be sold on terms that are satisfactory to the Company. Several of the communities authorized for disposition were sold in 1998. The communities sold in 1998 and the respective sales price and net proceeds are summarized below:

Communities	Location	Period disposed	Apartment homes	Debt	Gross sales price	Net proceeds
Arbor Park	Upland, CA	3Q98	260	$ —	$ 12,580	$12,540
Avalon Pointe	Stafford, VA	4Q98	140	6,380	9,450	2,920
Avalon Ridge	Silver Spring, MD	4Q98	432	26,815	35,210	7,700
Chase Lea	Owings Mill, MD	4Q98	296	16,835	21,840	4,500
Avalon at Carter Lake	Reston, VA	4Q98	259	—	16,800	16,560
Reflections	Fresno, CA	4Q98	516	—	22,420	21,980
Sommerset	Vacaville, CA	4Q98	136	—	7,900	7,700
			2,039	$50,030	$126,200	$73,900

To facilitate the sale of Sommerset, the Company provided financing to the purchaser for 80% of the gross sales price. Accordingly, $6,320 of the net proceeds will be received at maturity of this financing.

The assets targeted for sale include land, buildings and improvements and furniture, fixtures and equipment, and are recorded at the lower of cost or fair value less estimated selling costs. The Company recognized no write down in its real estate to arrive at net realizable value. At December 31, 1998, total real estate, net of accumulated depreciation, subject to sale totaled $231,492. Certain individual assets are secured by mortgage indebtedness which may be assumed by the purchaser or repaid by the Company from the net sales proceeds.

The Company's consolidated statements of operations includes net income of the communities held for sale of $3,916, $1,633 and $1,301 for the years ended December 31, 1998, 1997 and 1996, respectively. Depreciation expense on these assets, which was not recognized subsequent to the date of held-for-sale classification, totaled $1,332.

In connection with an agreement executed by Avalon in March 1998 which provided for the buyout of certain limited partners in DownREIT V Limited Partnership, the Company sold two communities in July 1998. Net proceeds from the sale of the two communities, containing an aggregate of 758 apartment homes, were approximately $44,000.

NOTE 8: COMMITMENTS AND CONTINGENCIES

Employment Agreements. The Company entered into three year employment agreements with nine executives and a one year employment agreement with one executive, all of which became effective as of June 4, 1998, the date of the Merger. With the exception of the one year agreement, the employment agreements provide for one-year

automatic renewal after the third year unless an advance notice of non-renewal is provided by either party. Upon a change in control, the agreements provide for an automatic extension of three years. The employment agreements provide for base salary and incentive compensation in the form of cash awards, stock options and stock grants subject to the discretion of, and attainment of performance goals established by, the Compensation Committee of the Board of Directors.

Each of the three year employment agreements also provides for base salary increases during the initial term in amounts determined by the Compensation Committee. During any renewal term base salary increases will be equal to the greater of 5% of the prior year's base salary, a factor based on increases in the consumer price index, or an amount determined at the discretion of the Compensation Committee. Certain of these employment agreements were terminated in accordance with the Company's announced organizational changes. See Footnote 13, Subsequent Events, for further information.

Presale Commitments. The Company occasionally enters into forward purchase commitments with unrelated third parties which allow the Company to purchase communities upon completion of construction. As of December 31, 1998, the Company has an agreement to purchase ten communities with an estimated 2,980 homes for an estimated aggregate purchase price of $386,500. The acquisition of one of these communities is expected to close in the third quarter of 1999, and the acquisition of the remaining communities are expected to close in 2000, 2001 and 2002. However, there can be no assurance that such acquisitions will be consummated or, if consummated on the schedule currently contemplated. As of December 31, 1998, the Company had provided interim construction financing of $67,129 for these communities.

Contingencies. The Company is subject to various legal proceedings and claims that arise in the ordinary course of business. These matters are generally covered by insurance. While the resolution of these matters cannot be predicted with certainty, Management believes that the final outcome of such matters will not have a material adverse effect on the financial position or results of operations of the Company.

NOTE 9: VALUE OF FINANCIAL INSTRUMENTS

The Company has historically used interest rate swap agreements (the "Swap Agreements") to reduce the impact of interest rate fluctuations on its variable rate tax-exempt bonds. The Swap Agreements are held for purposes other than trading. The amortization of the cost of the Swap Agreements is included in amortization expense. The remaining unamortized cost of the Swap Agreements is included in prepaid expenses and other assets on the balance sheet and is amortized over the remaining life of the agreements. As of December 31, 1998, the effect of these Swap Agreements is to fix $202,283 of the Company's tax-exempt debt at an average interest rate of 6.1% with an average maturity of 8 years.

The off-balance-sheet risk in these contracts includes the risk of a counterparty not performing under the terms of the contract. The counterparties to these contracts are major financial institutions with AAA credit ratings by the Standard & Poor's Ratings Group. The Company monitors the credit ratings of counterparties and the amount of the Company's debt subject to swap agreements with any one party. Therefore, the Company believes the likelihood of realizing material losses from counterparty nonperformance is remote.

The Company has not entered into any interest rate hedge agreements or treasury locks for its conventional unsecured debt.

Cash and cash equivalent balances are held with various financial institutions and may at times exceed the applicable Federal Deposit Insurance Corporation limit. The Company monitors credit ratings of these financial institutions and the concentration of cash and cash equivalent balances with any one financial institution and believes the likelihood of realizing material losses from the excess of cash and cash equivalent balances over insurance limits is remote.

The following estimated fair values of financial instruments were determined by management using available market information and established valuation methodologies, including discounted cash flows. Accordingly, the estimates presented are not necessarily indicative of the amounts the Company could realize on disposition of the financial instruments. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

- Cash equivalents, rents receivable, accounts payable and accrued expenses, and other liabilities are carried at their face amounts, which reasonably approximate their fair values.
- The Company's unsecured credit facility with an aggregate carrying value of $329,000 and $224,200 at December 31, 1998 and 1997, respectively approximates fair value.
- Bond indebtedness and notes payable with an aggregate carrying value of $1,155,371 and $263,284 had an estimated aggregate fair value of $1,137,411 and $291,293 at December 31, 1998 and 1997, respectively.

NOTE 10: SEGMENT REPORTING

The Company adopted SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," during 1998. SFAS No. 131 established standards for reporting financial and descriptive information about operating segments in annual financial statements. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company's chief operating decision making group consists primarily of the Company's senior officers.

The Company's reportable operating segments include Stable Communities, Developed Communities and Redeveloped Communities. Furthermore, each of these operating segments are measured within either the West Coast geographic area (consisting of the Northern California, Southern California and Pacific Northwest regions) or the East Coast geographic area (consisting of the Northeast, Mid-Atlantic and Midwest regions):

- Stable Communities are communities that 1) have attained stabilized occupancy levels (95% occupancy) and operating costs since the beginning of the prior calendar year (these communities are also known as Established

Communities); or 2) were acquired subsequent to the beginning of the previous calendar year but were stabilized in terms of occupancy levels and operating costs at the time of acquisition, and remained stabilized throughout the end of the current calendar year. Stable Communities do not include communities where planned redevelopment or development activities have not yet commenced. The primary financial measure for this business segment is Net Operating Income ("NOI"), which represents total revenue less operating expenses and property taxes. With respect to Established Communities, an additional financial measure of performance is NOI for the current year as compared against the prior year and against current year budgeted NOI. With respect to other Stable Communities, performance is primarily based on reviewing growth in NOI for the current period as compared against prior periods within the calendar year and against current year budgeted NOI.

- Developed Communities are communities that were under active development during any portion of the preceding calendar year that attained stabilized occupancy and expense levels during the current calendar year of presentation. The primary financial measure for this business segment is Operating Yield (defined as NOI divided by total capitalized costs). Performance of Developed Communities is based on comparing Operating Yields against projected yields as determined by Management prior to undertaking the development activity.

- Redeveloped Communities are communities that were under active redevelopment during any portion of the preceding calendar year that attained stabilized occupancy and expense levels during the current calendar year of presentation. The primary financial measure for this business segment is Operating Yield. Performance for Redeveloped Communities is based on comparing Operating Yields against projected yields as estimated by Management prior to undertaking the redevelopment activity.

Other communities owned by the Company which are not included in the above segments are communities that were under development or redevelopment or lease-up at any point in time during the applicable calendar year. The primary performance measure for these assets depends on the stage of development or redevelopment of the community. While under development or redevelopment, Management monitors actual construction costs against budgeted costs as well as economic occupancy. While under lease-up, the primary performance measures for these assets are projected Operating Yield as defined above, lease-up pace compared to budget and rent levels compared to budget.

The segments are classified based on the individual community's status as of the end of the given year. Therefore, each year the composition of communities within each business segment is adjusted. Accordingly, the amounts between years are not directly comparable.

The accounting policies applicable to the operating segments described above are the same as those described in the summary of significant accounting policies.

	Year Ended 12/31/98				
	Stable Communities	Developed Communities	Redeveloped Communities	Other	Total
West Coast Segments					
Total revenue	$ 77,924	$ 5,454	$ 24,107	$ 91,795	$ 199,280
Net Operating Income	$ 57,551	$ 4,165	$ 16,949	$ 59,131	$ 137,796
Previous gross real estate	$ 491,859	$ —	$ 17,797	$ 860,427	$1,370,083
Current year expenditures and acquisitions	2,903	55	2,430	350,782	356,170
Transfers	10,946	29,452	159,648	(200,046)	—
Sales	(26,947)	—	—	—	(26,947)
Current gross real estate	$ 478,761	$29,507	$179,875	$1,011,163	$1,699,306
Operating Yield (1)	12.0%	14.1%	9.4%		
East Coast Segments					
Total revenue	$ 136,156	$ —	$ —	$ 16,037	$ 152,193
Net Operating Income	$ 92,689	$ —	$ —	$ 10,647	$ 103,336
Previous gross real estate	$ —	$ —	$ —	$ —	$ —
Current year expenditures and acquisitions	1,950,918	—	—	279,988	2,230,906
Transfers	—	—	—	—	—
Sales	—	—	—	—	—
Current gross real estate	$1,950,918	$ —	$ —	$ 279,988	$2,230,906
Operating Yield (2)	10.2%	—	—		
Total, All Segments					
Total revenue	$ 214,080	$ 5,454	$ 24,107	$ 107,832	$ 351,473
Net Operating Income	$ 150,240	$ 4,165	$ 16,949	$ 69,778	$ 241,132
Previous gross real estate	$ 491,859	$ —	$ 17,797	$ 860,427	$1,370,083
Current year expenditures and acquisitions	1,953,821	55	2,430	630,770	2,587,076
Transfers	10,946	29,452	159,648	(200,046)	—
Sales	(26,947)	—	—	—	(26,947)
Current gross real estate	$2,429,679	$29,507	$179,875	$1,291,151	$3,930,212
Operating Yield (2)	10.6%	14.1%	9.4%		
Non-allocated operations					
Total revenue	$ —	$ —	$ —	$ 1,411	$ 1,411
Net Operating Income	$ —	$ —	$ —	$ 1,238	$ 1,238
Gross real estate	$ —	$ —	$ —	$ 112,469	$ 112,469
Total, AvalonBay					
Total revenue	$ 214,080	$ 5,454	$ 24,107	$ 109,243	$ 352,884
Net Operating Income	$ 150,240	$ 4,165	$ 16,949	$ 71,016	$ 242,370
Gross real estate	$2,429,679	$29,507	$179,875	$1,403,620	$4,042,681

(1) Operating Yield calculations are based on annualized NOI for acquisitions during respective years.

(2) Operating Yield calculations are based on a) annualized NOI for acquisitions during respective years and b) adjusted gross real estate to exclude step-up adjustments recorded in connection with the Merger.

Year Ended 12/31/97					Year Ended 12/31/96				
Stable Communities	Developed Communities	Redeveloped Communities	Other	Total	Stable Communities	Developed Communities	Redeveloped Communities	Other	Total
$ 75,547	$ —	$ 2,926	$ 47,749	$ 126,222	$ 57,717	$ 9,836	$—	$ 15,280	$ 82,833
$ 54,155	$ —	$ 2,210	$ 31,797	$ 88,162	$ 39,638	$ 7,791	$—	$ 9,964	$ 57,393
$416,233	$ 72,723	$ —	$258,934	$ 747,890	$386,614	$ —	$—	$110,477	$497,091
2,903	—	23	619,267	622,193	29,619	353	—	220,827	250,799
72,723	(72,723)	17,774	(17,774)	—	—	72,370	—	(72,370)	—
—	—	—	—	—	—	—	—	—	—
$491,859	$ —	$17,797	$860,427	$1,370,083	$416,233	$72,723	$—	$258,934	$747,890
11.0%	—	12.4%			9.9%	10.7%	—		
$ —	$ —	$ —	$ —	$ —	$ —	$ —	$—	$ —	$ —
$ —	$ —	$ —	$ —	$ —	$ —	$ —	$—	$ —	$ —
$ —	$ —	$ —	$ —	$ —	$ —	$ —	$—	$ —	$ —
—	—	—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—	—	—
$ —	$ —	$ —	$ —	$ —	$ —	$ —	$—	$ —	$ —
—	—	—			—	—	—		
$ 75,547	$ —	$ 2,926	$ 47,749	$ 126,222	$ 57,717	$ 9,836	$—	$ 15,280	$ 82,833
$ 54,155	$ —	$ 2,210	$ 31,797	$ 88,162	$ 39,638	$ 7,791	$—	$ 9,964	$ 57,393
$416,233	$ 72,723	$ —	$258,934	$ 747,890	$386,614	$ —	$—	$110,477	$497,091
2,903	—	23	619,267	622,193	29,619	353	—	220,827	250,799
72,723	(72,723)	17,774	(17,774)	—	—	72,370	—	(72,370)	—
—	—	—	—	—	—	—	—	—	—
$491,859	$ —	$17,797	$860,427	$1,370,083	$416,233	$72,723	$—	$258,934	$747,890
11.0%	—	12.4%			9.9%	10.7%	—		
$ —	$ —	$ —	$ 184	$ 184	$ —	$ —	$—	$ 5	$ 5
$ —	$ —	$ —	$ 184	$ 184	$ —	$ —	$—	$ 5	$ 5
$ —	$ —	$ —	$ 3,432	$ 3,432	$ —	$ —	$—	$ 2,457	$ 2,457
$ 75,547	$ —	$ 2,926	$ 47,933	$ 126,406	$ 57,717	$ 9,836	$—	$ 15,285	$ 82,838
$ 54,155	$ —	$ 2,210	$ 31,981	$ 88,346	$ 39,638	$ 7,791	$—	$ 9,969	$ 57,398
$491,859	$ —	$17,797	$863,859	$1,373,515	$416,233	$72,723	$—	$261,391	$750,347

Operating expenses as reflected on the Consolidated Statement of Operations include $15,244, $3,913 and $2,332 for the years ended December 31, 1998, 1997 and 1996, respectively, of property management overhead costs that are not allocated to individual communities. These costs are not reflected in Net Operating Income as shown in the above tables. Communities held for sale as reflected on the Consolidated Balance Sheets is net of $8,687 of accumulated depreciation as of December 31, 1998.

In June 1998, the Company completed the Merger with Avalon. The Merger and related transactions were accounted for using the purchase method of accounting in accordance with GAAP. Accordingly, the results of operations of the Avalon communities prior to June 4, 1998 are not included in the results of operations of the Company. Avalon communities are included in Established Communities for Management's decision making purposes although the results of operations prior to the Merger are not included in the Company's historical operating results determined in accordance with GAAP. For comparative purposes, the 1998, 1997 and 1996 operating information for East Coast segments are presented on the following page on a pro forma basis (unaudited) assuming the Merger had occurred as of January 1, 1996.

	Stable Communities	Developed Communities	Redeveloped Communities	Other	Total
For the year ended 12-31-98					
Total revenue	$ 173,738	$ 41,406	$—	$ 31,944	$ 247,088
Net Operating Income	$ 114,997	$ 31,736	$—	$ 21,250	$ 167,983
Previous gross real estate	$1,043,662	$ 67,119	$—	$ 402,515	$1,513,296
Current year expenditures, acquisitions and step-up adjustments	561,331	21,363	—	178,640	761,334
Transfers	67,119	196,193	—	(263,312)	—
Sales	(43,725)	—	—	—	(43,725)
Current gross real estate	$1,628,387	$284,675	$—	$ 317,843	$2,230,905
Operating Yield (1)	9.7%	11.4%	—		
For the year ended 12-31-97					
Total revenue	$ 129,149	$ 10,661	$—	$ 30,102	$ 169,912
Net Operating Income	$ 86,005	$ 7,482	$—	$ 26,704	$ 120,191
Previous gross real estate	$ 723,863	$ 12,294	$—	$ 342,283	$1,078,440
Current year expenditures, acquisitions and step-up adjustments	324,837	1,005	—	126,346	452,188
Transfers	12,294	53,820	—	(66,114)	—
Sales	(17,332)	—	—	—	(17,332)
Current gross real estate	$1,043,662	$ 67,119	$—	$ 402,515	$1,513,296
Operating Yield (1)	10.2%	11.1%	—		
For the year ended 12-31-96					
Total revenue	$ 105,723	$ 2,104	$—	$ 15,793	$ 123,620
Net Operating Income	$ 69,995	$ 1,488	$—	$ 10,584	$ 82,067
Previous gross real estate	$ 590,682	$ 38,097	$—	$ 152,276	$ 781,055
Current year expenditures, acquisitions and step-up adjustments	110,559	277	—	202,024	312,860
Transfers	38,097	(26,080)	—	(12,017)	—
Sales	(15,475)	—	—	—	(15,475)
Current gross real estate	$ 723,863	$ 12,294	$—	$ 342,283	$1,078,440
Operating Yield (1)	10.6%	12.1%	—		

(1) Operating Yield calculations are based on a) annualized NOI for acquisitions during respective years and b) adjusted gross real estate in 1998 to exclude step-up adjustments recorded in connection with the Merger.

NOTE 11: STOCK-BASED COMPENSATION PLANS

The Company has adopted the 1994 Stock Incentive Plan (the "Plan") as amended and restated on April 13, 1998 and subsequently amended on July 24, 1998, for the purpose of encouraging and enabling the Company's officers, associates and directors to acquire a proprietary interest in the Company. Individuals who are eligible to participate in the Plan include officers, other associates, outside directors and other key persons of the Company and its subsidiaries who are responsible for or contribute to the management, growth or profitability of the Company and its subsidiaries. The Plan authorizes (i) the grant of stock options that qualify as incentive stock options under Section 422 of the Code, (ii) the grant of stock options that do not so qualify, (iii) grants of shares of restricted and unrestricted Common Stock, (iv) grants of deferred stock awards, (v) performance share awards entitling the recipient to acquire shares of Common Stock and (vi) dividend equivalent rights.

Under the Plan, a maximum of 2,500,000 shares of Common Stock, plus 9.9% of any net increase in the total number of shares of Common Stock actually outstanding from time to time after April 13, 1998, may be issued. Notwithstanding the foregoing, the maximum number of shares of stock for which Incentive Stock Options may be issued under the Plan shall not exceed 2,500,000 and no awards shall be granted under the Plan after April 13, 2008. For purposes of this limitation, shares of Common Stock which are forfeited, canceled, reacquired by the Company, satisfied without the issuance of Common Stock or otherwise terminated (other than by exercise) shall be added back to the shares of Common Stock available for issuance under the Plan. Stock Options with respect to no more than 300,000 shares of stock may be granted to any one individual participant during any one calendar year period. Options granted to officers and employees under the Plan vest over periods determined by the Compensation Committee of the Board of Directors and expire ten years from the date of grant. Options granted to non-employee directors under the Plan are subject to accelerated vesting under certain limited circumstances and become exercisable on the first anniversary of the date of grant and expire ten years from the date of grant. Restricted stock granted to officers and employees under the Plan generally has a vesting period of at least three years, as determined by the Compensation Committee of the Board of Directors. Restricted stock granted to non-employee directors vests 20%

on the date of issuance and 20% on each of the first four anniversaries of the date of issuance. Information with respect to stock options granted under the Plan is as follows:

	Shares	Weighted Average Exercise Price Per Share
Options outstanding, December 31, 1995	563,750	$ 19.66
Exercised	(37,475)	19.86
Granted	229,100	26.23
Forfeited	(32,500)	20.43
Options outstanding, December 31, 1996	722,875	$ 21.70
Exercised	(26,251)	21.13
Granted	394,100	36.35
Forfeited	(20,350)	26.43
Options outstanding, December 31, 1997	1,070,374	$27.02
Exercised	(164,924)	21.71
Granted	1,225,132	36.81
Forfeited	(244,500)	35.25
Options outstanding, December 31, 1998	1,886,082	$ 32.74
Options exercisable:		
December 31, 1996	189,426	$ 19.76
December 31, 1997	343,974	$ 20.91
December 31, 1998	656,925	$ 27.26

The following table summarizes information concerning currently outstanding and exercisable options:

	Options Outstanding			Options Exercisable	
Exercise Price	Number Outstanding as of December 31, 1998	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$18.38	60,000	6.25	$18.38	45,000	$18.38
19.25	9,000	6.36	19.25	9,000	19.25
19.63	46,000	6.55	19.63	37,750	19.63
20.00	112,450	5.19	20.00	112,450	20.00
20.00	100,000	6.86	20.00	75,000	20.00
20.50	9,000	5.27	20.50	9,000	20.50
23.38	40,000	7.07	23.38	20,000	23.38
25.38	20,000	7.33	25.38	20,000	25.38
25.38	25,000	7.47	25.38	12,500	25.38
27.75	80,000	7.66	27.75	65,000	27.75
33.75	16,000	9.97	33.75	—	—
34.38	40,000	8.38	34.38	40,000	34.38
36.13	12,500	8.29	36.13	12,500	36.13
36.13	90,000	9.45	36.13	—	—
36.31	53,800	9.43	36.31	—	—
36.31	361,500	9.43	36.31	—	—
36.31	127,500	9.43	36.31	—	—
36.31	15,000	9.43	36.31	—	—
36.63	223,100	8.07	36.63	181,850	36.63
36.63	37,000	9.56	36.63	—	—
37.00	140,000	9.19	37.00	—	—
37.94	210,000	9.08	37.94	10,000	37.94
38.81	20,000	8.84	38.81	5,000	38.81
39.63	7,500	8.73	39.63	1,875	39.63
39.83	30,732	9.42	39.83	—	—
	1,886,082	8.41	$32.74	656,925	$27.26

Options to purchase 4,488,189, 348,400 and 786,125 shares of Common Stock were available for grant under the Plan at December 31, 1998, 1997 and 1996, respectively.

Before the Merger, Avalon had adopted its 1995 Equity Incentive Plan (the "1995 Incentive Plan"). The 1995 Incentive Plan authorized the grant of (i) stock options that qualified as incentive stock options under Section 422 of the Code, (ii) stock options that did not so qualify, (iii) shares of restricted and unrestricted common stock, (iv) shares of unrestricted common stock and (v) dividend equivalent rights.

Under the 1995 Incentive Plan, a maximum number of 3,315,054 shares of common stock were issuable, plus any shares of common stock represented by awards under Avalon's 1993 Stock Option and Incentive Plan (the "1993 Plan") that were forfeited, canceled, reacquired by Avalon, satisfied without the issuance of common stock or otherwise terminated (other than by exercise). Options granted to officers, non-employee directors and associates under the 1995 Incentive Plan generally vested over a three-year term, expired ten years from the date of grant and were exercisable at the market price on the date of grant.

The 1995 Incentive Plan was not terminated as a result of the Merger, but options are no longer being granted under the 1995 Incentive Plan. In connection with the Merger, the exercise prices of options under the 1995 Incentive Plan were adjusted to reflect the conversion ratio of Avalon common stock into Bay Common Stock. Officers, non-employee directors and associates with 1995 Incentive Plan options may exercise their options for the Company's Common Stock at the revalued exercise price. Information with respect to stock options granted under the 1995 Incentive Plan and the 1993 Plan is as follows:

	Shares	Weighted Average Exercise Price Per Share
Options outstanding, June 4, 1998	2,127,446	$34.00
Exercised	(34,177)	26.84
Granted	—	—
Forfeited	(41,015)	38.00
Options outstanding, December 31, 1998	2,052,254	$34.05
Options exercisable:		
December 31, 1998	1,014,530	$30.26

The following table summarizes information concerning currently outstanding and exercisable options under the 1995 Incentive Plan and the 1993 Plan:

	Options Outstanding			Options Exercisable	
Exercise Price	Number Outstanding as of December 31, 1998	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$26.19	23,049	6.37	$26.19	23,049	$26.19
26.68	573,598	4.86	26.68	573,598	26.68
26.68	11,524	4.86	26.68	11,524	26.68
27.33	35,407	6.35	27.33	35,407	27.33
27.33	2,305	7.04	27.33	1,537	27.33
27.33	1,152	8.96	27.33	384	27.33
28.15	26,330	7.48	28.15	17,554	28.15
28.31	23,049	7.37	28.31	23,049	28.31
30.10	6,915	5.37	30.10	6,915	30.10
30.26	7,683	7.69	30.26	5,122	30.26
34.98	9,604	7.96	34.98	6,403	34.98
35.31	30,732	8.36	35.31	30,732	35.31
36.12	1,921	9.19	36.12	—	—
36.44	1,921	8.68	36.44	640	36.44
36.61	64,665	9.41	36.61	—	—
36.69	1,921	9.32	36.69	—	—
37.10	1,921	8.73	37.10	640	37.10
37.18	5,762	9.37	37.18	—	—
37.26	384	9.27	37.26	—	—
37.58	355,000	9.19	37.58	—	—
37.66	45,714	8.87	37.66	15,223	37.66
38.15	782,898	8.83	38.15	260,705	38.15
38.72	768	8.86	38.72	256	38.72
39.29	3,457	8.96	39.29	1,152	39.29
39.70	1,921	8.80	39.70	640	39.70
39.86	32,653	9.01	39.86	—	—
	2,052,254	7.65	$34.05	1,014,530	$30.26

The Company applies Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for its plans. Accordingly, no compensation expense has been recognized for the stock option portion of the stock-based compensation plan. Had compensation expense for the Company's stock option plan been determined based on the fair value at the grant date for awards under the Plan consistent with the

methodology prescribed under SFAS No. 123, "Accounting for Stock-Based Compensation," the Company's net income and earnings per share would have been reduced to the following pro forma amounts (unaudited):

	Pro Forma		
	Year ended 12-31-98	Year ended 12-31-97	Year ended 12-31-96
Income before extraordinary items	$67,043	$30,541	$15,548
Net income available to common stockholders	$67,043	$30,541	$15,037
Income before extraordinary items per common share—basic	$ 1.35	$ 1.36	$ 1.04
Income before extraordinary items per common share—diluted	$ 1.34	$ 1.36	$ 1.04
Net income per share—basic	$ 1.35	$ 1.36	$ 1.00
Net income per share—diluted	$ 1.34	$ 1.36	$ 1.00

The fair value of the options granted during 1998 is estimated at $3.67 per share on the date of grant using the Black-Scholes option pricing model with the following assumptions: dividend yield of 5.96%, volatility of 16.77%, risk free interest rates of 5.55%, actual forfeitures, and an expected life of approximately 4 years. The fair value of the options granted during 1997 is estimated at $5.48 per share on the date of grant using the Black-Scholes option pricing model with the following assumptions: dividend yield of 4.44%, volatility of 18.30%, risk free interest rates of 6.34%, actual forfeitures, and an expected life of approximately 4 years. The fair value of the options granted during 1996 is estimated at $3.17 per share on the date of grant using the Black-Scholes option pricing model with the following assumptions: dividend yield of 6.50%, volatility of 20.18%, risk free interest rates of 6.17%, actual forfeitures, and an expected life of approximately 4 years.

The Company has adopted the 1996 Non-Qualified Employee Stock Purchase Plan, as amended and restated (the "1996 ESP Plan"). The primary purpose of the 1996 ESP Plan is to encourage Common Stock ownership by eligible directors and associates (the "Participants") in the belief that such ownership will increase each Participant's interest in the success of the Company. The 1996 ESP Plan provides for two purchase periods per year. A purchase period is a six month period beginning each January 1 and July 1 and ending each June 30 and December 31, respectively. Participants may contribute portions of their compensation during a purchase period and purchase Common Stock at the end thereof. One million shares of Common Stock are reserved for issuance under the 1996 ESP Plan. Participation in the 1996 ESP Plan entitles each Participant to purchase Common Stock at a price which is equal to the lesser of 85% of the closing price for a share of stock on the first day of such purchase period or 85% of the closing price on the last day of such purchase period. The Company issued 23,396 and 13,863 shares under the 1996 ESP Plan as of December 31, 1998 and 1997, respectively. No shares were issued under the 1996 ESP Plan as of December 31, 1996.

NOTE 12: QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

The following summary represents the quarterly results of operations for the years ended December 31, 1998 and 1997:

	Three months ended			
1998	March 31	June 30	September 30	December 31
Total revenue	$45,330	$69,948	$118,064	$119,542
Net income available to common stockholders	$ 8,950	$13,748	$ 23,771	$ 22,091
Net income per common share—basic	$ 0.34	$ 0.35	$ 0.37	$ 0.34
Net income per common share—diluted	$ 0.34	$ 0.34	$ 0.37	$ 0.34

	Three months ended			
1997	March 31	June 30	September 30	December 31
Total revenue	$26,283	$29,874	$ 32,860	$ 37,389
Net income available to common stockholders	$ 6,625	$ 7,184	$ 8,257	$ 9,396
Net income per common share—basic	$ 0.33	$ 0.33	$ 0.36	$ 0.37
Net income per common share—diluted	$ 0.33	$ 0.33	$ 0.36	$ 0.37

The sum of the quarterly net income per common share, basic and diluted, for 1998 and 1997, and the net income available to common stockholders for 1997 are not equal to the full year amounts primarily because the computations for each quarter and the full year are made independently.

NOTE 13: SUBSEQUENT EVENTS (UNAUDITED)

In January 1999, the Company issued $125,000 of medium-term notes. Interest on the notes is payable semi-annually on February 15 and August 15, and the notes will mature on February 15, 2004. The notes bear interest at 6.58%. The net proceeds of approximately $124,300 to the Company were used to repay amounts outstanding under the Company's Unsecured Facility.

In February 1999, the Company announced certain management changes. The Company expects to record a non-recurring charge in the first quarter of 1999 relating to this management realignment including severance costs and certain related organizational adjustments. Because a complete plan of management realignment was not in existence on June 4, 1998, the date of the Company's merger with Avalon, this charge is not considered a part of the Company's purchase price for Avalon and, accordingly, the expenses associated with the management realignment will be treated as a non-recurring charge. Management and the terminated officers are currently determining the amount of severance that each terminated officer is entitled to receive pursuant to their employment agreements and the valuations, if any, that must be performed pursuant to the terms of their employment agreements. Management is also completing an evaluation of the additional charge related to the other organizational changes. However, management currently estimates that the non-recurring charge that will be incurred in connection with these organizational adjustments, including severance payments and contract termination costs, costs to relocate accounting functions and office space reductions, will be approximately $16 million. No assurance can be given as to the amount of such non-recurring charge, which could be greater or less than the estimate provided.

REPORT OF MANAGEMENT

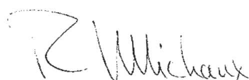
The consolidated financial statements, related notes and other financial information prepared by the management ("Management") of AvalonBay Communities, Inc. (the "Company") are presented in conformity with generally accepted accounting principles, applying certain estimates and judgments as required. Management is responsible for the integrity and objectivity of the consolidated financial statements and other financial information contained in this annual report.

The Company maintains a system of internal accounting controls designed to provide reasonable assurance that assets are safeguarded, transactions are executed and recorded as authorized by Management such that accounting records may be relied upon for preparation of financial statements. Management is responsible for the maintenance of these systems, which is accomplished through communication of established written codes of conduct, policies and procedures; hiring, retention and training of qualified associates; and appropriate delegation of authority and segregation of responsibilities. Adherence to these controls, policies and procedures is monitored and evaluated by the Company's independent public accountants.

The Audit Committee, composed solely of outside directors, meets periodically with Management and the independent public accountants to review matters relating to the system of internal accounting controls and the Company's financial statements. The independent public accountants have direct access to the Audit Committee, both with and without the presence of Management, to discuss the scope and results of their audits and their comments on the adequacy of the Company's internal accounting control system.

In planning and performing their audit of the Company's financial statements, the independent public accountants consider the internal control structure in determining their auditing procedures. The independent public accountants also prepare recommendations for improving policies and procedures and such recommendations are communicated to Management and the Audit Committee of the Board of Directors.

Thomas J. Sargeant
Senior Vice President,
Chief Financial Officer



Richard L. Michaux
Chief Executive Officer
and President

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To AvalonBay Communities, Inc.:

We have audited the accompanying consolidated balance sheet of AvalonBay Communities, Inc. (a Maryland corporation, the "Company") (formerly Bay Apartment Communities, Inc.) and subsidiaries as of December 31, 1998, and the related consolidated statements of operations, stockholders' equity and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of Bay Apartment Communities, Inc. as of December 31, 1997 and the years ended December 31, 1997 and 1996, were audited by other auditors whose report dated January 30, 1998 (and March 24, 1998 related to certain subsequent events), expressed an unqualified opinion on those statements.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of AvalonBay Communities, Inc. and subsidiaries as of December 31, 1998, and the results of their operations and their cash flows for the year then ended in conformity with generally accepted accounting principles.

Arthur Andersen LLP

Washington, D.C.
January 18, 1999

Market for Registrant's Common Equity and Related Stockholder Matters

The Company's Common Stock is traded on the New York Stock Exchange (the "NYSE") and the Pacific Stock Exchange (the "PCX") under the ticker symbol "AVB." The following table sets forth the quarterly high and low sales prices per share of the Company's Common Stock on the NYSE for the years ended December 31, 1998 and 1997. On March 1, 1999, there were 921 holders of record of 64,103,611 shares of the Company's Common Stock.

	1998			1997		
	Sales Price			Sales Price		
Quarter Ended	High	Low	Dividends Declared	High	Low	Dividends Declared
March 31	$39.250	$36.313	$0.42	$37.500	$34.125	$0.41
June 30	$37.875	$35.000	$0.51	$37.625	$32.125	$0.41
September 30	$38.438	$30.500	$0.51	$40.250	$36.500	$0.42
December 31	$34.313	$31.125	$0.51	$40.625	$37.438	$0.42

The Company expects to continue its policy of paying regular quarterly cash dividends. However, dividend distributions will be declared at the discretion of the Board of Directors and will depend on actual Funds from Operations of the Company, its financial condition, capital requirements, the annual distribution requirements under the REIT provisions of the Internal Revenue Code and such other factors as the Board of Directors may deem relevant. The Board of Directors may modify the Company's dividend policy from time to time.

The Company has an optional Dividend Reinvestment and Stock Purchase Plan (the "Plan") which provides a simple and convenient method for stockholders to invest cash dividends and optional cash payments in shares of Common Stock of the Company. All stockholders are eligible to participate in the Plan, including stockholders, whose shares are held in the name of a nominee or broker (the "Participants"). Participants in the Plan may purchase additional shares of Common Stock by (i) having the cash dividends on all or part of their shares of stock automatically reinvested, (ii) receiving directly, as usual, their cash dividends, if as and when declared, on their shares of stock and investing in the Plan by making cash payments of not less than $100 or more than $25,000 (or such larger amount as the Company may approve) per quarter, or (iii) investing both their cash dividends and such optional cash payments in shares of Common Stock.

Common Stock is acquired pursuant to the Plan at a price equal to 97% of the closing price on the NYSE for such shares of Common Stock on the higher of the dividend payment date or the applicable trading day. Generally, no brokerage commissions, fees or service charges are paid by Participants in connection with purchases under the Plan. Stockholders who do not participate in the Plan continue to receive cash dividends as declared.

CORPORATE INFORMATION

BOARD OF DIRECTORS

Gilbert M. Meyer
Chairman of the Board,
AvalonBay Communities, Inc.

Richard L. Michaux
Chief Executive Officer
and President,
AvalonBay Communities, Inc.

Bruce A. Choate
Chief Financial Officer,
Watson Land Company

Michael A. Futterman
Chairman,
American Realty Capital

John J. Healy, Jr.
Founder and President,
Hyde Street Holdings, Inc.

Christopher B. Leinberger
Managing Director,
Robert Charles Lesser & Co.
Partner,
Arcadia Land Co.

Richard W. Miller
Former Senior Executive Vice President and Chief Financial Officer, AT&T

Brenda J. Mixson
Chief Financial and Investment Officer and Managing Director,
Prime Capital Holdings, LLC

Thomas H. Nielsen
Consultant,
The Nielsen Company

Lance R. Primis
Managing Partner,
Lance R. Primis & Partners, LLC

Allan D. Schuster
Private Investor

OFFICERS

Gilbert M. Meyer
Chairman of the Board

Richard L. Michaux
Chief Executive Officer
and President

Bryce Blair
Chief Operating Officer

Robert H. Slater
Executive Vice President

Thomas J. Sargeant
Senior Vice President,
Chief Financial Officer

David W. Bellman
Vice President,
Construction

Matthew H. Birenbaum
Vice President,
Development

Gwyneth Jones Coté
Regional Vice President,
Property Operations

K. Scott Davis
Vice President,
Development and Acquisitions

Lili F. Dunn
Vice President,
Acquisitions and Dispositions

Samuel B. Fuller
Regional Vice President,
Development

Frederick S. Harris
Vice President,
Development

Dirk Herrman
Vice President,
Chief Marketing Officer

Leo S. Horey
Regional Vice President,
Property Operations

David J. Hubbard
Vice President,
Development

Henry G. Irwig
Senior Vice President,
Construction

David L. Kirzinger
Vice President,
Development

Lyn Lansdale
Vice President,
Ancillary Services

James R. Liberty
Vice President,
Construction Operations

Joanne M. Lockridge
Vice President,
Finance

William M. McLaughlin
Vice President,
Development

Daniel E. Murphy
Regional Vice President,
Development

Timothy J. Naughton
Regional Vice President,
Development

Edward M. Schulman
Vice President,
General Counsel

Debra L. Shotwell
Senior Vice President,
Human Resources/Admin.

Timothy J. Stanley
Vice President,
Development

COUNSEL

Goodwin, Procter & Hoar LLP
Boston, Massachusetts

AUDITORS

Arthur Andersen LLP
Washington, D.C.

TRANSFER AGENT

First Union National Bank
Charlotte, North Carolina

FORM 10–K

A copy of the Company's annual report on Form 10–K filed with the Securities and Exchange Commission may be obtained without charge by writing:

Investor Relations
AvalonBay Communities, Inc.
2900 Eisenhower Avenue
Suite 300
Alexandria, Virginia 22314

STOCK LISTING

NYSE – AVB

MEMBERSHIP

NAREIT, NMHC, NAHB

2900 Eisenhower Avenue, Suite 300, Alexandria, VA 22314
www.avalonbay.com