PROLOGIS
Form 424B2
July 28, 2003

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Registration Statement No. 333-79813 and 333-105717

(SUBJECT TO COMPLETION, ISSUED JULY 28, 2003)

PRELIMINARY PROSPECTUS SUPPLEMENT

(To Prospectus dated July 28, 2003)

Shares

% Series F Cumulative Redeemable Preferred Shares (Liquidation Preference $25.00 per share)

The Series F Preferred Shares will not be redeemable before August , 2008. Beginning August , 2008, we may redeem Series F Preferred Shares at $25 per share plus accrued distributions. Distributions on the Series F Preferred Shares will be cumulative from the date of issuance and are payable quarterly, starting September 30, 2003.

We will apply to list the Series F Preferred Shares on the New York Stock Exchange and expect that trading will commence within 30 days after the initial delivery of the Series F Preferred Shares.

Investing in the Series F Preferred Shares involves risks. See Risk Factors beginning on page 2 of the accompanying prospectus.

PRICE $25 A SHARE

	Price to Public	Underwriting Discounts and Commissions	Proceeds to ProLogis
Per Share	$	$	$
Total	$	$	$

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus supplement or the related prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

We have granted to the underwriters the right to purchase up to an additional Series F Preferred Shares to cover overallotments.

The underwriters expect to deliver the Series F Preferred Shares to purchasers on August , 2003.

Joint Book-Running Managers

Citigroup **Wachovia Securities**

Morgan Stanley

Banc of America Securities LLC

Banc One Capital Markets, Inc.

Bear, Stearns & Co. Inc.

JPMorgan

SG Cowen

July , 2003

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You should rely only on the information contained in or incorporated by reference in this prospectus supplement and the accompanying prospectus. We have not authorized anyone to provide you with different information. We are not making an offer of these securities in any jurisdiction where the offer is not permitted. You should not assume that the information contained in or incorporated by reference in this prospectus supplement or the accompanying prospectus is accurate as of any date other than the date on the front of this prospectus supplement, the accompanying prospectus or the documents incorporated by reference therein. Our business, financial condition, results of operations and prospects may have changed since those dates.

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References to we, us, and our in this prospectus supplement and the accompanying prospectus are to ProLogis and its consolidated subsidiaries, unless the context otherwise requires.

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PROSPECTUS SUPPLEMENT SUMMARY

The following information may not contain all the information that may be important to you. You should read the entire prospectus supplement and accompanying prospectus, as well as the documents incorporated by reference in the accompanying prospectus, before making an investment decision.

ProLogis

ProLogis is a real estate investment trust that operates a global network of industrial distribution properties. Our business strategy is designed to achieve long-term sustainable growth in cash flow and increase the overall return on equity for our shareholders.

Recent Developments

On July 22, 2003, we announced our preliminary unaudited results of operations for the second quarter ended June 30, 2003. The following information for the quarter and six months ended June 30, 2003 has been derived from our preliminary unaudited results of operations:

Second Quarter 2003

Unaudited Financial Results

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	**2002**	**2003**	**2002**
	(In thousands, except per share amounts)			
Revenues	$169,387	$174,533	$329,330	$346,793
Expenses	105,300	99,447	210,850	197,997
Earnings from Operations	64,087	75,086	118,480	148,796
Net Earnings	55,660	65,014	102,544	128,189
Net Earnings Attributable to Common Shares	47,481	56,835	86,186	111,831
Net Earnings per diluted Common Share	0.26	0.31	0.47	0.62

The Offering

Shares Offered	% Series F Preferred Shares of Beneficial Interest, $0.01 par value per share (shares if the underwriters over-allotment option is exercised in full).
Distributions	Distributions on the Series F Preferred Shares will be cumulative from the date of original issue and are payable quarterly in arrears on March 31, June 30, September 30 and December 31 of each year, commencing on September 30, 2003, at the rate of % of the liquidation preference per annum, or $ per Series F Preferred Share per annum.
Liquidation Preference	$25.00 per share, plus an amount equal to accrued and unpaid distributions (whether or not earned or declared).
Ranking	The Series F Preferred Shares will rank senior to our common shares and any other junior shares that we may issue in the future, and equal to all of our other preferred shares and any other parity shares that are currently outstanding or that we may issue in the future, in each case with respect to payment of distributions and amounts upon liquidation, dissolution or winding up.

Conversion Rights	The Series F Preferred Shares are not convertible into or exchangeable for any other property or any of our other securities.
Redemption at Option of ProLogis	Except in limited circumstances relating to the preservation of our status as a real estate investment trust, the Series F Preferred Shares are not redeemable until August , 2008. On or after August , 2008, we may redeem the Series F Preferred Shares, in whole or in part, at $25.00 per share plus any accrued and unpaid distributions through the date of redemption. The Series F Preferred Shares have no maturity date and will remain outstanding indefinitely unless redeemed.
Voting Rights	You will generally have no voting rights as a holder of Series F Preferred Shares. However, if distributions on the Series F Preferred Shares are in arrears for six quarterly distribution periods (whether or not consecutive), the holders of the Series F Preferred Shares (voting separately as a class with holders of all other series of parity preferred shares upon which like voting rights have been conferred and are exercisable) will have the right to elect two additional trustees to serve on our Board of Trustees until such distribution arrearage is eliminated. In addition, certain changes that would be materially adverse to the rights of holders of the Series F Preferred Shares cannot be made without the affirmative vote of holders of at least two-thirds of the outstanding Series F Preferred Shares. Holders of other outstanding series of preferred shares have substantially similar voting rights.
Listing	We intend to file an application to list the Series F Preferred Shares on the New York Stock Exchange and expect that trading will commence within 30 days after initial delivery of the Series F Preferred Shares.
Use of Proceeds	We will use the proceeds from the sale of the Series F Preferred Shares to repay outstanding borrowings under our credit facilities or to fund (together with other funds available to us) the redemption of our Series D Preferred Shares of Beneficial Interest.
Restriction on Ownership	In order to assist us in maintaining our status as a real estate investment trust for federal income tax purposes, ownership by any person of more than 25% of the outstanding Series F Preferred Shares is restricted.

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USE OF PROCEEDS

The net proceeds from the sale of the Series F Preferred Shares are expected to be approximately $ million, after deducting underwriting discounts and offering expenses payable by us (approximately $ million if the underwriters over-allotment option is exercised in full). We will use the net proceeds of the offering to either repay a portion of the borrowings under our revolving credit facilities or, with other cash available to us, fund the redemption of our Series D Preferred Shares of Beneficial Interest. If the net proceeds are used to fund the redemption of our Series D Preferred Shares, approximately $ million in additional funds will be required to complete the redemption. This additional amount will be funded through borrowings under our revolving credit facilities.

We currently have a total commitment of $1.19 billion under our credit facilities. As of July 25, 2003, this commitment is reduced by $21.0 million representing letters of credit outstanding with the lending banks. We have approximately $502.4 million outstanding and an available balance of approximately $664.3 million at July 25, 2003. Amounts repaid under the credit facilities may be reborrowed and we expect to make additional borrowings under the credit facilities following this offering for the development and acquisition of industrial distribution properties and for working capital purposes. Our $1.19 billion credit facilities are led by Bank of America, N.A., in the United States, ABN AMRO Bank N.V., in Europe, Royal Bank of Scotland, in Europe, and Sumitomo Mitsui Banking Corporation, in Japan. Affiliates of certain underwriters participating in this offering are lenders under our existing credit facility. Borrowings under our credit facilities generally bear interest at the interbank offered rate in the relevant market for the currency borrowed plus an applicable margin (generally 0.65% to 0.675% in the United States, 0.75% to 1.00% in Europe, and 0.75% to 1.9% in Japan). Our credit facilities mature at varying times between July 2003 and November 2005 and are generally renewable at our option.

DESCRIPTION OF THE SERIES F PREFERRED SHARES

The summary of certain terms and provisions of the Series F Preferred Shares contained in this prospectus supplement does not purport to be complete and is subject to, and qualified in its entirety by reference to, the terms and provisions of the articles supplementary relating to the Series F Preferred Shares and our Amended and Restated Declaration of Trust, as amended and supplemented, which are incorporated by reference herein. The following description of the particular terms of the Series F Preferred Shares supplements, and to the extent inconsistent therewith replaces, the description of the general terms and provisions of the preferred shares set forth in the accompanying prospectus, to which reference is hereby made.

General

Our Board of Trustees is authorized to issue, from our authorized but unissued shares of beneficial interest, preferred shares in series and to establish from time to time the number of preferred shares to be included in such series and to fix the designation and any preferences, conversion and other rights, voting powers, restrictions, limitations as to distributions, qualifications and terms and conditions of redemption of the shares of each such series. We currently have outstanding 2,000,000 Cumulative Redeemable Series C Preferred Shares of Beneficial Interest and 10,000,000 Cumulative Redeemable Series D Preferred Shares of Beneficial Interest.

When issued, the Series F Preferred Shares will be validly issued, fully paid and, except as set forth in the accompanying prospectus under Description of Common Shares Shareholder liability, nonassessable. The holders of the Series F Preferred Shares will have no preemptive rights with respect to any of our shares of capital securities or any of our other securities convertible into or carrying rights or options to purchase any such shares. The Series F Preferred Shares will not be subject to any sinking fund or other obligation of us to redeem or retire the Series F Preferred Shares. Unless otherwise redeemed by us, the Series F Preferred Shares will have a perpetual term with no maturity.

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The transfer agent, registrar and distribution disbursing agent for the Series F Preferred Shares will be EquiServe Trust Company, N.A., Canton, Massachusetts.

We intend to file an application to list the Series F Preferred Shares on the New York Stock Exchange and expect that trading will commence within 30 days after initial delivery of the Series F Preferred Shares.

Ranking

The Series F Preferred Shares will rank senior to our common shares and any other junior shares that we may issue in the future, and equal to all of our other preferred shares and any other parity shares that are currently outstanding or that we may issue in the future, in each case with respect to payment of dividends and amounts upon liquidation, dissolution or winding up.

Distributions

Holders of the Series F Preferred Shares shall be entitled to receive, when and as declared by the Board of Trustees out of funds legally available for the payment of distributions, cumulative, preferential cash distributions at the rate of % of the liquidation preference per annum (equivalent to $ per share per annum). Such distributions shall be cumulative from the date of original issue and shall be payable quarterly in arrears on the last day of each March, June, September and December or, if not a business day, the next succeeding business day (each such day being a distribution payment date). The first distribution, which will be paid on September 30, 2003, will be for less than a full quarter. Such distribution and any distribution payable on the Series F Preferred Shares for any partial distribution period will be computed on the basis of a 360-day year consisting of twelve 30-day months. Distributions will be payable to holders of record as they appear in our records at the close of business on the applicable record date, which shall be on such date designated by the Board of Trustees for the payment of distributions that is not more than 50 nor less than 10 days prior to such distribution payment date (which we refer to as a distribution record date).

No distributions on Series F Preferred Shares shall be declared by the Board of Trustees or paid or set apart for payment by us at such time as the terms and provisions of any agreement we have entered into, including any agreement relating to our indebtedness, prohibits such declaration, payment or setting apart for payment or provides that such declaration, payment or setting apart for payment would constitute a breach thereof or a default thereunder, or if such declaration or payment shall be restricted or prohibited by law.

Notwithstanding the foregoing, distributions on the Series F Preferred Shares will accrue whether or not we have earnings, whether or not there are funds legally available for the payment of such distributions and whether or not such distributions are declared. Accrued but unpaid distributions on the Series F Preferred Shares will not bear interest. Holders of the Series F Preferred Shares will not be entitled to any distributions in excess of full cumulative distributions as described above. See Description of Preferred Shares Dividends in the accompanying prospectus.

If, for any taxable year, we elect to designate as capital gain distributions (as defined in Section 857 of the Internal Revenue Code of 1986, as amended), any portion of the distributions (as determined for federal income tax purposes) paid or made available for the year to holders of all classes of shares, then the portion of such designated amount that shall be allocable to the holders of Series F Preferred Shares shall be the amount that the total distributions (as determined for federal income tax purposes) paid or made available to the holders of the Series F Preferred Shares for the year bears to the total distributions paid or made available for the year to holders of all classes of shares.

If any Series F Preferred Shares are outstanding, no full distributions shall be declared or paid or set apart for payment on any series of our preferred shares ranking, as to distributions, on a parity with or junior to the Series F Preferred Shares for any period unless full cumulative distributions have been or contemporaneously are declared and paid or declared and a sum sufficient for the payment thereof set apart for such payments on the Series F Preferred Shares for all past distribution periods and the then current distribution period. When distributions are not paid in full (or a sum sufficient for such full payment is not so set apart) upon the Series F Preferred Shares and the shares of any other series of preferred shares ranking on parity as to

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distributions with the Series F Preferred Shares, all distributions declared upon Series F Preferred Shares and any other series of preferred shares ranking on a parity as to distributions with the Series F Preferred Shares shall be declared pro rata so that the amount of distributions declared per share on the Series F Preferred Shares and such other series of preferred shares shall in all cases bear to each other the same ratio that accrued distributions per share on the Series F Preferred Shares and such other series of preferred shares bear to each other. No interest, or sum of money in lieu of interest, shall be payable in respect of any distribution payment or payments on Series F Preferred Shares which may be in arrears.

Except as provided in the immediately preceding paragraph, unless full cumulative distributions on the Series F Preferred Shares have been or contemporaneously are declared and paid or declared and a sum sufficient for the payment thereof set apart for payment for all past distribution periods and the then current distribution period, no distributions (other than in common shares or other capital shares ranking junior to the Series F Preferred Shares as to distributions and upon liquidation) shall be declared or paid or set aside for payment or other distribution shall be declared or made upon the common shares or any other of our capital shares ranking junior to or on a parity with the Series F Preferred Shares as to distributions or upon liquidation, nor shall any common shares or any other of our capital shares ranking junior to or on a parity with the Series F Preferred Shares as to distributions or upon liquidation be redeemed, purchased or otherwise acquired for any consideration (or any moneys be paid to or made available for a sinking fund for the redemption of any such shares) by us, except by conversion into or exchange for other of our capital shares ranking junior to the Series F Preferred Shares as to distributions and upon liquidation.

Any distribution payment made on Series F Preferred Shares shall first be credited against the earliest accrued but unpaid distribution due with respect to Series F Preferred Shares which remains payable.

Liquidation Rights

Upon any voluntary or involuntary liquidation, dissolution or winding up of our affairs, then, before any distribution or payment shall be made to the holders of any common shares or any other class or series of our capital shares ranking junior to the Series F Preferred Shares in the distribution of assets upon any liquidation, dissolution or winding up of us, the holders of Series F Preferred Shares shall be entitled to receive out of our assets legally available for distribution to shareholders, liquidating distributions in the amount of the liquidation preference ($25.00 per share), plus an amount equal to all distributions accrued and unpaid thereon. After payment of the full amount of the liquidating distributions to which they are entitled, the holders of Series F Preferred Shares will have no right or claim to any of our remaining assets. In the event that, upon any such voluntary or involuntary liquidation, dissolution or winding up, our available assets are insufficient to pay the amount of the liquidating distributions on all outstanding Series F Preferred Shares and the corresponding amounts payable on all shares of other classes or series of our capital shares ranking on a parity with the Series F Preferred Shares in the distribution of assets, then the holders of the Series F Preferred Shares and all other such classes or series of capital shares shall share ratably in any such distribution of assets in proportion to the full liquidating distributions to which they would otherwise be respectively entitled. For such purposes, the consolidation or merger of us with or into any other entity, or the sale, lease or conveyance of all or substantially all of our property or business, or a statutory share exchange shall not be deemed to constitute a liquidation, dissolution or winding up of us.

Redemption

The Series F Preferred Shares are not redeemable prior to August , 2008. On or after August , 2008, we, at our option upon not less than 30 nor more than 90 days written notice, may redeem the Series F Preferred Shares, in whole or in part, at any time or from time to time, for cash at a redemption price of $25.00 per share, plus all accrued and unpaid distributions thereon to the date fixed for redemption, without interest. Holders of Series F Preferred Shares to be redeemed shall surrender such Series F Preferred Shares at the place designated in such notice and shall be entitled to the redemption price and any accrued and unpaid distributions payable upon such redemption following such surrender. If fewer than all of the outstanding Series F Preferred Shares are to be redeemed, the number of shares to be redeemed will be determined by us and such shares may be redeemed pro rata from the holders of record of such shares in

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proportion to the number of such shares held by such holders (with adjustments to avoid redemption of fractional shares) or by lot in a manner determined by us.

Unless full cumulative distributions on all Series F Preferred Shares and all shares ranking on a parity with the Series F Preferred Shares with respect to the payment of distributions and amounts upon liquidation, dissolution and winding up (referred to as parity shares) shall have been or contemporaneously are declared and paid or declared and a sum sufficient for the payment thereof set apart for payment for all past distribution periods and the then current distribution period, no Series F Preferred Shares or parity shares shall be redeemed unless all outstanding Series F Preferred Shares and parity shares are simultaneously redeemed; provided, however, that the foregoing shall not prevent the purchase or acquisition of Series F Preferred Shares or parity shares pursuant to a purchase or exchange offer made on the same terms to holders of all outstanding Series F Preferred Shares or parity shares, as the case may be. Furthermore, unless full cumulative distributions on all outstanding Series F Preferred Shares and parity shares have been or contemporaneously are declared and paid or declared and a sum sufficient for the payment thereof set apart for payment for all past distribution periods and the then current distribution period, we shall not purchase or otherwise acquire directly or indirectly any Series F Preferred Shares or parity shares (except by conversion into or exchange for our capital shares ranking junior to the Series F Preferred Shares and parity shares as to distributions and upon liquidation).

Notice of redemption will be mailed at least 30 days but not more than 90 days before the redemption date to each holder of record of Series F Preferred Shares at the address shown on our share transfer books. Each notice shall state: (i) the redemption date; (ii) the number of Series F Preferred Shares to be redeemed; (iii) the redemption price of $25.00 per Series F Preferred Share, plus any accrued and unpaid distributions through the date of redemption; (iv) the place or places where certificates for Series F Preferred Shares are to be surrendered for payment of the redemption price; and (v) that distributions on the Series F Preferred Shares will cease to accrue on such redemption date. If fewer than all Series F Preferred Shares are to be redeemed, the notice mailed to each such holder thereof shall also specify the number of Series F Preferred Shares to be redeemed from each such holder. If notice of redemption of any Series F Preferred Shares has been given and if the funds necessary for such redemption have been set aside by us in trust for the benefit of the holders of Series F Preferred Shares so called for redemption, then from and after the redemption date, distributions will cease to accrue on the Series F Preferred Shares, such Series F Preferred Shares shall no longer be deemed outstanding and all rights of the holders of such shares will terminate, except the right to receive the redemption price.

The holders of Series F Preferred Shares at the close of business on a distribution record date will be entitled to receive the distribution payable with respect to such Series F Preferred Shares on the corresponding distribution payment date notwithstanding the redemption thereof between such distribution record date and the corresponding distribution payment date or our default in the payment of the distribution due. Except as provided above, we will make no payment or allowance for unpaid distributions, whether or not in arrears, on Series F Preferred Shares which have been called for redemption.

The Series F Preferred Shares have no stated maturity and will not be subject to any sinking fund or mandatory redemption. However, in order to preserve our status as a real estate investment trust as defined in the Internal Revenue Code, the Series F Preferred Shares may be subject to redemption as described in Description of Preferred Shares Restrictions on ownership in the accompanying prospectus. Any such redemption would apply only to shares held, directly or indirectly, by those shareholders with concentrated share ownership that would violate the preferred shares ownership limit provision. In addition, the number of shares subject to such a redemption would be limited to that number of concentrated shares sufficient in the opinion of the Board of Trustees to maintain or bring the ownership of shares into conformity with the preferred shares ownership limit provision. See Description of Preferred Shares Restrictions on ownership in the accompanying prospectus.

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Voting Rights

Except as indicated below, or except as otherwise from time to time required by applicable law, the holders of Series F Preferred Shares will have no voting rights.

If six quarterly distributions (whether or not consecutive) payable on the Series F Preferred Shares or any parity shares are in arrears, whether or not earned or declared, the number of trustees then constituting the Board of Trustees will be increased by two, and the holders of Series F Preferred Shares, voting together as a class with the holders of any other series of parity shares (any such other series, being voting preferred shares), will have the right to elect two additional trustees to serve on our Board of Trustees at any annual meeting of shareholders or a properly called special meeting of the holders of Series F Preferred Shares and such voting preferred shares and at each subsequent annual meeting of shareholders until all such distributions and distributions for the current quarterly period on the Series F Preferred Shares and such other voting preferred shares have been paid or declared and paid or set aside for payment. The term of office of all trustees so elected will terminate with the termination of such voting rights.

The approval of two-thirds of the outstanding Series F Preferred Shares and all other series of voting preferred shares similarly affected, voting as a single class, is required in order to (i) amend our Amended and Restated Declaration of Trust to affect materially and adversely the rights, preferences or voting power of the holders of the Series F Preferred Shares or the voting preferred shares, (ii) enter into a share exchange that affects the Series F Preferred Shares, consolidate with or merge into another entity, or permit another entity to consolidate with or merge into us, unless in each such case each Series F Preferred Share remains outstanding without a material adverse change to its terms and rights or is converted into or exchanged for preferred stock of the surviving entity having preferences, rights, voting powers, restrictions, limitations as to distributions, qualifications and terms or conditions of redemption thereof identical to that of a Series F Preferred Share (except for changes that do not materially and adversely affect the holders of the Series F Preferred Shares) or (iii) authorize, reclassify, create, or increase the authorized amount of any class of stock having rights senior to the Series F Preferred Shares with respect to the payment of distributions or amounts upon liquidation, dissolution or winding up. However, we may create additional classes of parity shares and shares ranking junior to the Series F Preferred Shares as to distributions or upon liquidation (each, referred to as junior shares), increase the authorized number of parity shares and junior shares and issue additional series of parity shares and junior shares without the consent of any holder of Series F Preferred Shares.

Except as provided above and as required by law, the holders of Series F Preferred Shares are not entitled to vote on any merger or consolidation involving us or a sale of all or substantially all of our assets.

Conversion

The Series F Preferred Shares are not convertible into or exchangeable for any of our other property or securities.

Restrictions on Ownership

For information regarding restrictions on ownership of the Series F Preferred Shares, see Description of Preferred Shares Restrictions on ownership in the accompanying prospectus.

FEDERAL INCOME TAX CONSIDERATIONS

The following summary of certain federal income tax considerations is based on current law, is for general information only, and is not tax advice. This discussion does not purport to deal with all aspects of taxation that may be relevant to particular shareholders in light of their personal investment or tax circumstances, or to certain types of shareholders (including insurance companies, tax exempt organizations, financial institutions or broker dealers, foreign corporations and persons who are not citizens or residents of the United States) subject to special treatment under the federal income tax laws. In addition, this section does not discuss foreign, state, or local taxation.

This prospectus supplement does not address the taxation of ProLogis or the impact on ProLogis of its election to be taxed as a real estate investment trust. Those matters are addressed in the accompanying prospectus under Federal Income Tax Considerations Taxation of ProLogis. Prospective investors should consult, and must depend on, their own tax advisors regarding the state, local, foreign and other tax consequences of holding and disposing of Series F Preferred Shares.

Dividends and Other Distributions. For a discussion regarding the taxation of dividends and other distributions, see Federal Income Tax Considerations Taxation of ProLogis shareholders in the accompanying prospectus.

Backup Withholding. For a discussion of backup withholding, see Federal Income Tax Considerations Taxation of ProLogis shareholders Information and reporting and backup withholding in the accompanying prospectus.

Sale or Exchange of Series F Preferred Shares. Upon the sale or exchange of Series F Preferred Shares to a party other than ProLogis, a holder of Series F Preferred Shares will realize a capital gain or loss measured by the difference between the amount realized on the sale or other disposition and the holder s adjusted tax basis in the Series F Preferred Shares, provided the Series F Preferred Shares are held as a capital asset. This gain or loss will be a long term capital gain or loss if the holder s holding period for the Series F Preferred Shares is more than one year at the time of the sale or exchange. Further, any loss on a sale of Series F Preferred Shares which were held by the holder for six months or less and on which a capital gain dividend was received will be treated as a long term capital loss, up to the amount of the capital gain dividend received on those such shares.

Redemption of Series F Preferred Shares. The treatment to be accorded to any redemption by ProLogis of Series F Preferred Shares can only be determined on the basis of particular facts as to each holder of Series F Preferred Shares at the time of redemption. In general, a preferred holder will recognize capital gain or loss measured by the difference between the amount realized by the holder upon the redemption and the holder s adjusted tax basis in the Series F Preferred Shares redeemed, provided the Series F Preferred Shares are held as a capital asset, if the redemption (i) results in a complete termination of the holder s share interest in all classes of shares of ProLogis under Section 302(b)(3) of the Internal Revenue Code, (ii) is substantially disproportionate with respect to the holder s interest in ProLogis under Section 302(b)(2) of the Internal Revenue Code (which will not be the case if only Series F Preferred Shares are redeemed, since they generally do not have voting rights) or (iii) is not essentially equivalent to a dividend with respect to the holder of Series F Preferred Shares under Section 302(b)(1) of the Internal Revenue Code. In determining whether any of these tests have been met, shares considered to be owned by the holder by reason of certain constructive ownership rules set forth in the Internal Revenue Code, as well as shares actually owned, must generally be taken into account. Because the determination as to whether any of the alternative tests of Section 302(b) of the Internal Revenue Code will be satisfied with respect to any particular holder of Series F Preferred Shares depends upon the facts and circumstances at the time when the determination must be made, prospective investors are advised to consult their own tax advisors to determine the tax treatment to them. Any portion of the redemption proceeds attributable to a declared but unpaid dividend will be treated as a distribution to the Series F Preferred Shares as described in the accompanying prospectus under Federal Income Tax Considerations Taxation of ProLogis shareholders.

A substantially disproportionate reduction in the interest of a holder of Series F Preferred Shares will have occurred if, as a result of the redemption, (1) the holder s ownership of all of the outstanding voting shares of ProLogis is reduced immediately after the redemption to less than 80% of the holder s percentage interest in the shares immediately before the redemption; (2) the holder s percentage ownership of the common shares after and before the redemption meets the same 80% requirement; and (3) the holder owns, immediately after the redemption, less than 50% of the total combined voting power of all classes of shares entitled to vote. Based upon current law, it is possible that a redemption of Series F Preferred Shares from a holder of Series F Preferred Shares would be considered not essentially equivalent to a dividend. However, whether a distribution is not essentially equivalent to a dividend depends on all of the facts and circumstances. The application of these tests to a redemption of Series F Preferred Shares is unclear, and a

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holder of Series F Preferred Shares intending to rely on any of these tests at the time of redemption should consult its own tax adviser to determine their application to its particular situation.

If the redemption does not meet any of the tests under Section 302 of the Internal Revenue Code, then the redemption proceeds received from the Series F Preferred Shares will be treated as a distribution on the Series F Preferred Shares as described under Federal Income Tax Considerations Taxation of ProLogis shareholders in the accompanying prospectus. If the redemption is taxed as a dividend, the holder s adjusted tax basis in the Series F Preferred Shares will be transferred to any other shareholdings of the holder in ProLogis. If, however, the shareholder has no remaining shareholdings in ProLogis, such basis could be transferred to a related person or it may be lost.

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UNDERWRITING

Subject to the terms and conditions set forth in an underwriting agreement dated July , 2003 (the Underwriting Agreement), we have agreed to sell to each of the underwriters named below, and each of the underwriters, for whom Citigroup Global Markets Inc., Morgan Stanley & Co. Incorporated and Wachovia Capital Markets, LLC are acting as joint book-running managers (the Representatives), have severally agreed to purchase the number of Series F Preferred Shares set forth opposite its name. In the Underwriting Agreement, the several underwriters have agreed, subject to the terms and conditions set forth therein, to purchase all the Series F Preferred Shares offered hereby (other than those covered by the underwriters overallotment option described below) if any such shares are purchased.

Underwriters	Number of Series F Preferred Shares
Citigroup Global Markets Inc.	
Morgan Stanley & Co. Incorporated	
Wachovia Capital Markets, LLC	
Banc of America Securities LLC	
Banc One Capital Markets, Inc.	
Bear, Stearns & Co. Inc.	
J.P. Morgan Securities Inc.	
SG Cowen Securities Corporation	
Total	

The Representatives have advised us that the underwriters propose initially to offer the Series F Preferred Shares to the public at the offering price set forth on the cover page of this prospectus supplement and to certain securities dealers at such price less a concession of $ per share. The underwriters may allow, and such dealers may reallow, a concession not in excess of $ per share to certain brokers and dealers. After the initial offering of the Series F Preferred Shares, the public offering price and concession may be changed.

We have granted to the underwriters an option, exercisable for 30 days from the original issue date of the Series F Preferred Shares, to purchase up to an aggregate of additional Series F Preferred Shares at the public offering price set forth on the cover page hereof, less underwriting discounts and commissions. The underwriters may exercise such option solely for the purpose of covering overallotments, if any, made in connection with the offering of the Series F Preferred Shares offered hereby. To the extent such option is exercised, each underwriter will become obligated, subject to certain conditions, to purchase approximately the same percentage of such additional Series F Preferred Shares as the number set forth next to such underwriter s name in the preceding table bears to the total number of Series F Preferred Shares set forth next to the names of all underwriters in the preceding table.

We have agreed, without the prior written consent of the Representatives on behalf of the underwriters, not to, during the period ending 35 days after the date of the Underwriting Agreement:

offer, pledge, sell, contract to sell, sell any option or contract to purchase, purchase any option or contract to sell, grant any option, right or warrant to purchase, lend, or otherwise transfer or dispose of, directly or indirectly, any Series F Preferred Shares or securities of the Company similar to the Series F Preferred Shares or any securities convertible into or exercisable or exchangeable for Series F Preferred Shares or securities of the Company similar to the Series F Preferred Shares; or

enter into any swap or other arrangement that transfers to another, in whole or in part, any of the economic consequences of ownership of the Series F Preferred Stock or securities of the Company similar to the Series F Preferred Shares;

whether any transaction described above is to be settled by delivery of Series F Preferred Shares or such other securities, in cash or otherwise. The foregoing sentence shall not apply to the redemption of our Series D Preferred Shares and the issuance and sale of the Series F Preferred Shares offered hereby.

We have agreed to indemnify the underwriters against certain liabilities, including liabilities under the Securities Act of 1933, as amended.

Prior to the offering, there has been no public market for the Series F Preferred Shares. We intend to list the Series F Preferred Shares on the New York Stock Exchange, and we expect trading in the Series F Preferred Shares on the New York Stock Exchange to begin within 30 days after the original issue date.

The Series F Preferred Shares are a new issue of securities with no established trading market. The underwriters have advised us that the underwriters intend to make a market in the Series F Preferred Shares but are not obligated to do so and may discontinue any market making activities at any time without notice. Neither we nor the underwriters can assure you that the trading market for the Series F Preferred Shares will be liquid.

In connection with the sale of the Series F Preferred Shares, certain of the underwriters may engage in transactions that stabilize, maintain or otherwise affect the price of the Series F Preferred Shares. Specifically, the underwriters may overallot the offering, creating a short position. In addition, the underwriters may bid for and purchase the Series F Preferred Shares in the open market to cover short positions or to stabilize the price of the Series F Preferred Shares. Any of these activities may stabilize or maintain the market price of the Series F Preferred Shares above independent market levels. The underwriters will not be required to engage in these activities, and may end any of these activities at any time without notice.

We will deliver the Series F Preferred Shares to the underwriters at the closing of this offering when the underwriters pay us the purchase price of such shares. The Underwriting Agreement provides that the closing will occur on August , 2003, which is business days after the date of this prospectus supplement. Rule 15c6-1 under the Securities Exchange Act of 1934, as amended, generally requires that securities trades in the secondary market settle in three business days, unless the parties to the trade expressly agree otherwise. Accordingly, purchasers who wish to trade Series F Preferred Shares on any day prior to the third business day before the date of the delivery of any payment on the Series F Preferred Shares will be required, by virtue of the fact that the Series F Preferred Shares initially will settle in business days from the date hereof, to specify an alternate settlement cycle at the time of any such trade to prevent a failed settlement. Purchasers of Series F Preferred Shares who wish to trade shares on the day of pricing or the next succeeding business days should consult their own advisor.

In the ordinary course of their respective businesses, several of the underwriters and their affiliates have engaged, and may engage, in commercial banking and investment banking transactions with us and certain of our affiliates for which they have received customary fees and expenses. In addition, affiliates of certain underwriters participating in this offering are lenders under our existing credit facilities. Because more than 10% of the proceeds of this offering, not including underwriting compensation, may be received by entities who are affiliated with National Association of Securities Dealers, Inc. members who are participating in this offering, this offering is being conducted in compliance with Rule 2710(c)(8) of the Conduct Rules of the National Association of Securities Dealers, Inc.

We expect to have an estimated $ of expenses in connection with this offering.

LEGAL MATTERS

The validity of the notes will be passed upon for us by Mayer, Brown, Rowe & Maw LLP, Chicago, Illinois. Certain legal matters will be passed upon for the underwriters by Shearman & Sterling LLP, New York, New York.

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PROSPECTUS

$1,000,000,000*

DEBT SECURITIES

PREFERRED SHARES

COMMON SHARES

We will provide specific terms of these securities in supplements to this prospectus. You should carefully read this prospectus and any supplement before you invest.

* Pursuant to Rule 429 under the Securities Act of 1933, this prospectus includes $308,029,182 of our debt securities, preferred shares and common shares, which were registered under a previous registration statement.

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION, NOR HAS THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE

The date of this Prospectus is July 28, 2003

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WHERE YOU CAN FIND MORE INFORMATION

We are subject to the informational requirements of the Securities Exchange Act of 1934 and, in accordance therewith, file reports, proxy statements and other information with the Securities and Exchange Commission. Such reports, proxy statements and other information can be inspected and copied at the public reference facilities maintained by the Securities and Exchange Commission at 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such material can be obtained at prescribed rates from the Public Reference Room of the Securities and Exchange Commission at 450 Fifth Street, N.W., Washington, D.C. 20549 or by calling the Securities and Exchange Commission at 1-800-SEC-0330. Such material can also be obtained from the Securities and Exchange Commission s worldwide web site at http://www.sec.gov. Our outstanding common shares, Series D cumulative redeemable preferred shares of beneficial interest and Series E cumulative redeemable preferred shares of beneficial interest, are listed on the New York Stock Exchange under the symbols PLD , PLD-PRD and PLD-PRE , respectively, and all such reports, proxy statements and other information filed by us with the New York Stock Exchange may be inspected at the New York Stock Exchange s offices at 20 Broad Street, New York, New York 10005. You can also obtain information about us at our website, www.prologis.com.

We have filed with the Securities and Exchange Commission a registration statement on Form S-3 under the Securities Act of 1933 with respect to our common shares being offered. This prospectus, which constitutes part of the registration statement, does not contain all of the information set forth in the registration statement. Parts of the registration statement are omitted from this prospectus in accordance with the rules and regulations of the Securities and Exchange Commission. For further information, your attention is directed to the registration statement. Statements made in this prospectus concerning the contents of any documents referred to herein are not necessarily complete, and in each case are qualified in all respects by reference to the copy of such document filed with the Securities and Exchange Commission.

The Securities and Exchange Commission allows us to incorporate by reference the information we file with the Securities and Exchange Commission, which means that we can disclose important information to you by referring you to those documents. The information incorporated by reference is an important part of this prospectus, and information that we file later with the Securities and Exchange Commission will automatically update and supersede this information.

We incorporate by reference the documents listed below:

(a) Our annual report on Form 10-K for the year ended December 31, 2002, filed on March 27, 2003;

(b) Our quarterly report on Form 10-Q for the quarter ended March 31, 2003, filed on May 14, 2003;

(c) Our periodic reports on Form 8-K filed February 19, 2003, February 21, 2003, April 4, 2003 and July 1, 2003; and

(d) The description of our common shares and preferred share purchase rights contained or incorporated by reference in our registration statement on Form 8-A filed February 23, 1994.

The Securities and Exchange Commission has assigned file number 1-12846 to the reports and other information that ProLogis files with the Securities and Exchange Commission.

You may request a copy of each of the above-listed ProLogis documents at no cost, by writing or telephoning us at the following address or telephone number.

Investor Relations Department
ProLogis
14100 East 35th Place
Aurora, Colorado 80011
(800) 820-0181
http://ir.prologis.com

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All documents subsequently filed by us pursuant to Section 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act, prior to the termination of the offering, shall be deemed to be incorporated by reference into this prospectus.

Any statement contained in a document incorporated or deemed to be incorporated herein shall be deemed modified or superseded for purposes of this prospectus to the extent that a statement contained herein or in any other subsequently filed document that is deemed to be incorporated herein modifies or supersedes such statement. Any statement so modified or superseded shall not be deemed, except as so modified or superseded, to constitute a part of this prospectus.

You should rely only on the information contained in this document or to which we have referred you. We have not authorized anyone to provide you with information that is inconsistent with information contained in this document or any document incorporated herein. This prospectus is not an offer to sell these securities in any state where the offer and sale of these securities is not permitted. The information in this prospectus is current as of the date it is mailed to security holders, and not necessarily as of any later date. If any material change occurs during the period that this prospectus is required to be delivered, this prospectus will be supplemented or amended.

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FORWARD-LOOKING STATEMENTS

The following statements are or may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995:

(1) statements, including our possible or assumed future results of operations including any forecasts, projections and descriptions of anticipated cost savings or other synergies referred to in such statements, and any such statements incorporated by reference from documents filed with the Securities and Exchange Commission by us, including any statements contained in such documents or this prospectus regarding the development or possible or assumed future results of operations of our businesses, the markets for our services and products, anticipated capital expenditures or competition;

(2) any statements preceded by, followed by or that include the words believes, expects, anticipates, intends, plans, seeks, estin similar expressions; and

(3) other statements contained or incorporated by reference in this prospectus regarding matters that are not historical facts.

Because such statements are subject to risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements. Shareholders are cautioned not to place undue reliance on such statements, which speak only as of the date the statements were made.

Among the factors that could cause actual results to differ materially are: changes in general economic conditions in our markets that could adversely affect demand for our properties and the creditworthiness of our customers, changes in financial markets, interest rates and foreign currency exchange rates that could adversely affect our cost of capital, our ability to meet our financial needs and obligations and our results of operations, increased or unanticipated competition for distribution properties in our markets, the availability of private capital to us and geopolitical concerns and uncertainties, and other risks detailed from time to time in the reports filed with the Securities and Exchange Commission by us.

Except for their ongoing obligations to disclose material information as required by the federal securities laws, we do not undertake any obligation to release publicly any revisions to any forward-looking statements to reflect events or circumstances after the date of the filing of this prospectus or to reflect the occurrence of unanticipated events.

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PROLOGIS

ProLogis is a real estate investment trust, or REIT, that operates a global network of industrial distribution properties. Our business strategy is designed to achieve long-term sustainable growth in cash flow and increase the overall return on equity for our shareholders. Our business is organized into two primary operating segments: property operations and the corporate distribution facilities services business, which we refer to as the CDFS business. During 2001 and 2002, we disposed of significant portions of our third operating segment, temperature-controlled distribution operations.

The property operations segment represents the long-term ownership, management and leasing of industrial distribution properties. The property operations segment generates income from rents and reimbursement of property operating expenses from unaffiliated customers. Also, our share of the earnings of eight unconsolidated property funds, and the fee income that we receive for managing the properties owned by the property funds, is included in the property operations segment. In addition to the property and asset management fees earned, we earn fees for other services performed on behalf of the property funds, including development, leasing and acquisition activities.

The CDFS business segment encompasses those activities that we engage in that are not primarily associated with the long-term ownership, management and leasing of industrial distribution properties. Within this operating segment, our primary activity is the development of distribution properties that are either contributed to property funds in which we maintain an ownership interest and act as manager or sold to unaffiliated customers. Income from the CDFS business segment is primarily generated through the gains recognized from the contributions and sales of developed properties and from the contribution of operating properties that were acquired with the intent to contribute the property to a property fund. We also use our development and leasing expertise to rehabilitate and/or reposition certain of the properties that we acquire such that the subsequent contribution of the property will generate a profit for us. And, we earn fees from customers for development activities performed on their behalf and realize profits from sales of land parcels when our development plans no longer include these parcels. These development projects are located in North America, in Europe and in Japan (we developed and contributed our first project in Asia during 2002). Additionally, we own or control (either through contracts, options or letters of intent) land that we intend to use for the development of distribution properties in North America and Europe.

We manage our business by utilizing the ProLogis Operating System®, an organizational structure and service delivery system that is built around our customers. The ProLogis Operating System® is made up of the Market Services Group, the Global Services Group, the Global Development Group and the ProLogis Solutions Group. When combined with our international network of distribution properties, the ProLogis Operating System® enables us to meet our customers distribution space needs on a global basis. We believe that by integrating international scope and expertise with strong local presence in our markets we have become an attractive choice for the largest global users of distribution properties, our targeted customer base.

We are organized under Maryland law and have elected to be taxed as a real estate investment trust under the Internal Revenue Code. Our world headquarters are located in Aurora, Colorado, our European headquarters are located in Luxembourg, with our European customer service headquarters located in Amsterdam, Netherlands, and our Asian headquarters are located in Tokyo, Japan.

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RISK FACTORS

Our operations involve various risks that could adversely affect our financial condition, results of operations, cash flow, ability to pay distributions on our common shares and the market price of our common shares. These risks include, among others:

General Real Estate Risks

General Economic Conditions

We are exposed to the general economic conditions and the local, regional, national and international conditions that affect the markets in which we own industrial distribution properties. Our operating performance depends on the economic conditions of markets in which our distribution properties are concentrated. While we do not have in excess of 10% of our total portfolio (including the properties owned by the property funds) in any one market, we do have significant holdings in Atlanta, Chicago, Dallas/ Ft. Worth, Houston, Los Angeles, Memphis, Paris and San Francisco. Our operating performance could be adversely affected if conditions in these larger markets, such as an oversupply of distribution space or a reduction in demand for industrial distribution properties, become less favorable relative to other geographic areas. Any material oversupply of distribution space or material reduction of demand for distribution space could adversely affect our operating income and the value of our common shares.

Risks Particular To Real Estate

Real property investments are subject to varying degrees of risk. While we seek to minimize these risks through geographic diversification, our market research and property management capabilities, these risks cannot be eliminated. The factors that can affect real estate values include:

- local conditions, such as an oversupply of distribution space or a reduction in demand for industrial real estate changes in an area;
- changes in the general economic climate;
- the quality and philosophy of management;
- the attractiveness of our properties to potential customers;
- competition from other available properties;
- our ability to provide adequate maintenance and insurance on our properties;
- our ability to control variable operating costs;
- governmental regulations, including zoning, usage and tax laws and changes in these laws; and
- potential liability under, and changes in, environmental, zoning and other laws.

Risks Associated with Concentration of Our Investments in the Industrial Sector

Our property operations and CDFS business segments are concentrated in the industrial distribution sector. This concentration may expose us to the risk of economic downturns in this sector to a greater extent than if our business activities included other types of real estate investments.

Risks Associated with Our Development Activities

We have developed a significant number of distribution properties since our inception and intend to continue to pursue development activities as opportunities arise. Such development activities generally require various government and other approvals and we may not receive such approvals. We will be subject to risks associated with such development activities, including:

the risk that development opportunities explored by us may be abandoned with the related investment written off;

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the risk that construction costs of a property may exceed original estimates or may not be concluded on schedule (including the possibility of contract default, the effects of local weather conditions and local or national strikes or shortages in materials, building supplies or energy and fuel for equipment) which could make the project less profitable than originally estimated; and

the risk that occupancy rates and rents of a completed project will not make the project as profitable as originally estimated.

Risks Associated with the Contribution and Sale of Properties

We have contributed to property funds or sold to third parties, a significant number of distribution properties in recent years and we intend to continue to contribute or sell properties as opportunities arise, particularly in our CDFS business segment. Our ability to contribute or sell properties on advantageous terms is dependent upon several factors, some of which are beyond the control of our management, primarily competition from other owners of properties that are also trying to dispose of their properties. Our ability to complete and lease developed properties will impact our ability to contribute or sell these properties. Continued access to private debt and equity capital by the property funds is necessary in order for us to continue our strategy of contributing properties to property funds. Should we not have sufficient properties available that meet the investment criteria of current or future property funds, or should the property funds have reduced or no access to capital on favorable terms, then the dispositions could be delayed resulting in adverse effects on our liquidity and on our ability to meet projected earnings levels in a particular reporting period. Failure to meet our projected earnings levels in a particular reporting period could have an adverse effect on the market price of common shares. Further, our inability to redeploy the proceeds from our divestitures in accordance with our investment strategy could have an adverse affect on our results of operations.

Risks Associated with Acquisition of Properties

We acquire distribution properties from time to time. The acquisition of properties involves risks, including the risk that the acquired property will not perform as anticipated and that the actual costs for rehabilitation, renovation and improvements identified in the pre-acquisition due diligence process exceed estimates. There is, and it is expected that there will continue to be, significant competition for investment opportunities that meet our investment criteria as well as risks associated with obtaining financing for acquisition activities, if necessary.

Tenant Default

Our results of operations and distributable cash flow would be adversely affected if a significant number of our tenants are unable to meet their obligations to us. In the event of default by a significant number of tenants, we may experience delays and incur substantial costs in enforcing our rights as landlord.

Ability to Renew Leases or Re-let Space as Leases Expire

Our results of operations and distributable cash flow would be adversely affected if we were unable to lease, on economically favorable terms, a significant amount of space in our distribution properties. As of June 30, 2003, we have 15.8 million square feet (out of a total of 108.8 million occupied square feet) of distribution space with leases that expire during the last six months of 2003 and the property funds have a combined 3.9 million square feet (out of a total of 90.6 million occupied square feet) of distribution space with leases that expire during the last six months of 2003. The number of distribution properties in a market or submarket could adversely affect both our ability to lease distribution space and the rental rates that can be obtained in new leases.

Real Estate Investments Are Not As Liquid As Other Types Of Assets

Real estate investments are not as liquid as other types of assets and that may tend to limit our ability to react promptly to changes in economic or other conditions. In addition, significant expenditures associated with real estate investments, such as mortgage payments, real estate taxes and maintenance costs, are generally not reduced when circumstances cause a reduction in income from the investments. Like other companies qualifying as REITs under the Internal Revenue Code, we must either comply with the safe harbor rules relating to the number of

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properties disposed of in a year, their tax bases and the cost of improvements made to the properties, or meet other tests which enable a REIT to avoid punitive taxation on the sale of assets. Thus, our ability at any time to sell assets, or contribute assets to property funds or other entities in which we have an ownership interest may be restricted.

Our Insurance Coverage Does Not Include All Potential Losses

We and our unconsolidated investees currently carry comprehensive insurance coverage including property, liability, fire, flood, earthquake, environmental, terrorism, extended coverage and rental loss as appropriate for the markets where each of our properties and business operations are located. The insurance coverage contains policy specifications and insured limits customarily carried for similar properties and business activities. We believe our properties and the properties of our unconsolidated investees, including our property funds, are adequately insured. However, there are certain losses, including losses from floods and losses from earthquakes, acts of war, acts of terrorism or riots, that are not generally insured against or that are not generally fully insured against because it is not deemed to be economically feasible or prudent to do so. However, if an uninsured loss or a loss in excess of insured limits occur with respect to one or more of our properties, we could experience a significant loss of capital invested and potential revenues in these properties and could potentially remain obligated under any recourse debt associated with the property.

Potential Environmental Liability

Under various federal, state and local laws, ordinances and regulations, a current or previous owner, developer or operator of real estate may be liable for the costs of removal or remediation of hazardous or toxic substances at, on, under or in its property. The costs of removal or remediation of such substances could be substantial. Such laws often impose liability without regard to whether the owner or operator knew of, or was responsible for, the release or presence of such hazardous substances. We conduct Phase I environmental assessments as part of our due diligence activities. We have not been notified nor are we aware of any environmental condition with respect to our real estate investments that are likely to be material to our financial condition. However, we cannot give any assurance that such conditions do not exist or may not arise in the future. The presence of such substances on our real estate investments could aALIGN="right">(3,207)

Other assets and liabilities, net

178 240

Net cash used in operating activities

(2,048) (11,865)

Cash flows investing activities:

Restricted cash

(103) (50)

Capital expenditures

(2,609) (1,920)

Purchases of available for sale investments

(896) (661)

Proceeds from sales of available for sale investments

966 155

Net cash used in investing activities

(2,642) (2,476)

Cash flows financing activities:

Proceeds from debt issuance		40,000
Debt repayment	(4,500)	(3,000)
Cash dividends paid	(7,364)	(4,875)
Payment of employee tax withholdings on equity transactions	(406)	(647)
Acquisition earnout payments	(3,390)	(357)
Net cash (used in) provided by financing activities	(15,660)	31,121
Effect of exchange rates fluctuations on cash and cash equivalents	(1,759)	(1,595)

Net (decrease) increase in cash and cash equivalents	(22,109)	15,185
Cash and cash equivalents at beginning of period	181,646	117,605
Cash and cash equivalents at end of period	$159,537	$132,790

The accompanying notes to Condensed Consolidated Financial Statements are an integral part of these statements.

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HEIDRICK & STRUGGLES INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(All tables in thousands, except share and per share figures)

(Unaudited)

1. Basis of Presentation of Interim Financial Information

The accompanying unaudited Condensed Consolidated Financial Statements of Heidrick & Struggles International, Inc. and subsidiaries (the Company) have been prepared pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (SEC). The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Significant items subject to estimates and assumptions include revenue recognition, allowance for doubtful accounts, interim effective tax rate, allowances for deferred tax assets, assessment of goodwill and other intangible assets for impairment, compensation accruals, stock-based compensation and contingent liabilities. Estimates are subject to a degree of uncertainty and actual results could differ from these estimates. These financial statements and notes are to be read in conjunction with the Company s Consolidated Financial Statements and Notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2013, as filed with the SEC on March 13, 2014.

2. Summary of Significant Accounting Policies

A complete listing of the Company s significant accounting policies is discussed in Note 2, *Summary of Significant Accounting Policies*, in the Notes to Consolidated Financial Statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2013.

Recent Financial Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers. The ASU requires that an entity recognizes revenue to depict the transfer of promised goods or services to customer in an amount that reflects the consideration to which the Company expects to be entitled in exchange for these goods or services. The standard is effective for annual reporting periods beginning after December 15, 2016, including interim periods, using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients or (ii) a retrospective approach with the cumulative effect upon initial adoption recognized at the date of adoption. The Company is currently evaluating the effect that this pronouncement will have on its financial statements and related disclosures. The effect is not known or reasonably estimable at this time.

3. Allowance for Doubtful Accounts

The activity of the allowance for doubtful accounts for the nine months ended September 30, 2014 is as follows:

Balance at December 31, 2013	$ 4,709
Provision charged to income	740
Write-offs	(612)
Currency	(124)
Balance at September 30, 2014	$ 4,713

4. Property and Equipment, net

The components of the Company s property and equipment are as follows:

	September 30, 2014	December 31, 2013
Leasehold improvements	$ 43,552	$ 44,242
Office furniture, fixtures and equipment	18,554	24,301
Computer equipment and software	29,854	38,039
Property and equipment, gross	91,960	106,582
Accumulated depreciation	(61,890)	(71,621)
Property and equipment, net	$ 30,070	$ 34,961

Depreciation expense was $2.3 million and $2.6 million for the three months ended September 30, 2014 and 2013, respectively. Depreciation expense for the nine months ended September 30, 2014 and 2013 was $7.2 million and $7.7 million, respectively.

5. Restricted Cash

The components of the Company s restricted cash are as follows:

	September 30, 2014	December 31, 2013
Non-current restricted cash:		
Retention escrow	$ 6,500	$ 6,501
Lease guarantees	1,399	1,377
Business licenses	99	
Total non-current restricted cash	$ 7,998	$ 7,878

The retention escrow is associated with the Senn Delaney acquisition and will be paid to certain key executives of Senn Delaney if they remain with the Company for three years subsequent to the acquisition (See Note 8, *Acquisitions*). The Company has certain business licenses and lease agreements with terms that require the Company to restrict cash through the termination dates of the agreements, which extend through 2017 and 2018, respectively.

6. Investments

The components of the Company s investments are as follows:

	September 30, 2014	December 31, 2013
U.S. non-qualified deferred compensation plan	$ 13,592	$ 13,232
Warrants and equity securities	684	616
Total	$ 14,276	$ 13,848

The Company s U.S. non-qualified deferred compensation plan consists primarily of U.S. marketable securities and mutual funds, all of which are valued using Level 1 inputs (See Note 7, *Fair Value Measurements*). The aggregate cost basis for these investments was $10.1 million and $9.9 million as of September 30, 2014 and December 31, 2013, respectively.

7. Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A three-level fair value hierarchy prioritizes the inputs used to measure fair value. The hierarchy requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows:

Level 1 Quoted prices in active markets for identical assets and liabilities.

Level 2 Quoted prices in active markets for similar assets and liabilities, or other inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

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	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
At September 30, 2014				
U.S. non-qualified deferred compensation plan	$ 13,592	$	$	$ 13,592
Assets designated for retirement and pension plans		22,344		22,344
Derivatives designated as cash flow hedge		198		198
Warrants and equity securities			684	684
Acquisition earnout accruals			(11,897)	(11,897)
	$ 13,592	$ 22,542	$ (11,213)	$ 24,921

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
At December 31, 2013				
U.S. non-qualified deferred compensation plan	$ 13,232	$	$	$ 13,232
Assets designated for retirement and pension plans		24,312		24,312
Derivatives designated as cash flow hedge		180		180
Warrants and equity securities			616	616
Acquisition earnout accruals			(14,053)	(14,053)
	$ 13,232	$ 24,492	$ (13,437)	$ 24,287

The following table provides a reconciliation of the beginning and ending balance of Level 3 assets and liabilities for the nine months ended September 30, 2014.

	Warrants and Equity Securities	Acquisition Earnout Accruals	Total
Balance at December 31, 2013	$ 616	$ (14,053)	$ (13,437)
Realized / unrealized gains	68		68

Earnout accretion		(1,308)	(1,308)
Earnout payments		3,390	3,390
Foreign currency translation		74	74
Balance at September 30, 2014	$ 684	$ (11,897)	$ (11,213)

The Level 2 assets above are fair valued using a market approach. The Level 3 liabilities are: (i) accruals for future earnout payments related to prior acquisitions, the values of which are determined based on discounted cash flow models; and (ii) warrant and equity securities, the values of which are determined using a valuation model. The Company considers the recorded value of its financial assets and liabilities, which consist primarily of cash and cash equivalents, accounts receivable, and accounts payable, to approximate the fair value of the respective assets and liabilities at September 30, 2014 and December 31, 2013 based upon the short-term nature of the assets and liabilities.

8. Acquisitions

Scambler MacGregor Executive Search Pty Limited

In November 2013, the Company acquired Scambler MacGregor, an Australian-based retained Executive Search boutique in the financial services industry for 1.1 million Australian dollars (equivalent to $1.0 million at September 30, 2014 and December 31, 2013, respectively) of initial consideration, pursuant to a stock purchase, which was funded from existing cash. In December 2013, the Company paid an additional $0.1 million related to the final working capital settlement. The Company

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also recorded $0.4 million of intangible assets and $2.7 million of goodwill. The goodwill is primarily related to the acquired workforce and strategic fit. The former owners of Scambler MacGregor are eligible to receive earnout payments of up to 2.8 million Australian dollars based on the achievement of certain revenue metrics over the period November 2013 through December 2018. As a result, the Company accrued 2.3 million Australian dollars (equivalent to $2.0 million at September 30, 2014 and December 31, 2013), representing the estimated fair value of future earnout payments as of the acquisition date.

Senn-Delaney Leadership Consulting Group, LLC

In December 2012, the Company acquired Senn-Delaney Leadership Consulting Group, LLC, a global leader of corporate culture shaping. Under the terms of the purchase agreement, the Company paid $53.5 million at closing for 100 percent of the equity of Senn Delaney. The agreement also included additional cash consideration up to $15.0 million based on the realization of specific earnings milestones achieved over the period December 2012 through December 2015, of which $3.4 million was paid during the second quarter of 2014. The Company has accrued $9.9 million and $12.1 million at September 30, 2014 and December 31, 2013, respectively, for the remaining cash consideration. The Company has recognized $0.3 million and $0.5 million of accretion expense included in *General and administrative expenses* in the three months ended September 30, 2014 and 2013, respectively, and $1.2 million and $1.6 million of accretion expense in the nine months ended September 30, 2014 and 2013, respectively. The Company also holds $6.5 million in a retention escrow that will be paid to certain key executives of Senn Delaney if they remain with the Company for three years subsequent to the acquisition. The Company recognized $0.3 million and $0.5 million of compensation expense included in *Salaries and employee benefits* in the three months ended September 30, 2014 and September 30, 2013, respectively, related to the retention awards. The Company recognized $1.5 million and $1.8 million of compensation expense included in *Salaries and employee benefits* in the nine months ended September 30, 2014 and 2013, respectively, related to the retention awards.

9. Goodwill and Other Intangible Assets, Net

Goodwill

Changes in the carrying amount of goodwill by segment for the nine months ended September 30, 2014 are as follows:

	Executive Search and Leadership Consulting-Americas	Executive Search and Leadership Consulting Asia Pacific	Culture Shaping	Total
Balance at December 31, 2013	$ 82,640	$ 10,854	$ 29,780	$ 123,274
Exchange rate fluctuations	(221)	(351)	(45)	(617)
Balance at September 30, 2014	$ 82,419	$ 10,503	$ 29,735	$ 122,657

Other Intangible Assets, Net

The Company s other intangible assets, net by segment, are as follows:

	September 30, 2014	December 31, 2013
Executive Search and Leadership Consulting		
Americas	$ 1,114	$ 1,340
Asia Pacific	449	591
Total Executive Search and Leadership Consulting	1,563	1,931
Culture Shaping	20,869	24,706
Total Other intangible assets, net	$ 22,432	$ 26,637

The carrying amount of amortizable intangible assets and the related accumulated amortization are as follows:

		September 30, 2014			December 31, 2013		
	Weighted Average Life (in years)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer relationships	8.7	$ 23,454	$ (14,254)	$ 9,200	$ 23,541	$ (11,834)	$ 11,707
Trade name	15.0	9,397	(2,085)	7,312	9,430	(1,223)	8,207
Software	7.0	7,200	(1,800)	5,400	7,200	(1,029)	6,171
Non-compete	5.0	600	(80)	520	603	(51)	552
Total intangible assets	10.2	$ 40,651	$ (18,219)	$ 22,432	$ 40,774	$ (14,137)	$ 26,637

Intangible asset amortization expense for the three months ended September 30, 2014 and 2013 was $1.3 million and $1.5 million, respectively. Intangible asset amortization expense for the nine months ended September 30, 2014 and 2013 was $4.1 million and $4.3 million, respectively. The estimated intangible amortization expense is $5.5 million for fiscal year 2014, $4.7 million for fiscal year 2015, $4.5 million for fiscal year 2016, $3.6 million for fiscal year 2017, and $2.8 million for fiscal year 2018. These amounts are based on intangible assets recorded as of September 30, 2014, and actual amortization expense could differ from these estimates as a result of future acquisitions and other factors.

10. Derivative Financial Instruments

The Company uses derivative instruments to manage exposures to interest rate risk. The Company s primary objective in holding derivatives is to reduce the volatility of earnings and cash flows associated with changes in interest rates. The Company s derivatives expose it to credit risk to the extent that the counterparties may be unable to meet the terms of the agreement. The Company does, however, seek to mitigate such risks by limiting its counterparties to financial institutions that meet certain criteria. In addition, the potential risk of loss with any one counterparty resulting from this type of credit risk is monitored. Management does not expect material losses as a result of defaults by counterparties.

The Company pays short-term variable interest rates, plus a spread which is dependent on the Company s leverage ratio, calculated as defined within the Amendment and Restatement Agreement (Restated Credit Agreement). The term loan exposes the Company to the variability in interest payments and therefore fluctuations in interest expense and cash flows due to changes in interest rates.

On February 28, 2013, the Company entered into an interest rate swap to hedge the variable interest rate exposure from the underlying term facility (See Note 12, *Line of Credit and Term Loan*). The interest rate swap was entered into to manage fluctuations in cash flows resulting from interest rate risk attributable to changes in the short-term variable interest rate. This interest rate swap involves the exchange of variable-rate interest payments for fixed-rate interest payments based on the contractual underlying notional amount. Gains or losses on the interest rate swap that are linked to the term loan being hedged are expected to perfectly offset the losses or gains on the underlying term loan from the short-term variable interest rate. The effective portion of changes in the fair value of a derivative that is designated and that qualifies as a cash flow hedge is recorded in *Accumulated other comprehensive income* and is subsequently reclassified into earnings in the period when the hedged forecasted transaction affects earnings. If a derivative is deemed to be ineffective, the ineffective portion of the change in fair value of the derivative is recognized directly in earnings. During the quarter ended September 30, 2014, the Company s interest rate swap entered into for purposes of managing fluctuations in cash flows resulting from the variable rate term loan was deemed effective and the Company expects it will be effective for the next twelve months. The notional amount of the interest rate swap was $31.0 million and $35.5 million as of September 30, 2014 and December 31, 2013, respectively.

The summary of information with respect to the interest rate swap is as follows:

	September 30, 2014		**December 31, 2013**	
Interest Rate Swap Contract	**Fair Value (1)**	**Gain(2)**	**Fair Value (1)**	**Gain(2)**
Derivative designed as cash flow hedge	$ 198	$ 198	$ 180	$ 180

(1) Included in the Condensed Consolidated Balance Sheets within *Other current assets.*

(2) Included in *Accumulated other comprehensive income, net* is $75 and $65 thousand of tax as of September 30, 2014 and December 31, 2013, respectively.

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The Company reclassified from *Accumulated other comprehensive income* into *Interest, net* $0.1 million during the three months ended September 30, 2014 and 2013 and $0.2 million during the nine months ended September 30, 2014 and 2013.

11. Other Non-Current Liabilities

The components of other non-current liabilities are as follows:

	September 30, 2014	December 31, 2013
Accrued salaries and employee benefits	$ 29,564	$ 30,879
Premise related costs	15,318	16,562
Accrued earnout payments	7,759	11,628
Other	700	2,260
Total other non-current liabilities	$ 53,341	$ 61,329

12. Line of Credit and Term Loan

On June 22, 2011, the Company and certain foreign subsidiary borrowers of the Company entered into a Credit Agreement (the Agreement) with its lenders. The Agreement provides the terms under which the lenders will make available to the Company a committed unsecured revolving credit facility in an aggregate amount of up to $75 million (the Revolving Facility). The Agreement includes an expansion feature that allows the Company to seek to increase the aggregate commitment under the Revolving Facility by up to $25 million provided that the Company is in compliance with certain conditions set forth in the Agreement. The Agreement also provides for the issuance of letters of credit. The Revolving Facility matures on June 22, 2016. Under the Agreement, the Company may borrow U.S. dollars, euros, British pounds sterling, Australian dollars or other major traded currencies as agreed by the lenders. Borrowings under the Agreement bear interest, at the Company s election, at the existing Alternate Base Rate (as defined in the Agreement) or Adjusted LIBOR Rate (as defined in the Agreement) plus a spread as determined by the Company s leverage ratio.

On January 31, 2013, the Company and certain foreign subsidiary borrowers of the Company entered into a Restated Credit Agreement which amended the Agreement to add a committed term loan facility in an aggregate amount of up to $40 million (the Term Facility). There was no other material term change in the Agreement.

On January 31, 2013 the Company borrowed $40 million under the Term Facility. The Term Facility is being repaid over a five-year period pursuant to which the Company will make quarterly payments of $1.5 million through 2016 and quarterly payments of $2.0 million during 2017. The remaining outstanding balance of the Term Facility will be paid on January 31, 2018. The interest rate on the debt is Adjusted LIBOR plus a spread which is dependent on the Company s leverage ratio. The Company entered into an interest rate swap to address the risk related to the fluctuation in Adjusted LIBOR (See Note 10, *Derivative Financial Instruments*). As of September 30, 2014 the Company s interest rate, including the impact of the interest rate swap, was 2.54%.

As of September 30, 2014 and December 31, 2013 there was $31.0 million and $35.5 million, respectively, outstanding under the Term Facility. There were no borrowings made under the Revolving Facility during the nine months ended September 30, 2014 and for the year ended December 31, 2013. The Company was in compliance with the financial and other covenants under the Restated Credit Agreement and no event of default existed as of September 30, 2014 and for the year ended December 31, 2013, respectively.

13. Stock-based Compensation

The Company s 2012 Heidrick & Struggles GlobalShare Program (the 2012 Program) provides for grants of stock options, stock appreciation rights, and other stock-based awards that are valued based upon the grant date fair value of shares. The 2012 Program originally authorized 1,300,000 shares of Common Stock for issuance pursuant to awards under the plan. These awards may be granted to directors, selected employees and independent contractors. On May 22, 2014, the stockholders of the Company approved an amendment to the 2012 Program to increase the number of shares of Common Stock reserved for issuance under the 2012 Program by 700,000 shares. As of September 30, 2014, 772,665 awards have been issued under the 2012 Program and 1,573,375 shares remain available for future awards, which includes 346,040 forfeited awards. The 2012 Program provides that no awards can be granted after May 24, 2022.

The Company measures its stock-based compensation costs based on the grant date fair value of the awards and recognizes these costs in the financial statements over the requisite service period.

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A summary of information with respect to stock-based compensation is as follows:

	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
Salaries and employee benefits	$ 1,044	$ 302	$ 2,434	$ 2,475
General and administrative expenses			$ 451	$ 300
Income tax benefit related to stock-based compensation included in net income	$ 465	$ 118	$ 1,286	$ 1,087

Restricted Stock Units

Restricted stock unit activity for the nine months ended September 30, 2014:

	Number of Restricted Stock Units	Weighted-Average Grant-date Fair Value
Outstanding on December 31, 2013	270,455	$ 18.64
Granted	295,733	18.02
Vested and converted to common stock	(93,159)	19.65
Forfeited	(10,312)	17.45
Outstanding on September 30, 2014	462,717	18.07

As of September 30, 2014, there was $4.2 million of pre-tax unrecognized compensation expense related to unvested restricted stock units, which is expected to be recognized over a weighted average of 2.8 years.

Performance Stock Units

The Company grants performance stock units to certain of its senior executives. The performance stock units are generally subject to a cliff vesting at the end of a three year period. The vesting will vary between 0% 200% based on the attainment of operating income goals over the 3 year vesting period. The performance stock units are expensed on a straight-line basis over the 3 year vesting period.

In the first quarter of 2014, the Company granted market-based performance stock units to the Chief Executive Officer as part of his initial compensation package. The market-based awards vest after a two-year service period and if the price of the Company s common stock exceeds specified targets. The fair value of the market-based awards was determined using the Monte-Carlo simulation model. A Monte Carlo simulation model uses stock price volatility and other variables to estimate the probability of satisfying the market conditions and the resulting fair value of the award. Compensation costs related to the market-based awards are recognized regardless of whether the market condition is satisfied, as long as the requisite service has been provided.

Performance stock unit activity for the nine months ended September 30, 2014:

	Number of Performance Stock Units	Weighted-Average Grant-date Fair Value
Outstanding on December 31, 2013	61,321	$ 19.77
Granted	186,705	17.19
Vested and converted to common stock	(9,429)	27.18
Forfeited	(9,427)	27.18
Outstanding on September 30, 2014	229,170	17.06

As of September 30, 2014, there was $2.2 million of pre-tax unrecognized compensation expense related to unvested performance stock units, which is expected to be recognized over a weighted average of 2.0 years.

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14. Income Taxes

The Company reported income before taxes of $8.9 million and $7.6 million and recorded an income tax provision of $5.9 million and $3.4 million for the three months ended September 30, 2014 and 2013, respectively. The increase in income tax provision from the third quarter of 2013 includes a discrete item for the establishment of a $2.3 million valuation allowance in the Asia Pacific segment as well as a change in the forecasted mix of income.

The Company reported income before taxes of $22.2 million and $12.7 million and recorded an income tax provision of $16.1 million and $7.8 million for the nine months ended September 30, 2014 and 2013, respectively. The increase in the income tax provision from the prior year includes a discrete item for the establishment of valuation allowances of $4.8 million in the Asia Pacific segment. The Company s effective income tax rate reflects an adjusted full-year expected annualized tax rate of approximately 75 percent.

15. Changes in Accumulated Other Comprehensive Income

The changes in *Accumulated other comprehensive income* (AOCI) by component for the nine months ended September, 2014 is summarized below:

	Cash Flow Hedge	Available-for-Sale Securities	Foreign Currency Translation	Pension	AOCI
Balance at December 31, 2013	$ 115	$ 2,921	$ 11,607	$ 326	$ 14,969
Other comprehensive income (loss) before reclassification, net of tax	(94)	448	(1,067)		(713)
Amount reclassified from AOCI (1)	102	(288)			(186)
Net current period other comprehensive income (loss)	8	160	(1,067)		(899)
Balance at September 30, 2014	$ 123	$ 3,081	$ 10,540	$ 326	$ 14,070

(1) Cash Flow Hedge and Available-for-Sale Securities reclassifications from AOCI are included in *Interest, net* and *Other, net*, respectively, in the Condensed Consolidated Statement of Comprehensive Income.

16. Segment Information

The Company operates its executive search and leadership consulting services in the Americas; Europe (which includes Africa); and Asia Pacific (which includes the Middle East) and operates its culture shaping business as a separate segment.

For segment purposes, reimbursements of out-of-pocket expenses classified as revenue and other operating income are reported separately and, therefore, are not included in the results of each segment. The Company believes that analyzing trends in revenue before reimbursements (net revenue), analyzing operating expenses as a percentage of net revenue, and analyzing operating income (loss) more appropriately reflects its core operations.

During 2014, consistent with the Company s practice to periodically review its reporting structure and segments, the Company evaluated its allocation of corporate and support costs to each of its regions. In conjunction with that review, to better align the Company s cost and reporting structure, additional costs were allocated to the regions reflecting management s current view of the costs necessary to support the regional operations. The prior period results have been recast to reflect these changes and present comparative year-over-year results.

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The revenue and operating income (loss) by segment are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Revenue:				
Executive Search and Leadership Consulting				
Americas	$ 64,982	$ 65,522	$ 193,034	$ 192,906
Europe	27,207	23,366	84,632	65,042
Asia Pacific	23,305	23,528	69,162	68,464
Total Executive Search and Leadership Consulting	115,494	112,416	346,828	326,412
Culture Shaping	10,335	6,565	26,202	17,580
Revenue before reimbursements (net revenue)	125,829	118,981	373,030	343,992
Reimbursements	4,432	4,523	13,721	14,148
Total	$ 130,261	$ 123,504	$ 386,751	$ 358,140

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Operating income (loss):				
Executive Search and Leadership Consulting				
Americas	$ 14,257	$ 17,604	$ 43,266	$ 47,028
Europe	1,946	342	4,373	(4,740)
Asia Pacific	2,228	1,737	4,790	4,797
Total Executive Search and Leadership Consulting	18,431	19,683	52,429	47,085
Culture Shaping	2,866	(708)	3,643	(3,691)
Total segments	21,297	18,975	56,072	43,394
Global Operations Support	(11,740)	(10,622)	(33,223)	(28,910)
Total	$ 9,557	$ 8,353	$ 22,849	$ 14,484

17. Guarantees

The Company has issued cash collateralized bank guarantees and letter of credit backed bank guarantees supporting certain obligations, primarily the payment of office lease obligations and business license requirements for certain of its international subsidiaries. The bank guarantees were made to secure the respective agreements and are for the terms of the agreements, which extend through 2018. For each bank guarantee issued, the Company would have to perform under the guarantee if the subsidiary defaults on a lease payment. The maximum amount of undiscounted payments the Company would be required to make in the event of default on all outstanding bank guarantees is approximately $2.2 million as of September 30, 2014. The Company has not accrued for these arrangements as no event of default exists or is expected to exist.

18. Commitments and Contingencies

Litigation

The Company has contingent liabilities from various pending claims and litigation matters arising in the ordinary course of the Company s business, some of which involve claims for damages that are substantial in amount, and some of which are covered by insurance. In accordance with ASC 450, *Contingencies*, the Company records a reserve for estimated losses when the loss is probable and the amount can be reasonably estimated. Based upon information currently available, the Company believes the ultimate resolution of any pending claims or litigation will not have a material adverse effect on its financial condition, results of operations or liquidity.

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UK Employee Benefits Trust

On January 27, 2010, HM Revenue & Customs (HMRC) in the United Kingdom notified the Company that it was challenging the tax treatment of certain of the Company s contributions in the United Kingdom to an Employee Benefits Trust between 2002 and 2008. HMRC alleges that these contributions should have been subject to Pay As You Earn tax and Class 1 National Insurance Contributions in the United Kingdom; and HMRC is proposing an adjustment to the Company s payroll tax liability for the affected years. The aggregate amount of HMRC s proposed adjustment is approximately £3.9 million (equivalent to $6.3 million at September 30, 2014). The Company has appealed the proposed adjustment. At this time, the Company believes that the likelihood of an unfavorable outcome with respect to the proposed adjustment is not probable and the potential amount of any loss cannot be reasonably estimated. The Company also believes that the amount of any final adjustment would not be material to the Company s financial condition.

19. Subsequent Event

On October 1, 2014, the Company amended the terms of its current lease agreement to extend the term of the lease in Chicago, Illinois from October 1, 2015 through September 30, 2026. The impact of new lease on the Company s Condensed Consolidated Financial Statements is not material.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Management s Discussion and Analysis of Financial Condition and Results of Operations as well as other sections of this report on Form 10-Q contain forward-looking statements. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Forward-looking statements are not historical facts, but instead represent only our beliefs, assumptions, expectations, estimates, forecasts and projections regarding future events, many of which, by their nature, are inherently uncertain and outside our control. These statements include statements other than historical information or statements of current condition and may relate to our future plans and objectives and results. By identifying these statements for you in this manner, we are alerting you to the possibility that our actual results and financial condition may differ, possibly materially, from the anticipated results and financial condition indicated in these forward-looking statements.

Factors that may affect the outcome of the forward-looking statements include, among other things, leadership changes, our ability to attract, integrate, manage and retain qualified consultants and senior leaders; our ability to develop and maintain strong, long-term relationships with our clients; fluctuations in the global economy and our ability to execute successfully our leadership advisory strategy through business cycles; the timing, speed or robustness of any future economic recovery; social or political instability in markets where we operate, the impact of foreign currency exchange rate fluctuations; unfavorable tax law changes and tax authority rulings; price competition; the ability to forecast, on a quarterly basis, variable compensation accruals that ultimately are determined based on the achievement of annual results; our ability to realize our tax losses; the timing of the establishment or reversal of valuation allowance on deferred tax assets; the mix of profit and loss by country; our reliance on information management systems; any impairment of our goodwill and other intangible assets; and the ability to align our cost structure and headcount with net revenue. For more information on the factors that could affect the outcome of forward-looking statements, refer to our Annual Report on Form 10-K for the year ended December 31, 2013, under Risk Factors in Item 1A. We caution the reader that the list of factors may not be exhaustive. We undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

Executive Overview

Our Business

We are a leadership advisory firm providing executive search, leadership consulting and culture shaping services. We help our clients build leadership teams by facilitating the recruitment, management and development of senior executives. We believe focusing on top-level services offers us several advantages that include access to and influence with key decision makers, increased potential for recurring search consulting engagements, higher fees per search, enhanced brand visibility, and a leveraged global footprint, which create added barriers to entry for potential competitors. Working at the top of client organizations also allows us to attract and retain high-caliber consultants.

In addition to executive search, we provide culture shaping services and leadership consulting expertise including executive assessment, leadership development, board and top team effectiveness, and succession planning.

We provide our services to a broad range of clients through the expertise of consultants located in major cities around the world. Our executive search services are provided on a retained basis. Revenue before reimbursements of out-of-pocket expenses (net revenue) consists of retainers and indirect expenses billed to clients. Typically, we are paid a retainer for our executive search services equal to approximately one-third of the estimated first year compensation for the position to be filled. In addition, if the actual compensation of a placed candidate exceeds the estimated compensation, we often are authorized to bill the client for one-third of the excess. Indirect expenses are calculated as a percentage of the retainer with certain dollar limits per search. Net revenue associated with culture shaping consulting is recognized proportionally as services are performed. Net revenue associated with licenses to use culture shaping proprietary materials is typically recognized over the term of the license. Net revenue from leadership consulting is recognized in accordance with the completion of the engagement deliverables.

Key Performance Indicators

We manage and assess Heidrick & Struggles overall performance through various means, with the primary financial and operational measures including net revenue, operating income, operating margin, Adjusted EBITDA (Non-GAAP), and Adjusted EBITDA margin (Non-GAAP). Executive Search and Leadership Consulting performance is also measured using consultant headcount and consultant productivity. Specific to Executive Search, confirmation trends and average revenue per search or project are used to measure performance.

Revenue is driven by market conditions and a combination of the number of executive search engagements and leadership consulting and culture shaping projects and the average revenue per search or project. With the exception of compensation expense, incremental increases in revenue do not necessarily result in proportionate increases in costs, particularly operating and administrative expenses, thus potentially improving operating margins.

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The number of consultants, confirmation trends, number of searches or projects completed, productivity levels and the average revenue per search or project will vary from quarter to quarter, affecting net revenue and operating margin.

Our Compensation Model

At the Executive Search consultant level there are fixed and variable components of compensation. Individuals are rewarded for their performance based on a system that directly ties a portion of their compensation to the amount of net revenue for which they are responsible. A portion of the reward may be based upon individual performance against a series of non-financial measures. Credit towards the variable portion of an executive search consultant s compensation is earned by generating net revenue for winning and executing work. Each quarter, we review and update the expected annual performance of all Executive Search consultants and accrue variable compensation accordingly. The amount of variable compensation that is accrued for each Executive Search consultant is based on a tiered payout model. Overall Company performance determines the amount available for total variable compensation. The more net revenue that is generated by the consultant, the higher the percentage credited towards the consultant s variable compensation and thus accrued by our Company as expense. The mix of individual consultants who generate the revenue can significantly affect the total amount of compensation expense recorded, which directly impacts operating margin. As a result, the variable portion of the compensation expense may fluctuate significantly from quarter to quarter. The total variable compensation is discretionary and is based on Company-wide financial targets approved by the Human Resources and Compensation Committee of the Board of Directors.

A portion of our Executive Search consultants and management cash bonuses is deferred and paid over a three-year vesting period. The compensation expense related to the amounts being deferred is recognized on a graded vesting attribution method over the requisite service period. This service period begins on January 1 of the respective fiscal year and continues through the deferral date, which coincides with our bonus payments in the first quarter of the following year, and for an additional three year vesting period. The deferrals are recorded in *Accrued salaries and employee benefits* and *Other non-current liabilities* in the Condensed Consolidated Balance Sheets.

Fourth Quarter 2014 Outlook

We are currently forecasting 2014 fourth quarter net revenue of between $112 million and $123 million. Our 2014 fourth quarter guidance is based upon, among other things, management s assumptions for the anticipated volume of new Executive Search confirmations and Leadership Consulting and Culture Shaping projects, the current backlog, consultant productivity, consultant retention, the seasonality of our business and no change in future currency rates**.**

Our 2014 guidance is subject to a number of risks and uncertainties, including those discussed under Item 1A *Risk Factors* in our 2013 Annual Report on Form 10-K. As such, actual results could vary from these projections.

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Results of Operations

The following table summarizes, for the periods indicated, our results of operations as a percentage of revenue before reimbursements (net revenue):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Revenue:				
Revenue before reimbursements (net revenue)	100.0 %	100.0%	100.0%	100.0%
Reimbursements	3.5	3.8	3.7	4.1
Total revenue	103.5	103.8	103.7	104.1
Operating expenses:				
Salaries and employee benefits	66.8	68.6	67.6	68.7
General and administrative expenses	25.6	24.3	26.3	27.1
Reimbursed expenses	3.5	3.8	3.7	4.1
Total operating expenses	95.9	96.8	97.6	99.9
Operating income	7.6	7.0	6.1	4.2
Non-operating expense				
Interest, net	(0.1)	(0.1)	(0.1)	
Other, net	(0.4)	(0.6)	(0.1)	(0.5)
Net non-operating expense	(0.5)	(0.7)	(0.2)	(0.5)
Income before income taxes	7.1	6.3	5.9	3.7
Provision for income taxes	4.7	2.9	4.3	2.3
Net income	2.4 %	3.5%	1.6%	1.4%

Note: Totals and sub-totals may not equal the sum of individual line items due to rounding.

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We operate our executive search and leadership consulting services in the Americas; Europe (which includes Africa); and Asia Pacific (which includes the Middle East) and operate our culture shaping business as a separate segment (See Note 16, *Segment Information*).

During 2014, consistent with our practice to periodically review our reporting structure and segments, we evaluated our allocation of corporate and support costs to each of our regions. In conjunction with that review, to better align our cost and reporting structure, additional costs were allocated to the regions reflecting our current view of the costs necessary to support the regional operations. The prior period results have been recast to reflect these changes and present comparative year-over-year results.

The following table sets forth, for the periods indicated, our revenue and operating income (loss) by segment (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	**2013**	**2014**	**2013**
Revenue:				
Executive Search and Leadership Consulting				
Americas	$ 64,982	$ 65,522	$ 193,034	$ 192,906
Europe	27,207	23,366	84,632	65,042
Asia Pacific	23,305	23,528	69,162	68,464
Total Executive Search and Leadership Consulting	115,494	112,416	346,828	326,412
Culture Shaping	10,335	6,565	26,202	17,580
Revenue before reimbursements (net revenue)	125,829	118,981	373,030	343,992
Reimbursements	4,432	4,523	13,721	14,148
Total	$ 130,261	$ 123,504	$ 386,751	$ 358,140

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	**2013**	**2014**	**2013**
Operating income (loss):				
Executive Search and Leadership Consulting				
Americas	$ 14,257	$ 17,604	$ 43,266	$ 47,028
Europe	1,946	342	4,373	(4,740)
Asia Pacific	2,228	1,737	4,790	4,797
Total Executive Search and Leadership Consulting	18,431	19,683	52,429	47,085
Culture Shaping	2,866	(708)	3,643	(3,691)
Total segments	21,297	18,975	56,072	43,394
Global Operations Support	(11,740)	(10,622)	(33,223)	(28,910)

Total	$ 9,557	$ 8,353	$ 22,849	$ 14,484

Three Months Ended September 30, 2014 Compared to the Three Months Ended September 30, 2013

Total revenue. Consolidated total revenue increased $6.8 million, or 5.5%, to $130.3 million in 2014 from $123.5 million in 2013. The increase in total revenue was due primarily to the increase in revenue before reimbursements (net revenue).

Revenue before reimbursements (net revenue). Consolidated net revenue increased $6.8 million, or 5.8%, to $125.8 million for the three months ended September 30, 2014 from $119.0 million for the three months ended September 30, 2013. The positive impact of exchange rate fluctuations resulted in one percentage point of the increase. Executive Search and Leadership Consulting net revenue was $115.5 million, an increase of $3.1 million compared to the three months ended September 30, 2013. Increases in the Financial Services, Global Technology & Services, and Industrial search practices were the primary drivers of the increase in consolidated net revenue; however, these increases were partially offset by declines in net revenue from the Consumer Markets and Healthcare & Life Sciences practices. Culture Shaping net revenue was $10.3 million for the three months ended September 30, 2014 an increase of $3.8 million compared to the three months ended September 30, 2013. The impact of exchange rate fluctuations in the Culture Shaping segment resulted in approximately one percentage point of the increase in the third quarter of 2014. The number of Executive Search and Leadership Consulting consultants was 311 as of September 30, 2014 compared to 308 as of September 30, 2013. Productivity, as measured by annualized net Executive Search and Leadership Consulting revenue per consultant was $1.5 million in the third quarter of 2014 compared to $1.4 million in the third quarter of 2013. Specific to Executive Search, our primary business, the number of confirmed searches increased 8% compared to the third quarter of 2013 and the average revenue per executive search was $122,200 in the third quarter of 2014 compared to $124,500 in the third quarter of 2013.

For Executive Search and Leadership Consulting, net revenue in the Americas segment was $65.0 million for the three months ended September 30, 2014, a decrease of $0.5 million, or less than one percentage point, from $65.5 million in the third quarter of 2013. Net revenue in the Europe segment was $27.2 million for the three months ended September 30, 2014, an increase of $3.8 million, or 16.4%, from $23.4 million in the third quarter of 2013. The impact of exchange rate fluctuations in the Europe segment resulted in approximately five percentage points of the increase in the third quarter of 2014. Net revenue in the Asia Pacific segment was $23.3 million for the three months ended September 30, 2014, a decrease of $0.2 million, or 1.0%, from $23.5 million in the third quarter of 2013. The decrease in net revenue in the Asia Pacific segment in the third quarter of 2014 includes a one percentage point benefit for exchange rate fluctuations.

Salaries and employee benefits. Consolidated salaries and employee benefits expense increased $2.4 million, or 2.9%, to $84.0 million for the three months ended September 30, 2014 from $81.7 million for the three months ended September 30, 2013. This increase is due to higher performance related compensation of $3.1 million resulting from an increase in net revenue. The increase in variable compensation expense was partially offset by a decrease in fixed compensation of $0.7 million. The decrease in fixed compensation is primarily due to $3.3 million of lower severance expense related to an executive departure in the prior year, partially offset by higher base salaries and employee benefits costs. In the 2014 third quarter we had on average 1,463 employees, compared to an average of 1,465 employees in the 2013 third quarter.

Exchange rate fluctuations increased salaries and employee benefits expense by $0.8 million or approximately one percent.

As a percentage of net revenue, salaries and employee benefits expense was 66.8% in the third quarter of 2014, compared to 68.6% in the third quarter of 2013.

General and administrative expenses. Consolidated general and administrative expenses increased $3.3 million, or 11.3%, to $32.2 million for the three months ended September 30, 2014 from $29.0 million for the three months ended September 30, 2013. The increase is primarily due to $1.8 million for a global partner meeting held during the quarter, $0.5 million for professional fees and $0.5 million for hiring and staffing fees.

Exchange rate fluctuations increased general and administrative expense by $0.2 million or less than one percentage point.

As a percentage of net revenue, general and administrative expenses were 25.6% in the third quarter of 2014 compared to 24.3% in the third quarter of 2013.

Operating income. Consolidated operating income was $9.6 million for the three months ended September 30, 2014 compared to $8.4 million for the three months ended September 30, 2013.

Net non-operating expense. Net non-operating expense was $0.6 million for the three months ended September 30, 2014 compared to non-operating expense of $0.8 million for the three months ended September 30, 2013.

Net interest expense was $0.1 million in the third quarter of 2014 and 2013. Interest income of $0.1 million for the three months ended September 30, 2014, was offset by $0.2 million of interest expense associated with the Term Loan. For the three months ended September 30, 2013, interest income was $0.2 million, offset by $0.3 million of interest expense associated with the Term Loan.

Net other non-operating expense was $0.5 million for the three months ended September 30, 2014, compared to net other non-operating expense of $0.7 million for the three months ended September 30, 2013. Net other non-operating expense consists of exchange gains and losses from balances which are denominated in currencies other than the functional currency and are not considered permanent in nature.

Income taxes. See Note 14, *Income Taxes.*

Executive Search and Leadership Consulting

Americas

The Americas segment reported operating income of $14.3 million for the three months ended September 30, 2014, a decrease of $3.3 million compared to $17.6 million for the three months ended September 30, 2013. The decrease in operating income was due to increases in salaries and employee benefits of $2.1 million and general and administrative expenses of $0.8 million and a decrease in net revenue of $0.5 million. The increase in salaries and employee benefits expense was due to a $1.3 million increase in performance-related compensation and a $0.8 million increase in fixed compensation. Performance-related compensation increased due primarily to higher global net revenue. Fixed compensation increased primarily due to severance costs. The increase in general and administrative expense was primarily due to hiring and staffing fees.

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The decrease in net revenue was due to decreases in the Consumer Markets, Healthcare & Life Sciences, and Industrial practice groups, partially offset by increases in the Global Technology & Services and Financial Services practice groups. The number of consultants was 139 and 137 as of September 30, 2014 and 2013, respectively.

Europe

The Europe segment reported operating income of $1.9 million for the three months ended September 30, 2014, an improvement of $1.6 million compared to $0.3 million for the three months ended September 30, 2013. The increase in operating income was primarily due to an increase in net revenue of $3.8 million, partially offset by increases in salaries and employee benefits expense of $1.6 million and in general and administrative expense of $0.6 million. The increase in net revenue was due to increases in the Financial Services and Industrial practice groups, partially offset by decreases in the Global Technology & Services and Education, Nonprofit & Social Enterprise practice groups. The number of consultants was 91 and 87 as of September 30, 2014 and 2013, respectively.

The increase in salaries and employee benefits expense was due to a $1.2 million increase in performance-related compensation associated with the increase in net revenue and a $0.4 million increase in fixed compensation. Exchange rate fluctuations negatively impacted base salaries expense. The increase in general and administrative expense is primarily due to higher travel and entertainment and professional services.

Asia Pacific

The Asia Pacific segment reported operating income of $2.2 million for the three months ended September 30, 2014, an improvement of $0.5 million compared to $1.7 million for the three months ended September 30, 2013. Decreases in salaries and employee benefits of $0.6 million and general and administrative expenses of $0.1 million were partially offset by a decrease in net revenue of $0.2 million. The decrease in salaries and employee benefits reflects lower performance-related compensation of $0.8 million, partially offset by an increase in fixed compensation of $0.2 million.

The decrease in net revenue was due to decreases in the Consumer Markets, Global Technology & Services, and Healthcare & Life Sciences practice groups, partially offset by increases in the Education, Nonprofit & Social Enterprise and Financial Services practice groups. The number of consultants was 81 and 84 as of September 30, 2014 and 2013, respectively.

Culture Shaping

The Culture Shaping segment reported operating income of $2.9 million for the three months ended September 30, 2014, an improvement of $3.6 million compared to an operating loss of $0.7 million for the three months ended September 30, 2013. The improvement was due to an increase in net revenue of $3.8 million and a decrease in general and administrative expenses of $0.4 million, partially offset by an increase in salaries and benefits of $0.6 million.

Net revenue increased due to the stage of the project execution for several large clients. Net revenue in the prior year excluded $0.3 million of pre-acquisition deferred revenue that we were unable to recognize as a result of purchase accounting. The decrease in general and administrative costs was due to lower amortization and accretion expense. The increase in salary and benefit expenses was due to higher consultant costs for additional staffing related to increased projects.

Global Operations Support

Global Operations Support expenses for the three months ended September 30, 2014 increased $1.1 million, to $11.7 million from $10.6 million for the three months ended September 30, 2013. General and administrative expense increased $2.4 million and salaries and employee benefits expense decreased $1.3 million.

The increase in general and administrative expense was primarily due to $1.8 million for a global partners meeting. The decrease in salaries and employee benefits expense reflects a decrease in fixed compensation of $2.3 million due to an executive severance of $3.3 million in the prior year, partially offset by an increase in support staff headcount and stock-based compensation and an increase in performance-related compensation of $1.0 million related to higher net revenue and an increase of participants in the bonus plan.

Nine Months Ended September 30, 2014 Compared to the Nine Months Ended September 30, 2013

Total revenue. Consolidated total revenue increased $28.7 million, or 8.0%, to $386.8 million in 2014 from $358.1 million in 2013. The increase in total revenue was due to the increase in revenue before reimbursements (net revenue).

Revenue before reimbursements (net revenue). Consolidated net revenue increased $29.0 million, or 8.4%, to $373.0 million for the nine months ended September 30, 2014 from $344.0 million for the nine months ended September 30, 2013. The negative impact of exchange rate fluctuations resulted in less than one percentage point of the increase. Executive Search and

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Leadership Consulting net revenue was $346.8 million for the nine months ended September 30, 2014, an increase of $20.4 million compared to the nine months ended September 30, 2013. Increases in the Global Technology & Services, Financial Services, and Consumer Markets search practices were the primary drivers of the increase in consolidated net revenue; however, these increases were partially offset by declines in net revenue from the Healthcare & Life Sciences and Industrial practices. Culture Shaping net revenue was $26.2 million for the nine months ended September 30, 2014, an increase of $8.6 million compared to the nine months ended September 30, 2013. The number of Executive Search and Leadership Consulting consultants was 311 as of September 30, 2014 compared to 308 as of September 30, 2013. Productivity, as measured by annualized net Executive Search and Leadership Consulting revenue per consultant was $1.5 million in the first nine months of 2014 compared to $1.4 million in the first nine months of 2013. Specific to Executive Search, our primary business, the number of confirmed searches increased 7% compared to the first nine months of 2013, and average revenue per executive search was $113,400 in the first nine months ended September 30, 2014 compared to $111,700 for the nine months ended September 30, 2013.

For Executive Search and Leadership Consulting, net revenue in the Americas segment was $193.0 million for the nine months ended September 30, 2014, essentially flat with the prior year. Net revenue in the Europe segment was $84.6 million for the nine months ended September 30, 2014, an increase of $19.6 million, or 30.2%, from $65.0 million for the nine months ended September 30, 2013. Exchange rate fluctuations contributed seven percentage points of the Europe segment net revenue increase for the first nine months of 2014. Net revenue in the Asia Pacific segment was $69.2 million for the nine months ended September 30, 2014, an increase of $0.7 million, or 1.0%, from $68.5 million for the nine months ended September 30, 2013. The increase in net revenue in the Asia Pacific segment for the nine months ended September 30, 2014 includes a two percentage point detriment for exchange rate fluctuations.

Salaries and employee benefits. Consolidated salaries and employee benefits expense increased $15.9 million, or 6.7%, to $252.1 million for the nine months ended September 30, 2014 from $236.2 million for the nine months ended September 30, 2013. The increase reflects higher performance related compensation of $19.8 million resulting from an increase in net revenue, partially offset by a decrease in fixed compensation of $3.9 million due to lower severance expense primarily from an executive departure in the prior year. In the first nine months ended September 30, 2014 we had on average 1,457 employees, compared to an average of 1,489 employees as of September 30, 2013. The decrease in headcount is due to the timing of new hires.

Exchange rate fluctuations increased salaries and employee benefits expense by $1.1 million or less than one percentage point.

As a percentage of net revenue, salaries and employee benefits expense was 67.6% in the first nine months of 2014, compared to 68.7% in the first nine months of 2013.

General and administrative expenses. Consolidated general and administrative expenses increased $4.8 million, or 5.1%, to $98.1 million for the nine months ended September 30, 2014 from $93.3 million for the nine months ended September 30, 2013. The increase was primarily due to $1.8 million for a global partner meeting, $1.5 million for hiring and staffing fees, $1.5 million for new information technology system contracts, and $1.0 million for a state franchise tax matter. The increase was partially offset by a $0.6 million reduction in legal, strategy, and other professional consulting fees.

Exchange rate fluctuations increased general and administrative expense by $0.2 million or less than one percentage point.

As a percentage of net revenue, general and administrative expenses were 26.3% in the first nine months of 2014, compared to 27.1% in the first nine months of 2013.

Operating income. Our consolidated operating income was $22.8 million for the nine months ended September 30, 2014 and $14.5 million for the nine months ended September 30, 2013.

Net non-operating expense. Net non-operating expense was $0.7 million for the nine months ended September 30, 2014 compared to $1.8 million for the nine months ended September 30, 2013.

Net interest expense was $0.2 million and $0.1 million for the nine months ended September 30, 2014 and September 30, 2013, respectively. Interest income was $0.4 million for the nine months ended September 30, 2014 offset by $0.6 million of interest expense associated with the Term Loan. For the nine months ended September 30, 2013, interest income was $0.5 million, offset by $0.6 million of interest expense associated with the Term Loan.

Net other non-operating expense was $0.4 million for the nine months ended September 30, 2014, compared to $1.7 million for the nine months ended September 30, 2013. Net other non-operating expense consists of exchange gains and losses from balances which are denominated in currencies other than the functional currency and are not considered permanent in nature.

Income taxes. See Note 14*, Income Taxes*.

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Executive Search and Leadership Consulting

Americas

The Americas segment reported operating income of $43.3 million for the nine months ended September 30, 2014, a decrease of $3.7 million compared to $47.0 million for the nine months ended September 30, 2013. The decrease in operating income was due to an increase in salaries and employee benefits of $4.4 million, which was partially offset by a decrease in general and administrative expense of $0.6 million and an increase in net revenue of $0.1 million.

The increase in salaries and employee benefits expense was due to an $8.5 million increase in performance-related compensation due primarily to higher global net revenue, partially offset by a $4.1 million decrease in fixed compensation related to lower headcount. The decrease in general and administrative costs was primarily due to the regional partner meeting in the prior year, partially offset by increased hiring and staffing fees. The number of consultants was 139 and 137 as of September 30, 2014 and 2013, respectively.

Europe

The Europe segment reported operating income of $4.4 million for the nine months ended September 30, 2014, an increase of $9.1 million compared to a $4.7 million operating loss for the nine months ended September 30, 2013. The increase in operating income was due to an increase in net revenue of $19.6 million, partially offset by increases in salaries and employee benefits expense of $8.3 million and general and administrative expense of $2.2 million. The increase in net revenue was across all industry practices, except the Education, Nonprofit & Social Enterprise practice. The number of consultants was 91 and 87 as of September 30, 2014 and 2013, respectively.

The increase in salaries and employee benefits expense was due to a $7.7 million increase in performance-related compensation associated with the increase in net revenue and a $0.6 million increase in fixed compensation. The increase in fixed costs was due to impacts of exchange rate fluctuations and higher costs related to sign-on bonuses which were offset by $1.1 million of lower severance costs. The increase in general and administrative expense of $2.2 million was due to $0.5 million of hiring and staffing fees, a $0.5 million bad debt charge, $0.4 million related to a value added tax charge and professional services.

Asia Pacific

The Asia Pacific segment reported operating income of $4.8 million for the nine months ended September 30, 2014. The increase in net revenue of $0.7 million was fully offset by an increase in general and administrative expenses. The increase in net revenue was due to increases in the Global Technology & Services, Financial Services, and Healthcare & Life Sciences search practices, partially offset by declines in net revenue from the Industrial practice. The number of consultants was 81 and 84 as of September 30, 2014 and 2013, respectively. The increase in general and administrative expenses was due to increased internal travel and entertainment costs and professional services.

Culture Shaping

The Culture Shaping segment reported operating income of $3.6 million for the nine months ended September 30, 2014, an improvement of $7.3 million compared to an operating loss of $3.7 million for the nine months ended September 30, 2013. The improvement was due to an increase in net revenue of $8.6 million and a decrease in general and administrative expense of $0.5 million, partially offset by an increase in salary and employee benefits of $1.8 million.

Net revenue increased due to the stage of the project execution for several large clients. Net revenue excluded $0.3 million and $3.9 million for the nine months ended September 30, 2014 and 2013, respectively, of pre-acquisition deferred revenue that we were unable to recognize as a result of purchase accounting. The decrease in general and administrative expenses is due to lower amortization and accretion expense. The increase in salary and benefit expenses is due to higher consultant costs for additional staffing related to increased projects and other compensation costs.

Global Operations Support

Global Operations Support expenses for the nine months ended September 30, 2014 increased $4.3 million or 14.9% to $33.2 million from $28.9 million for the nine months ended September 30, 2013. General and administrative expense increased $2.9 million and salaries and employee benefits expense increased $1.4 million.

The increase in general and administrative expense was primarily due to $1.8 million related to a global partners meeting, a state franchise tax matter of $1.0 million and higher IT systems contracts, partially offset by lower professional legal fees. The increase in salaries and employee benefits expense was due to a $2.1 million increase in performance-related compensation associated with higher net revenue and more participants in the bonus plan and a $0.7 million decrease in fixed compensation. The decrease in fixed compensation is due to $3.3 million for an executive severance in the prior year, partially offset by an increase in support staff headcount and stock-based compensation.

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Liquidity and Capital Resources

General. We continually evaluate our liquidity requirements, capital needs and availability of capital resources based on our operating needs. We believe that our available cash balances together with the funds expected to be generated from operations and funds available under our committed revolving credit facility and our term loan facility will be sufficient to finance our operations for the foreseeable future, as well as to finance the cash payments associated with our cash dividends and stock repurchase program.

We pay the non-deferred portion of annual bonuses in the first quarter following the year in which they are earned. Employee bonuses are accrued throughout the year and are based on our performance and the performance of the individual employee.

Lines of credit and Term Loan. On January 31, 2013, the Company and certain foreign subsidiary borrowers of the Company entered into an Amendment and Restatement Agreement (Restated Credit Agreement), pursuant to which the Company, the Lenders and the Administrative Agent amended and restated the Credit Agreement (Agreement) dated as of June 22, 2011 (See Note 12, *Line of Credit and Term Loan* in the Notes to Condensed Consolidated Financial Statements). Pursuant to the Restated Credit Agreement, the Agreement was amended to add a committed term loan facility in an aggregate amount of up to $40 million (the Term Facility). On January 31, 2013, the Company borrowed $40 million under the Term Facility and $31.0 million was outstanding as of September 30, 2014. The Term Facility is being amortized over a five-year period pursuant to which the Company will make quarterly payments of $1.5 million through 2016 and quarterly payments of $2.0 million during 2017. The remaining outstanding balance of the Term Facility will be paid on January 31, 2018. The other material terms of the Agreement were not amended by the Restated Credit Agreement.

There were no other borrowings made under these agreements for the nine months ended September 30, 2014 and 2013, respectively. We were in compliance with the financial and other covenants under the Restated Credit Agreement and no event of default existed as of September 30, 2014 and 2013, respectively.

Cash and cash equivalents. Cash and cash equivalents at September 30, 2014, December 31, 2013 and September 30, 2013 were $159.5 million, $181.6 million and $132.8 million, respectively. The $159.5 million of cash and cash equivalents at September 30, 2014, includes $48.2 million held by our foreign subsidiaries. A portion of the $48.2 million is considered permanently reinvested in these foreign subsidiaries. If these funds were required to satisfy obligations in the U.S., the repatriation of these funds could cause us to incur additional U.S. income taxes or foreign withholding taxes. Any additional taxes could be offset, in part or in whole, by foreign tax credits. The amount of such taxes and application of tax credits would be dependent on the income tax laws and other circumstances at the time these amounts are repatriated. Based on these variables, it is not practicable to determine the income tax liability that might be incurred if these earnings were to be repatriated.

Cash flows used in operating activities. For the nine months ended September 30, 2014, cash used in operating activities was $2.0 million, principally reflecting a decrease in accrued expenses primarily due to cash bonus payments of approximately $86 million with the 2014 variable compensation accruals of $81 million partially offsetting these payments and an increase in accounts and other receivables of $27.2 million, offset by the higher net income.

Cash used in operating activities for the nine months ended September 30, 2013, was $11.9 million, principally reflecting a decrease in accrued expenses primarily due to cash bonus payments of approximately $87 million with the 2013 bonus accruals partially offsetting these payments and a $21.6 million increase in accounts and other receivables, partially offset by $15.0 million of non-cash expenses.

Cash flows used in investing activities. Cash used in investing activities was $2.6 million for the nine months ended September 30, 2014 primarily due to capital expenditures of $2.6 million.

Cash used in investing activities was $2.5 million for the nine months ended September 30, 2013 primarily due to capital expenditures of $1.9 million and purchases of available for sale investments of $0.7 million.

Cash flows (used in) provided by financing activities. Cash used in financing activities for the nine months ended September 30, 2014 was $15.7 million primarily due to $7.4 million of quarterly cash dividends to shareholders, $3.4 million earnout payment related to the Senn Delaney acquisition, $4.5 million debt repayment, and $0.4 million of payments for employee tax withholdings on equity transactions.

Cash provided by financing activities for the nine months ended September 30, 2013 was $31.1 million primarily due to $40.0 million of proceeds from the issuance of debt, partially offset by $4.9 million of quarterly cash dividends to shareholders, $3.0 million debt repayment, $0.6 million of payments for employee tax withholdings on equity transactions, and $0.4 million earnout payment related to the Bell McCaw Bampflyde acquisition.

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Off-Balance Sheet Arrangements. We do not have material off-balance sheet arrangements, special purpose entities, trading activities of non-exchange traded contracts or transactions with related parties.

Application of Critical Accounting Policies and Estimates

Management s Discussion and Analysis of Financial Condition and Results of Operations is based upon our Condensed Consolidated Financial Statements, which have been prepared using accounting principles generally accepted in the United States of America. Our significant accounting policies are discussed in Note 2, *Summary of Significant Accounting Policies*, in the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2013, as filed with the U.S. Securities and Exchange Commission (SEC) on March 13, 2014, and in Note 2, *Summary of Significant Accounting Policies*, in the Notes to Condensed Consolidated Financial Statements included in Item 1. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. If actual amounts are ultimately different from previous estimates, the revisions are included in our results of operations for the period in which the actual amounts become known.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used, or if changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the financial statements. Management believes its critical accounting policies that reflect its more significant estimates and assumptions relate to revenue recognition, allowance for doubtful accounts, interim effective tax rate, allowances for deferred taxes, assessment of goodwill and other intangible assets for impairment, compensation accruals, stock-based compensation and contingent liabilities. See Application of Critical Accounting Policies and Estimates in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2013, as filed with the SEC on March 13, 2014.

Recent Financial Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers. The ASU requires that an entity recognizes revenue to depict the transfer of promised goods or services to customer in an amount that reflects the consideration to which the Company expects to be entitled in exchange for these goods or services. The standard is effective for annual reporting periods beginning after December 15, 2016, including interim periods, using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients or (ii) a retrospective approach with the cumulative effect upon initial adoption recognized at the date of adoption. The Company is currently evaluating the effect that this pronouncement will have on its financial statements and related disclosures. The effect is not known or reasonably estimable at this time.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Currency market risk. With our operations in the Americas, Europe and Asia Pacific we conduct business using various currencies. Revenue earned in each country is generally matched with the associated expenses incurred, thereby reducing currency risk to earnings. However, because certain assets and liabilities are denominated in currencies other than the U.S. dollar, changes in currency rates may cause fluctuations in the valuation of such assets and liabilities. As the local currency of our subsidiaries has generally been designated as the functional currency, we are affected by the translation of foreign currency financial statements into U.S. dollars. A 10% change in the average exchange rate for currencies of all foreign countries in which we operate would have increased or decreased our net income for the nine months ended September 30, 2014 by $0.8 million. For financial information by geographic segment, see Note 16, *Segment Information*, in the Notes to Condensed Consolidated Financial Statements.

Interest Rate Risk. We are exposed to interest rate risk related to our debt. We mitigate this risk through the use of an interest rate swap; see Note 10, *Derivative Financial Instruments* and Note 12, *Line of Credit and Term Loan,* in the Notes to Condensed Consolidated Financial Statements, for more information on our debt and interest rate swaps. A 10% change in interest rates would not have a material impact on the fair value of the outstanding interest rate swap agreement for the nine months ended September 30, 2014.

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ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures as defined in the Securities Exchange Act of 1934, as amended (the Exchange Act), Rule 13a-15(e) and 15d-15(e), that are designed to ensure that information required to be disclosed in the Company s reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to the Company s management, including its principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. Any system of controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives.

Management of the Company, with the participation of the principal executive officer and the principal financial officer, evaluated the effectiveness of the design and operation of the Company s disclosure controls and procedures as of September 30, 2014. Based on the evaluation, the Company s principal executive officer and principal financial officer concluded that the Company s disclosure controls and procedures were effective as of September 30, 2014.

(b) Changes in Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The information presented in Note 18, *Commitments and Contingencies*, to our Condensed Consolidated Financial Statements within this Quarterly Report on Form 10-Q is incorporated herein by reference.

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Item 6. Exhibits

Exhibit No.	Description
*31.1	Certification of the Company s Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
*31.2	Certification of the Company s Executive Vice President and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
*32.1	Certification of the Company s Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
*32.2	Certification of the Company s Executive Vice President and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
*101.INS	XBRL Instance Document
*101.SCH	XBRL Taxonomy Extension Schema Document
*101.CAL	XBRL Taxonomy Calculation Linkbase Document
*101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
*101.LAB	XBRL Taxonomy Extension Label Linkbase Document
*101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

* Filed herewith.

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SIGNATURE

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

Date: October 28, 2014

Heidrick & Struggles International, Inc.

(Registrant)

By: /s/ Karen K. Pepping
Karen K. Pepping
Senior Vice President, Chief Accounting Officer and

Controller